Essential Services Commission
Level 37, 2 Lonsdale St
MELBOURNE VIC 3000

Lodged by email: retailenergyreview@esc.vic.gov.au

30 January 2019

Victorian Default Offer for domestic and small business electricity customers: Staff Working Paper

The Australian Energy Council (the AEC) welcomes the opportunity to make a submission regarding the Essential Services Commission (ESC) Staff Working Paper (the Staff Paper) seeking to implement the Victorian Default Offer (VDO).

The AEC is the industry body representing 23 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

The AEC strongly opposes price regulation. Price regulation will cause unintended consequences for Victorian consumers, with the Terms of Reference (ToR) given to the ESC exacerbating the risks of these eventuating. Instructing the ESC to to rush this process will ultimately result in errors. While the ToR do not allow for a discussion on the merits of the VDO, it is incumbent on the ESC, as the body responsible for its implementation, to highlight unresolved issues, and ensure that the likely negative outcomes of the hasty implementation of this fundamental reform are mitigated as best as possible for Victorian consumers.

The electricity market is complex, and the suggestion of Thwaites Review panel that the market could be simplified (without risk) at the stroke of a pen is fundamentally inaccurate. The issues highlighted by the AEC and other key stakeholders (both from industry and the consumer sector) are no closer to being understood 18 months after the introduction of a Basic Service Offer (BSO) was suggested in August 2017.

As an industry body representing competitors, the AEC is prohibited by the Competition and Consumer Act to discuss with its members matters relating to price setting and cost structures necessary to respond to the specific questions raised in the Staff Paper. As such, this submission will provide high-level views on the ESC position, focusing on the practical implementation of an untested price setting method like the VDO. Our members will make submissions individually regarding the lowest risk method of setting the VDO.

The risks of price regulation

Retail prices have not been set since in Victoria they were deregulated in January 2009. Since that time the electricity sector has evolved greatly, and is now one of the most competitive in the world.

We accept that in the past decade there has been price regulation of other monopoly industries, but monopoly regulation is inherently different to regulating a highly complex and competitive sector like retail electricity.

Level 14, 50 Market Street
Melbourne 3000
GPO Box 1823 Melbourne Victoria 3001

P +61 3 9205 3100
E info@energycouncil.com.au
W energycouncil.com.au

ABN 926 084 953 07

This creates a clear risk for retailers (and their investors). Regulators in Australia do not have adequate recent expertise in electricity price setting. We have been heartened by the consultation process the ESC has undertaken to date, however there remain serious risks for our members (and their customers) that are unlikely to be resolved in the time allowed by the ToR.

The AEC is concerned by the manner in which the ToR has been drafted and the implications on the competitive market. The ESC are required to set the VDO based on the efficient costs to run a retail business. Other regulators nationally have tended to set their prices based on the costs of a new entrant retailer. This is a very significant difference. As the below diagram (*figure 10.5 from the ACCC Retail electricity Pricing Inquiry)* shows, 'efficient' varies significantly based on retailer size. If the ESC deems a Tier 1 retailer represents efficiency, then smaller retailers will be unable to recover their costs. Conversely, if an average second tier retailer is considered efficient, the Tier 1s with larger customer bases will achieve windfall gains.

Given the ToR require the ESC to "safeguard consumers unable or unwilling to engage in the retail electricity market without impeding the consumer benefits experienced by those who are active in the market" this is a difficult challenge. Safeguarding consumers infers the price is set as low as possible, whereas not impeding the benefits of the competitive market suggests the price should be set as a reasonable 'cap' akin to the Default Market Offer suggested by the ACCC.

Set the price too high and consumers who disengage pay more than they need to. Set it too low and risk retailers going out of business. The retailers at risk are not the Tier 1 or other established participants, but rather the smaller retailers challenging them. Given that, we would expect to see the prevalence of low priced 'challenger' offers decrease, and an increased concentration towards the larger retailers.

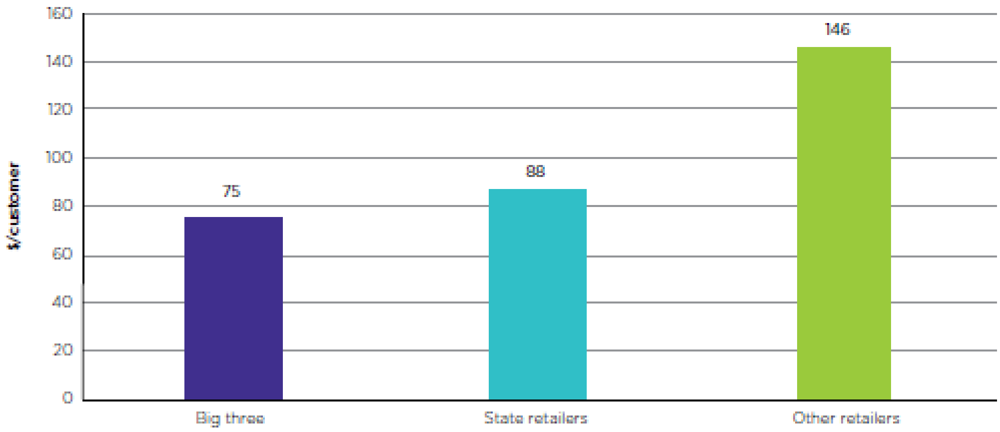
This scenario reflects the recent experience in the United Kingdom. The imposition of price caps has put extreme pressures on standalone energy retailers, where 10 small retailers have collapsed in the past 12 months[1]. The AEC strongly suggests the ESC set the VDO as conservatively as possible to avoid this experience being duplicated in Victoria. A conservative VDO would also better reflect the ESC's obligations under section 10 of the Electricity Industry Act 2000 (EIA) and section 8A of the Essential Services Commission Act 2001 by allowing smaller retailers to continue to compete for the benefit of Victorian customers. The ESC Act requires the ESC to have regard to the incentives for long term investment, the financial viability of the industry, and other factors such as market power. The EIA states that the ESC must also promote the development of full retail competition.

The changing nature of the Victorian market is highlighted by the continuing transition of customers from the tier 1 retailers to the tier 2s. In 2008 when prices were last regulated, the Tier 1 retailers held 85%[2] of customers in Victoria, and there were only 14 licensed retailers. Now, just 59% of Victorian customers remain with the Tier 1s[3]. Smaller players have vastly different economies of scale to the Tier 1s, and all have developed innovative offerings that enable them to compete for Victorian customers. This creates issues with setting a 'fair' regulated price. The ACCC Inquiry highlighted this issue in their analysis of retailer cost to serve (CTS). As shown below, the variation between the Tier 1s and other retailers is $71 per customer across the NEM. Given 'other retailers' includes very large second tiers such as Red, Lumo, Alinta and Simply, the ESC can expect that the variation between the CTS of the Tier 1s and very small retailers to be even greater.

---

[1] https://www.forbes.com/sites/gauravsharma/2019/01/27/why-independent-u-k-energy-suppliers-are-collapsing-at-an-alarming-rate/#7582fb2511d4
[2] ESC, Energy Retailers Comparative Performance Report – Pricing and the Competitive Market 2008-09, December 2009 p4
[3] AEMC, 2018 Retail Energy Competition Review, page iv

Figure 10.5: NEM-wide CTS by retailer tier, 2016–17, $ per residential customer



Source: ACCC analysis based on retailers' data.

Note: The 'State retailers' figure includes data from Ergon Energy and ActewAGL that is not included in other figures within this report.

Practical matters unresolved

As the AEC has pointed out on countless occasions, the Victorian energy market is complex, and there is a need for genuine consultation to resolve countless practical matters that have the potential to result in harm for some Victorians.

Absent any proper policy discussion, the ESC will be required to make a number of assumptions in setting the price, assumptions that cannot benefit all consumers. The below examples are known issues that must be resolved. This list is by no means exhaustive, highlighting the complexity of the Victorian energy market.

Network tariff structures

The ToR describes the VDO as a simple tariff, open to any customer. This means that either retailers will need to bear network cost risk for customers on time varying network tariffs, or networks will need to allow customers on time varying tariffs to switch back to a flat tariff when they take up the VDO.

This issue is particularly prevalent for some customers for which there is no choice on network tariff. For example, Ausnet solar customers are required to be on a time of use solar tariff, the costs of which vary greatly to their single rate consumption only tariff. The Ausnet small single rate (NEE11) tariff is an inclining block tariff with a standing charge of $115 per year, and variable charges of 10.0603c per kWh for block 1, and 13.0609c per kWh for block 2. Ausnet's two rate solar tariff (NEE26) has a standing charge of $127, and variable charges of 18.3709c per kWh for peak, and 3.8943c per kWh for off peak.

If a retailer is expected to offer the same simple VDO to both of these customers then their network cost exposure will be vastly different. The suggestion in the Staff Paper that this can be treated as a mere pass through highlights our concern that inadequate understanding of the current electricity market will result in decisions being made that do not take into account the practical complexities of retailing energy in Victoria.

There are no doubt other network tariffs in Victoria for which this issue will be pertinent. Before the VDO is developed further this matter must be better understood.

Level 14, 50 Market Street
Melbourne 3000
GPO Box 1823 Melbourne Victoria 3001

P +61 3 9205 3100
E info@energycouncil.com.au
W energycouncil.com.au

ABN 926 084 953 07

Obligation to supply

Retailers currently only have an obligation to supply when they are the Financially Responsible Market Participant (FRMP) at a site, or if there is no FRMP, where they are the local retailer. This is an important protection in a competitive market for an essential service.

However, the VDO is to be offered unconditionally by all retailers, to all domestic and small business customers. The obligation to supply carefully balances the risks of retailers being required to take on customers they may not want, with the risk a customer may be unable to obtain supply. The risk appropriately increases as a retailer grows (that is, they become FRMP at more sites). The VDO does not allow any risk mitigation. Any licensed retailer in Victoria will be required to take on any customer that requests the VDO. While this might seem inconsequential for a very large integrated retailer, for a very small retailer, with no upstream investment in generation, the risks are substantial. If their retail customer base increases at a rate above what they predicted, or the customers they gain do not consume energy in the manner they predicted, they could be exposed to very large spot price risk due to an inadequate contract position.

The risk is heightened given the rules appear to require a retailer like Next Business Energy who only supplies energy to small business customers to supply energy to residential customers on request. This means they would need to comply with a vastly increased number of obligations in the Energy Retail Code, including the significant payment difficulty framework.

Assumed consumption levels

In setting tariffs, retailers are required to make assumptions about the consumption of their customers. In general, the tariff would 'balance' at their customer base's average usage level. This balancing affects the standing and variable components of a flat tariff.

In setting the VDO, the ESC has a choice. They could set the tariff efficiently, that is perfectly attributing all fixed costs within the standing charge, and all other costs in the variable charge, or they could determine the appropriate balancing point for the VDO.

Both have their advantages and disadvantages. If an efficient method is determined, customers currently accustomed to a balancing method might experience bill shock as the pricing of the tariff is likely to look substantially different to the tariff they are currently receiving.

The balancing method will create winners and losers depending on the annual usage rate chosen. High users benefit from a high standing charge and a low variable charge. Low users benefit from the inverse.

This creates two problems. Initially, in telling standing offer customers that the price they are on is now 'fair', they will likely be discouraged from seeking out a better deal in the market. If their annual usage is out of line with the assumed consumption level, they might pay too much.

The next matter is evolutionary. Customers advantaged by the assumed consumption level will be encouraged to shift onto the VDO, artificially decreasing the true cost of their supply. The remaining customers disadvantaged by the consumption level will be left to cover their costs over time.

Transparency

The AEC is very concerned that neither the ESC nor the Victorian Government has publically released the methodology for setting the BSO. The Staff Paper notes that the main difference between the VDO and the BSO work previously completed is the inclusion of 'modest customer acquisition and retention costs (CARC)'.

Given this (in particular given the extreme time pressures the ToR places on the ESC), retailers must be given the opportunity to understand the methodology the ESC developed previously to complete the BSO.

The Staff Paper requests retailers re-submit views on matters previously raised and responded to in the BSO paper, despite the ESC noting that the work already undertaken is a ‘starting point’. This is clearly inefficient, and creates the impression that the BSO work is being hidden intentionally. At the very least, the ESC must make clear which elements of the VDO are open to discussion, and which have already been determined.

Engagement and further consultation

The AEC strongly suggests the ESC and the Department of Energy, Land, Water and Planning immediately facilitate a joint roundtable with key stakeholders to ensure the practical issues relating to the VDO are identified and resolved as soon as practicable.

Resolution of these matters are critical to ensuring that to the extent possible, the ESC mitigates the negative outcomes of this reform.

For any questions about our submission please contact me by email at ben.barnes@energycouncil.com.au or on (03) 9205 3115.

Yours sincerely,

Ben Barnes
Director, Retail Policy

Level 14, 50 Market Street
Melbourne 3000
GPO Box 1823 Melbourne Victoria 3001

P +61 3 9205 3100
E info@energycouncil.com.au
W energycouncil.com.au

ABN 926 084 953 07