

Essential Services Commission
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4 April 2019

Victorian Default Offer to apply from 1 July 2019: Draft Advice

The Australian Energy Council (the 'AEC') welcomes the opportunity to make a submission regarding the Essential Services Commission's ('ESC') Draft Advice (the 'Draft Advice') outlining the Victorian Default Offer ('VDO') that is intended to be implemented on 1 July 2019.

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.

Given the position of the AEC as a representative of competitor businesses, we operate in strict compliance with the Competition and Consumer Act (the 'CCA'). The CCA prohibits the AEC discussing with members confidential information relating to costs and how they set their prices. This submission has been drafted in line with our CCA obligations, and intends to highlight our concerns with the ESC's approach, utilising only the information the ESC had before it. Our members will provide more detailed submissions on the impact of the Draft Advice on their businesses.

The AEC considers that the Draft Advice, if implemented, would have profoundly negative consequences for the Victorian retail market and the 95% of residential customers (and 84% of small business customers) who have engaged and currently enjoy a market deal. You cannot have both a low-priced default and a highly competitive market.

If the VDO was implemented in line with the Draft Advice, it is possible we would observe the following:

- **Withdrawal of the most competitively priced market offers** - this was a key conclusion of the Australian Energy Market Commission in its analysis of the Default Market Offer,¹ and a well understood and predictable outcome of imposing price regulation on a competitive market.
- **Reductions in current levels of service** - retailers will reconsider elements of the service levels they have developed in the competitive market to win customers and differentiate themselves from other retailers. They may withdraw some of the key aspects of their offerings or impose charges for services that were previously offered without charge. Examples of the services that could disappear are energy utilisation products, and additional support for vulnerable customers over and above the minimum level of prescribed support. Given the difficulty in differentiating approaches

¹ AEMC, Customer and competition impacts of a default offer, Final report, 20 December 2018

between VDO and market offer customers, any service level reductions would likely be across the entire customer base.

- **Reduced innovation over time** - the VDO could undermine retailers' incentives to invest in their operations as they may not be able to recover those costs or capture the benefits. The ESC notes retailers' efficiency gains since the last IPART determination in 2013 - and explains this as a basis for using the ACCC's estimates of retailer costs - but this occurred following the removal of price regulation. Regulatory incentives are an inferior substitute for competitive pressures.

These outcomes are at odds with the ESC's clear objectives under section 10 of the Electricity Industry Act. With this in mind, the challenge for the ESC is to balance the sometimes contradictory elements of its Terms of Reference, its legislative objectives, and the conclusions of the Thwaites Review.

Fairness

The Draft Advice does not provide a view on the likely effect of the VDO on the lower priced offers available today. Rather, it simply notes that the VDO represents a "fair" price and that "prices across the entire market would converge on the efficient cost of providing electricity services". The ESC states that it has interpreted the Government's requirement to set the VDO "without impeding the consumer benefits experienced by those who are active in the market" as a statement of policy design rather than a factor to take into account when developing a pricing methodology. In effect, the ESC is saying that because the policy does not prohibit engaged consumers entering into other deals (even if that is implausible), then the VDO price will have no impact on them. The wording in the Draft Advice is careful – "customers will be free to enter into alternative contracts if they represent good value for money (even if they cost more than the VDO)".

The Draft Advice sets the VDO at, or below, the current median market offer price. By definition, approximately half of the market offers available today are cheaper than the VDO. According to the Draft Advice, these offers are priced below the efficient costs of supply, with the retailer foregoing margin. In the long term, retailers may be able to develop efficiencies that might allow them to offer some products priced below the VDO, but there is no evidence to suggest that there is a correlation between lower costs and the lowest priced offers today. A simple check of the Victorian Energy Compare website highlights that the retailers offering the cheapest products are likely to be foregoing margin under the methodology in the Draft Advice.

The ESC needs to provide the Government with clear advice as to what it expects to happen to these offers after 1 July 2019.

Impacts of the VDO

The Draft Advice sets what the AEC considers to be the lowest possible price for the VDO. The ESC states that this is reflective of a 'fair' price, but the VDO can only be fair if it strikes the balance between ensuring that no customer who is engaged becomes worse off and that disengaged customers do not end up paying too much. The AEC does not believe the ESC has achieved that balance. The Draft Advice will significantly increase the likelihood that engaged customers will be disadvantaged as a result of this reform.

The ESC states multiple times in the Draft Advice that the Terms of Reference do not allow them to include any headroom in the VDO. This is presented as a justification for why the price has been set so low. But an absence of headroom does not of itself justify a VDO in line with the Draft Advice.

To clarify, price regulation for the upcoming year requires a regulator to make forecasts for costs not yet incurred (or even ascertainable). Given these costs cannot be known at the time of the determination, regulators are required to identify appropriate upper and lower thresholds for each limb of the cost stack.

From within those threshold bands, a regulator must use its judgement to identify where the price should be set. In effect, this judgement determines who bears the risk. Setting the price in the lower range of the band reduces the price for current standing offer customers, but passes this risk onto retailers, and ultimately customers who have found a cheaper deal. Setting the price in the higher range means standing offer customers would pay slightly more, but it may result in a better deal for other customers as the risks for retailers are lower. It is important to note that the band itself is based on the reasonable predictions of what the costs might be. Given this, any notion that setting the price in the higher range of the band represents headroom is fundamentally incorrect.

We encourage the ESC to consider this balance, in particular its interpretation of the concept of “fairness” when finalising the VDO. In our view, the ESC has not accounted for an appropriate margin for error. As a consequence, the risks being borne by engaged consumers are too high.

The Grattan Institute highlighted this point in their submission to the Australian Energy Regulator’s Default Market Offer (‘DMO’) Draft Decision.

“There is no ‘right answer’ to setting the DMO. But in our view the balance of risks supports erring on the side of a higher rather than a lower DMO. Customers are currently moving off high standing offers to lower market offers, and so the risks of setting a DMO that is too high are, in practice, modest. The same is not true of setting the DMO too low. Setting prices at or below the true cost of supply will substantially damage competition. This damage, once done, takes a long time to fix.”²

Given the differing policy intent of the VDO when compared to the DMO, these concerns are even more critical in Victoria.

Developing the cost stack

The Draft Advice appropriately captures the necessary elements of the cost stack. In determining a price for each element, the ESC has identified a number of possible approaches, each resulting in different outcomes. Yet there is no consistency between approaches for each element of the cost stack. For example, the wholesale cost has been calculated using a 12 month average while the LRET was calculated using a 40 day mark to market model. The ESC has provided no evidence as to why this inconsistency is appropriate.

This concern is two-fold. Initially this lack of consistency creates concerns because it appears that the ESC has made decisions based on which approach would result in the lowest VDO. Secondly, in the longer term, the inconsistency decreases retailer confidence that the VDO will be predictable. It must be noted that there is no perfect methodology for any element of the cost stack. Every decision will require a judgement call.

Ultimately, a lack of predictability will constrain the ability of retailers to make long term investments in the market. This can only be to the detriment of energy consumers. This unpredictability is most evident in the Draft Advice relating to retail operating costs (ROC) and retail operating margin (ROM). For ROC, the ESC did not utilise the regulatory benchmark approach as it considered the benchmarks to be out of date. The ESC instead preferred to utilise the ACCC report’s 2017 dataset³, despite recent public (and audited) results of listed retailers highlighting that the ACCC dataset is now too low⁴.

² Grattan Institute, Default market offer draft determination: a pragmatic approach to a delicate balancing act, <https://www.aer.gov.au/system/files/Grattan%20Institute%20-%20AER%20Default%20Market%20Offer%20-%20Submission%20to%20Draft%20Determination%20-%202019%20March%202019.pdf>, accessed 1 April 2019

³ ACCC, Retail Electricity Pricing Inquiry—Final Report, June 2018.

⁴ ESC Draft Advice pg 45

Yet the ESC has utilised the regulatory benchmark approach for determining ROM. These two elements of the cost stack are intrinsically linked and must be considered together. If (as the ESC appears to believe) historical regulators overestimated the ROC, then the ROM was in fact higher than stated. It cannot be disregarded that other regulators also included an allowance for headroom in their approach.

We strongly encourage the ESC to develop a VDO methodology that utilises consistent regulatory approaches, particularly where elements of the cost stack are linked.

Determining the ROC

The AEC does not agree with the methodology utilised by the ESC in setting the ROC. The Draft Advice disregards the regulatory benchmarks, in favour of utilising the data provided by retailers to the ACCC as part of the Retail Electricity Pricing Inquiry (REPI). The REPI data was obtained over a 10 year period, up until 30 June 2017. This dataset is now more than 18 months old, and does not take into account differences in recording metrics between businesses. Since June 2017, annual reports of AGL and Origin have been published. The ESC does not give any insight into why the data contained in these reports should be disregarded.

The ROC provided in the VDO is significantly below regulatory benchmarks, and the likely 'true' ROC average across the NEM for 2019. If all retailers faced an uplift in the range of the listed retailers, we would expect the average ROC across the NEM to be much higher in 2019 than it was in 2017. This is not surprising given the regulatory and political scrutiny faced by the sector in that time.

In noting the impacts regulatory change has on retailers, the ESC provided an allowance of \$3 per customer for implementation of the Payment Difficulty Framework. This is welcomed, but the AEC notes that the PDF is just one of a vast number of significant regulatory reforms that have faced retailers since 2017. In Victoria, the Thwaites review outlined 11 key recommendations (and significantly more sub-recommendations) that retailers are now required to implement. These include an obligation to present the best offer on bills, provision of the clear advice entitlement, changes to estimated billing and bill change notifications. All of these changes will increase costs and must be accounted for in the VDO. In addition, we anticipate these multiple reforms, and the rushed manner in which they are being implemented, will cause customer confusion. Ultimately, this will result in significantly increased complaints to the Energy and Water Ombudsman. These increased costs have not been accounted for in the Draft Advice.

Failure of the ESC to undertake an appropriate cost benefit assessment prior to implementation of these recommendations should not preclude an allowance for their costs being included in the VDO.

Future setting of the VDO

Once this first VDO is finalised, the ESC must commit to applying the same methodologies for future VDOs unless there is a genuine and material reason to make a change. This means that the ESC must ensure that its methodologies are consistent and in the interests of Victorian consumers in the long term, and not simply for one particular VDO.

This issue is particularly pertinent for this first VDO. The ESC will need to commence development of the 2020 VDO almost immediately after the price for the 2019 VDO is implemented. Publically available information indicates that the 2020 VDO will need to be much higher than the 2019 VDO given sharp increases in forward wholesale contracts in the first few months of 2019. Network businesses are also projecting cost increases in 2020. These rising costs will require the VDO to be increased. If the ESC were to choose to change methodologies merely to mitigate some of these potential price increases, investor confidence in the energy sector would be significantly undermined.

Given these likely price increases in 2020, the AEC encourages the ESC to consider how these impacts will flow through to customers. Customers will likely be encouraged to sign up to the VDO in 2019 by both the Government and the ESC announcing significant price decreases for existing standing offer customers. The very low price of the VDO will likely also encourage (both via the best offer message and other collateral) some customers to actively choose to opt out of the competitive market and accept the regulated price. This may not necessarily be in their best interests in 2020. The Government will own this price increase, and customers encouraged to believe that they are on a 'fair' offer will likely be disadvantaged.

The impact of retailers exiting the market

The AEC is alarmed by the ESC's apparent indifference towards the prospect of retailers exiting the market if they are unable to recover their costs in a price regulated market⁵. In the electricity market, if a retailer is no longer financially viable, their ability to interact with the market is immediately suspended, and their customers automatically transferred to their respective local retailer. It should go without saying that this is not a positive experience for the impacted customers. Losing an energy retailer is not the same as the closure of any other business where customers merely find another supplier of the product or service. Further, the closure of any retail business means the loss of jobs, and the value of investments and innovation that the retailer brought to the market.

Given the essentiality of electricity, customers need to maintain constant access. The Retailer of Last Resort (RoLR) framework is set up to transfer the customer's personal details to the local retailer within 24 hours, where they will be placed on that retailer's standing offer. No other details are transferred, and existing payment details, hardship arrangements, pending service orders, and historical data are immediately lost. This has in the past, and will in the future, cause confusion for thousands of customers. The energy industry has experienced three RoLR events since the commencement of competitive markets. The insolvent retailers were relatively small but the impact to consumers and the market was significant. The retailers of last resort struggled to manage the sudden influx of new customers, in particular the consequential issues resulting from having no understanding of the customer histories and service requests.

Given the severity of this impact, it is critical that the ESC take seriously that this policy might impede on the ability of some retailers to continue to operate. The retailers at greatest risk of becoming unsustainable due to the VDO are often the retailers attempting to gain market share by offering the cheapest offers. This will exacerbate the customer's negative experience and lack of confidence in the energy market. Not only will they be automatically transferred to a retailer they have no relationship with, the VDO price will likely be higher than they are currently paying, causing bill shock.

The availability of offers for embedded network customers

The setting of a very low VDO has particular impacts on customers in embedded networks ('ENs'). As noted by the ESC, the General Exemption Order allows the ESC to determine a maximum price. After 1 July 2019, this price will become the VDO.

This creates a significant and immediate customer impact. While licensed retailers will be able to offer market offer products priced above the VDO if customers wish to access them, EN operators cannot. This results in the VDO acting as a hard price cap for these customers. In the current market, EN operators offer a number of products discounted off the existing standing offer. While these products will be allowed to continue for licensed retailers, this is not the case for EN customers. In many instances discounted products reduce the price paid to below the price of the VDO. It is highly likely these offers will be lost from 1 July 2019, and customers will be forced to pay more.

⁵ Dr Ron Ben David "How that money is divided amongst retailers is up to the market to sort out, not the regulator.", The Age, published 9 March 2019

Next steps

The AEC is continuing to analyse the impacts of a VDO set in line with the Draft Advice on the electricity market. We would welcome the opportunity to share this analysis in the coming weeks, understanding the constrained timeframes under which the ESC is working. In the meantime, we strongly recommend the ESC work to ensure its final advice, to the maximum extent possible, decreases the significant risks this policy places on Victorian electricity consumers.

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

Yours sincerely,



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