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24 December 2024

Essential Services Commission
Level 8, 570 Bourke Street
Melbourne Victoria 3000

By email VDO@esc.vic.gov.au

Re: Electricity pricing for a consumer-driven future: Consultation paper

Red Energy and Lumo Energy (Red and Lumo) welcome the opportunity to make a submission to the Essential Services Commission's (ESC) Victorian Default Offer (VDO) 2025-26 Request for Comment paper.

The ESC is consulting on the VDO that will apply from 1 July 2025 to 30 June 2026. To support it in this process, it has requested submissions from its stakeholders on some aspects of the methodologies it uses to calculate the cost components of the VDO. The ESC has chosen to restrict the matters that it will consult on in this review to prevent any unnecessary changes and maintain a consistent and predictable approach.

Below we respond to select matters.

Estimating retail operating costs for domestic and small business customers.

Red and Lumo do not support a separate estimation of VDO retail operating costs for domestic and small business customers. This is because we provide a mass market offering to both our Small Medium Enterprise (SME) customers and our residential customers with mostly common systems, processes and resources. We incur largely the same retail operating costs when servicing both of these customer classes and untangling and allocating specific costs to each class of customers would in most cases be impossible or arbitrary.

If there is a cost that can be clearly distinguished between these two customer classes, it is bad and doubtful debts which are known by customer class. Red and Lumo residential customers are holding a much larger share of bad and doubtful debt compared to our SME customers. However, the quantum of debt that both of these customer classes carry does not impact the manner that we treat these customers. We provide both of these customer classes with a mass market offering and the same team services and support both classes of customer when they're struggling with payment.

In summary, we do not support a separate estimation of retail operating costs for domestic and small business customers because of potential unforeseen consequences and cross subsidies that could arise from what would be an arbitrary allocation of costs. The only element of operating cost that could be distinguished meaningfully would be bad and doubtful debts.



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We suggest that it is more important for the ESC to ensure that the total operating costs allowance of an efficient retailer that is used to determine the VDO is assessed correctly. In responding to the AER's Issues Paper on DMO7, we highlighted, with examples from public documents, how some retailers have applied wide discretion in how they classify various retail operating costs in order to report lower average retail operating costs. Examples identified include excluding software as a service IT expenditure, reclassifying third party sales commissions into reported margin and offsetting retail operating costs with additional fees and charges levied on customers. If the VDO operating cost allowance reflects similar reporting methodologies, this has serious implications for retailer's actual cost recovery. To express our concerns about this issue, we provided a confidential submission to the AER, a copy of which we have attached here. (See confidential attachment)

Retail operating margin

Red and Lumo believe that the level of systemic risk of operating in the Victorian retail market has increased. One example of this is deficiency in the Victorian Energy Upgrades (VEU) scheme where since mid 2023 the supply of VEECs against pro-rata targets has been reducing and the spot price has been increasing and some retailers have found themselves having to pay the shortfall penalty which is not tax deductible. Alternatively, they are forced to find certificates at a premium to the allowance in the VDO in the forward market.

Recent years have seen the introduction of a large volume of complex regulatory change which has lifted the risk of inadvertent non-compliance by retailers, at the same time penalties for even self disclosed non-compliance have escalated dramatically. This raises the cost of capital for retailers participating in what is an inherently more risky market and the regulated return in the VDO should reflect this inherent risk. Examples of recent complex regulatory change includes the introduction of best offer comparisons on bills and at time of sale, changes to the payment difficulties framework, introduction of family violence protections. Another key example was the final elements of the *Energy Legislation Amendment (Energy Fairness) Act 2021* (the Act) that introduced new criminal offences and increased fines and penalties more generally.

While in themselves such reforms are well intentioned, which in most cases we have supported, the complexity, and risk of unintended non-compliance has increased. This has been reflected in the fines levied against retailers. In addition the consequences and level of penalties have also increased significantly. This combination highlights an increase in inherent risk of energy retailing which should be reflected in margin allowance.

Given that retailers are exposed to growing regulatory risk in the market, as recent examples highlight, the retail operating margin should not be reduced. In fact the current level is arguably insufficient reward for the growing systemic risks of a highly regulated business.

Treatment of solar exports

To date, the ESC has adopted independent advice and used interval meter data, net of solar exports, to develop a load profile that is used to assess the wholesale cost of electricity. This is



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the correct approach because this load profile reflects the one retailers are actually required to hedge to manage market risk. Why this is the case is explained below.

If a retailer chose to be unhedged, the wholesale costs it would pay to supply its customers would be defined by the wholesale market spot price multiplied by its market purchases. Retailers are unable to opt out of buying solar exports from their customers, therefore their net position is what is settled in the wholesale market.

A prudent retailer will always seek to hedge for both their residential and small business customers' imports against the spot market cost. It will therefore typically purchase a combination of hedge contracts, caps and swaps, which are settled against the spot market price and volume. The load profile that the prudent retailer hedges is that which it would otherwise buy at spot market price i.e. customer consumption net of the volume of surplus solar exports it is required to buy.

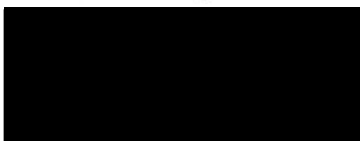
In summary, the ESC's and Frontier's decision to develop a load profile that is used to assess the wholesale cost of electricity which is net of exports represents the correct approach in principle. This reflects the manner in which retailers actually hedge their load. It also (appropriately) avoids further cross-subsidising customers with solar by customers who do not have access to solar generation, which is clearly inequitable and socially retrogressive.

Unlike other jurisdictions which still have large volumes of basic meters, in Victoria interval data is available for the ESC and Frontier. Current practice of using a load profile net of exports to assess the wholesale cost of electricity for the VDO has been applied for a lengthy period and we support the maintaining a stable regulatory approach. We see no reason for the ESC to change the current approach, particularly in a way which would be contrary to retailers' actual market practice.

About Red and Lumo

We are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria, New South Wales, Queensland and South Australia and the ACT to over 1.4 million customers. Should you wish to discuss aspects or have any further enquiries regarding this submission, please call [REDACTED]

Yours sincerely



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