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Review of electricity and gas retail markets in Victoria - Discussion Paper

The Australian Energy Council (the Energy Council) welcomes the opportunity to make a submission to the Department of Environment, Land, Water and Planning (the Department) Review of electricity and gas retail markets in Victoria - Discussion Paper (the Discussion Paper).

The Energy Council is the industry body representing 21 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.

Competition in retail energy markets, as in other sectors of the Australian economy, incentivises business to improve service, develop products that meet consumer needs and find ways to lower their costs so they remain competitive. Competitive energy markets, with deregulated prices, encourage efficient price discovery through the development of market offers. Deregulated pricing encourages retailers to design products and services to cater for the needs of different customer segments. Competitive electricity and gas offers have made it easier for customers to manage their bills, to access information and to get greater control over energy usage. The Energy Council has consistently advocated that deregulated retail energy markets drive the best outcomes for consumers.

The Energy Council welcomes the Discussion Paper, and anticipates that its findings will demonstrate that the competitive market is working, and that it provides options that improve outcomes for consumers. Since the Victorian Government phased out regulated retail prices in 2009, competitive markets have facilitated the advancement of customer preferences and encouraged innovation around products and services and the development of new technologies. Victoria has seen a substantial increase in the range of products and services available to energy customers over the past 8 years.

Once price caps were removed in Victoria competition developed strongly; with new and existing retailers offering customers more diverse products with a growth in the number of retailers. We note in the Discussion Paper that *"in 2015/16, 23 electricity and 11 gas retailers supplied the residential segment of the markets, 24 electricity and 10 gas retailers supplied small business, while 29 electricity and 8 gas retailers supplied large businesses in Victoria"*. The Energy Council submits this level of retailer activity strengthens the level of competition in the market. In addition the Australian Energy Market Commission (AEMC) 2016 Retail Competition Review concluded that the retail electricity and gas markets in Victoria are competitiveⁱⁱ.

Victorian consumers show that they are proactive consumers, willing to shop around and find an energy contract that best suits them. We note that Victoria has one of the highest rates of customer churn between energy companies globally.

Competition and the long term interests of consumers

Victoria has come a long way since the electricity market was fully deregulated in 2009 with over 90 per cent of Victorian homes now on market offers; and making savings by shifting away from standing offers. The AEMC has highlighted that Victorians can achieve a discount of more than 30 per cent by simply moving from a standing offer to a market offer. This can represent household savings of up to \$383 each year off the median

standing offerⁱⁱⁱ. As well as discounts, customers may also respond to a range of non-price offers in the market, such as movie tickets, airline points and the opportunity to purchase green credits. The competitive market has also encouraged the development and deployment of new related products and services, like solar PV and batteries.

Response to matters raised at the Stakeholder Forum

The Energy Council acknowledges that in a competitive market those customers who make the effort to seek out offers will likely be better off than those who do not engage. Although some customers are better at navigating retail offers than others, it is incorrect to suggest that hardship customers struggle to engage with retailers. It was suggested by stakeholders at the Stakeholder Forum on 8 February 2017, that retailers choose not to engage with customers who are experiencing difficulty in managing their energy bills.

In fact, our members find that hardship customers are very engaged, and their retailer is in turn encouraging that engagement through direct contact, based on their difficulty to pay their bill. The AEMC found that *“customers in the most vulnerable segment – vulnerable low income – are engaging and participating in the market at similar rates to other customers. These customers are also very familiar with, and connected into the available support services, such as concessions/ or rebates on their energy bills and payment plans with their retailer”*.^{iv}

We also note that consumer protection clauses in Victoria’s Energy Retail Code (ie clause 71B) oblige retailers to speak with customers identified as being in hardship in order to recommend the most appropriate tariff to assist them in managing their costs.

It was also suggested at the Stakeholder Forum that retailers do not communicate with their customers when their contract is coming to an end, and they may move on to a less beneficial tariff without their knowledge. This is incorrect. In fact, retailers have an obligation under the Victorian Energy Retail Code (clause 48) to notify a small customer with a fixed term retail contract that the contract is due to end, and to give notice no earlier than 40 business days and no later than 20 business days before the end date of the contract. Further, it mandates that retailers must communicate to customers the options available to them, including the availability of a standing offer. Of course, the onus is on the customer to take up an available option, but retailers do provide these details to their customers.

For most customers the cheapest offer is the best offer, but this maxim is not always true. Price needs to be a consideration in the context of other factors, such as whether or not they have solar panels, and consumption levels or time of use patterns. Switching websites, both government and commercial, can assist customers with this assessment. In addition to price, customers value other factors including payment options, service quality, participation in loyalty rewards schemes, fixed price periods and energy efficiency advice. In addition, access to deals on solar PV, air conditioners and other appliances, and perceived environmental benefits such as green power or a commitment to offset emissions, are valued by customers.

The Stakeholder Forum also highlighted questions about price dispersion. Absolute parity in price for customers in a competitive market is neither realistic, nor desirable. The Energy Council submits that price dispersion is evidence of a competitive market, and of itself is not necessarily a negative. Price dispersion is also prevalent in the highly competitive retail fuel and telecommunication markets. When industries are restructured and deregulated, prices commence a natural drift from a regulated ‘average cost’ uniform tariff to competitive differential prices, and this leads to price dispersion. However, this should be counterbalanced by hardship and concession schemes, and retailers’ obligations under the Energy Retail Code, which operate to ensure that vulnerable households are assisted.

Market structure and regulation & pricing, costs and margins

Retailers are selling a product that is, on the face of it, homogenous, and whose physical delivery is carried out by the regulated network. However, the customer proposition for electricity is different from many other goods and services. Subject to the physical constraints of their connection, customers can consume as much as they like, when they like, which means that a retailer has an important role in procuring electricity and gas efficiently for customers who do not have to pre-determine their consumption patterns. Crucially, competitive retail markets support effective competitive wholesale markets, as each retailer needs to get the most optimal deal they can and choose the best procurement strategies^v to ensure it is not higher-cost than its rivals. This

puts more effective competitive pressure on wholesale suppliers than if a single monopoly retailer could pass through wholesale costs because they had no competitors.

The Energy Council submits that the role of the retailer is broader than just an engine to sell energy and is concerned that this important aspect of the service they provide has not been acknowledged in any detail in the Discussion Paper. In regards to government policy, retailers must competitively procure large and small renewable energy certificates and in some cases energy efficiency activities. The competitive pressure to manage costs means that these policy goals are delivered more efficiently than if there was a single central procurer (eg the government) of these. Retailers also must manage:

- Wholesale energy purchases;
- Renewable energy certificate purchases;
- Bespoke customer protection obligations in Victoria;
- Marketing/acquisition costs, given the high level of switching;
- IT costs (e.g. due to smart meter installation);
- Assisting customers on hardship;
- Credit and bad debt risk;
- Government concessions; and
- Energy efficiency schemes (VEET).

There is no recognition in the Discussion Paper of the cost to retailers of hardship programs, managing customer disputes, communication and additional reporting that is required in the Victorian market, and the architecture of which is specific to the Victorian market.

The Victorian Government set out to harmonise the Victorian Retail Code with the National Energy Customer Framework (NECF) back in 2014, but significant differences between the two remain. The Energy Council is concerned that as Victoria continues to operate under its own framework, even greater differences will emerge between the NECF and Victoria. Two significant examples of this are the proposed Payment Difficulties framework in Victoria; and the recent AEMC credit support requirements^{vi} rule changes that do not apply in Victoria. These differences mean greater costs for those retailers who operate in Victoria and across multiple jurisdictions (ie almost all of them), without any obvious justification for why national consistency is not preferred.

Additionally, the Essential Services Commission (ESC) committed in 2014 to retiring the Victorian Energy Marketing Code of Conduct (MCC). This did not occur and the ESC is now auditing retailers against the MCC requirements, despite the previous commitment to retire these requirements.

The Energy Council is concerned that Victoria-specific regulatory costs are only likely to increase over time. Most retailers have customers in multiple jurisdictions and so incur substantial extra costs for setting up different processes for systems in Victoria. We can anticipate a tipping point where the divergence is so great that they will need to look at running separate systems, processes and people to comply with Victoria. The costs of the losses in economies of scale will be borne largely by Victorian consumers. This is avoidable with a nationally consistent approach.

Competition is about providing choice, and this manifests in a diversity of retail offers. Differences include:

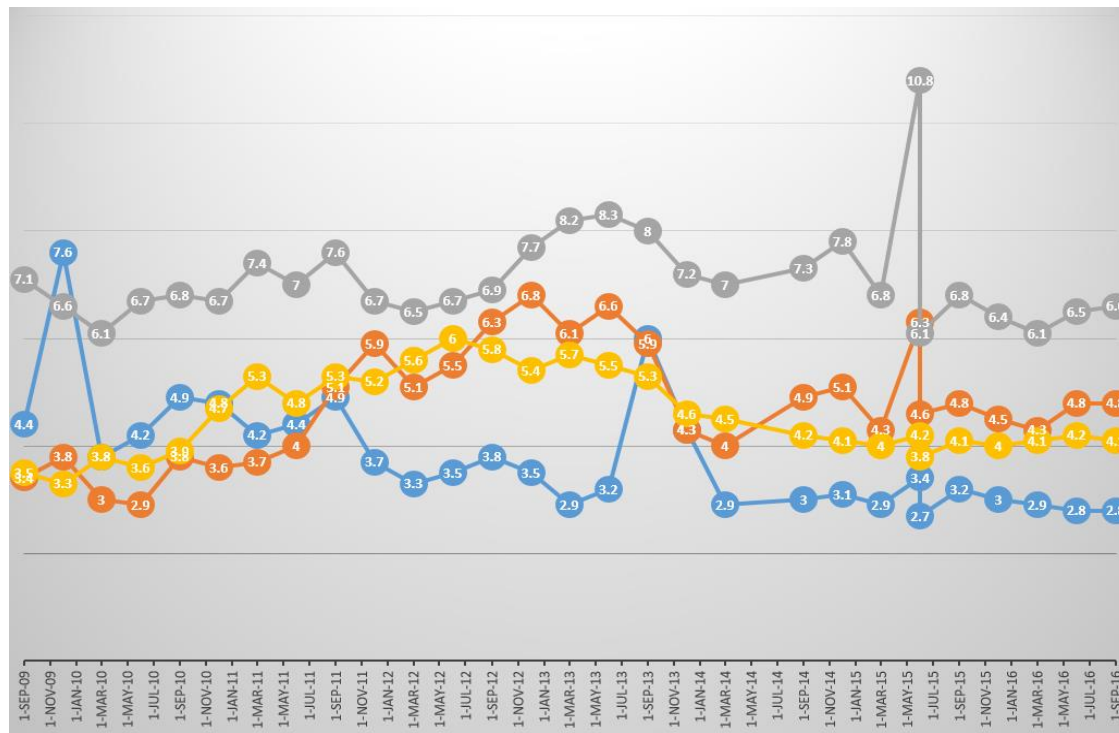
- the fixed versus variable tariff mix;
- payment options;
- special discounts such as the “hour of power” and free Saturdays,
- partner offers such as cinema tickets and discounted footy memberships,
- different levels of access to usage information,
- feed-in tariffs; and
- environmental credentials.

All of these different product offerings are valued by consumers. Competition is further enhanced by the emergence of new energy services such as rooftop PV and battery storage. While these are often offered by parties other than traditional retailers, many retailers also participate in these markets.

Victorian churn rates also continue to be the highest in Australia (see Figure 1). The Energy Council submits that the high switching rates indicate that the market is competitive as customers can move between retailers

with relative ease. The retailer is therefore required to put more effort into persuading existing customers not to leave, and persuading new customers to leave other retailers and join them. This is achieved only when retailers are more cognisant of customer needs, and make offers that will attract customers to such an extent that they are prepared to make the effort to leave their current retailer.

Figure 1: Percentage of electricity customers that switched retailers^{vii}



In some cases switching rates do not tell the complete story as some retailers have multiple offers and customers can switch between these products within the same company without being shown in the switching rate.

Restraints on competition

Competitive markets are best placed to facilitate the advancement of customer preferences and to encourage innovation around products and services and the development of new technologies. The AEMC recently highlighted that *“without consumer choice, there is no way for these preferences to be revealed and no way for the market to act on this knowledge. A market with consumer choice therefore promotes innovation and efficiency.”*^{viii}

Competitive markets flourish best under a suite of supporting general legislation and regulation that facilitate contracting between parties, trust between market participants, respect for property rights and so on. The case for further industry-specific regulation is typically less clear. While we agree that appropriate regulation can enhance competition by addressing market failure, care must be taken to only do so when it is clear that such intervention will efficiently address an identified market failure, resulting in delivered benefits for the market and consumers. The Energy Council does not submit that there is an existing market failure that requires intervention in the retail market.

It could be argued that in order to ensure that retail competition continues to deliver benefits to consumers, stringent ring fencing provisions apply to regulated businesses. This will ensure competitive neutrality, and low barriers to entry, in the provision of services to customers. It is considered that networks should not be able to use their regulated, monopoly advantage to distort the competitive market and deliver services to consumers directly.

Consumer awareness, understanding and engagement

Effective competition requires both sellers to actively seek out customers and consumers to seek out offers. Retailers have a variety of marketing channels to both existing and potential customers. These include various forms of direct marketing and partnerships with other organisations, such as One Big Switch as well as price comparison websites.

Experience in other jurisdictions

The AEMC report found that competition has been effective in delivering value to consumers in South East Queensland, New South Wales, Victoria, and South Australia. Deregulated gas markets were also seen to be effective in delivering competition in New South Wales, Victoria and South Australia^{ix}.

According to the AEMC, customers who shop around in deregulated markets can make substantial savings on their electricity bill. Figure 2 outlines the savings customers made by simply comparing offers and switching to a better offer with Victorians able to make the greatest savings.

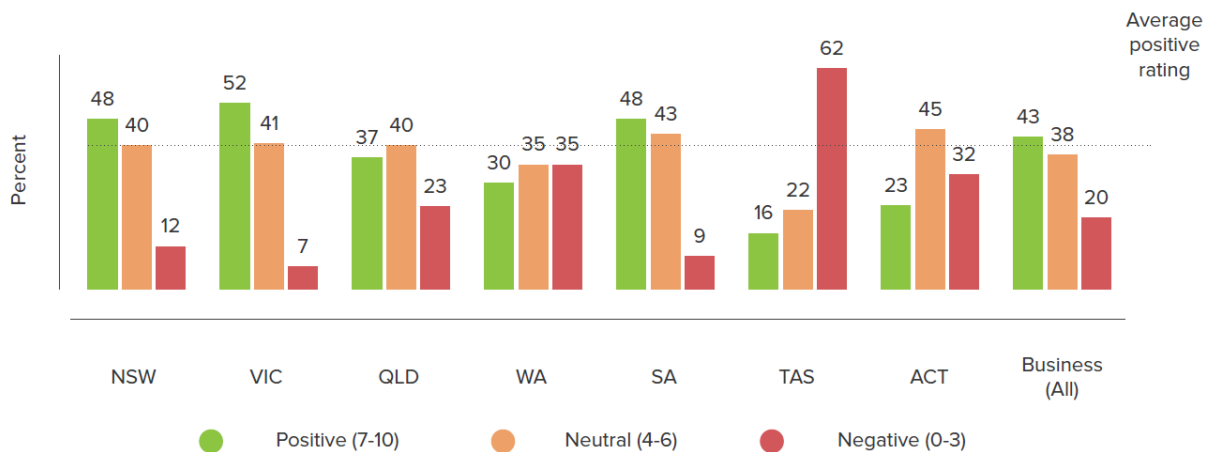
Figure 2: Typical savings customers made switching from an electricity standing or default offer to a competitive market offer annual savings^x



In addition the recent Energy Consumers Australia (ECA) Energy Consumer Sentiment Survey report^{xi}, states where prices are deregulated, consumers are much more likely to be satisfied with the level of competition in energy markets.

Victorian, South Australians and New South Wales customers were satisfied with the level of competition. Customers in these states were also more likely to say the market is working in their interests and/or that it could provide value for money in the long term. Figure 3 shows the consumer survey's findings.

Figure 3: How satisfied are you with the level of competition in the energy market in your area? 0-10 scale, 0 = 'not at all satisfied', 10 = 'very satisfied'



Highlighting the relationship between effectively competitive markets and customer satisfaction, the AEMC found that there were only four electricity retailers, and three gas retail businesses, in the ACT, and found that competition was not effective in this market. The ACT still has regulated gas and electricity prices. This contributed to households in the ACT being the second least satisfied with the levels of competition in their jurisdiction (23 per cent) second last to behind Tasmania.

The U.K. provides a good example of the challenges of regulating competition. At the end of 2015 the Energy Supply Association of Australia commissioned Emeritus Professor Stephen Littlechild, a former UK Director General of Electricity Supply and consultant on regulation and competition^{xii}, to assess the regulation of retail energy markets in the UK and Australia.

The Littlechild report found that interventions in the retail market as a result of concerns that competition had not delivered enough for consumers in the UK had not delivered outcomes “as intended”, and had led to customer churn falling, supplier profits increasing and households losing a range of tariff offers. The UK attempted to get customers to actively engage in shopping around by sharply reducing the number of offers each retailer could make and constraining the shape of the tariff which resulted in retail margins actually increasing. This also led to customers losing access to specific tariffs that suited their circumstances^{xiii}.

Finally the report found that retail competition had previously worked to keep prices low for customers taking advantage of offers^{xiv}. The Littlechild report illustrates that under regulation, decisions that the market will not work, or may not work, and that central planning will lead to a better outcome are almost always wrong.

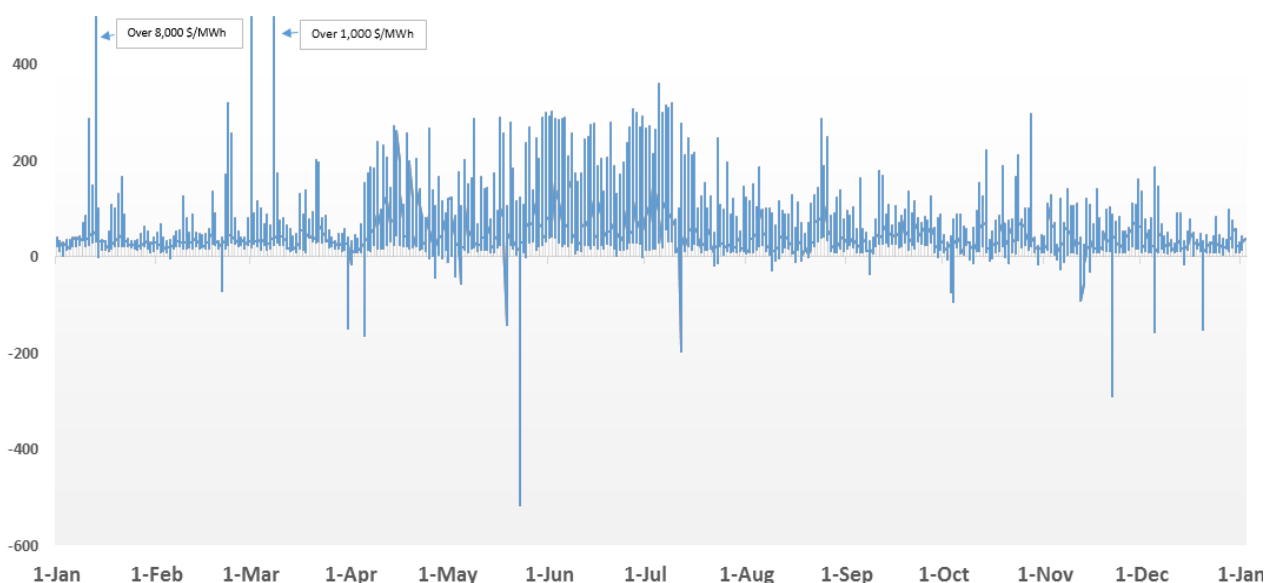
Price increase from Hazelwood

The Energy Council acknowledges that the downward trend of standing offers is being interrupted in the short term by the anticipated closure of the Hazelwood Power Station. Further price increases will likely be a direct result of major changes in the generation of electricity in Victoria and its impact on the wholesale electricity market, rather than the level of retail competition.

Retailers in the National Electricity Market (NEM) manage wholesale risk and stabilise end customer prices. They do this by contracting with suppliers in advance to manage the volatility in wholesale prices. This is an ongoing process which includes a mixture of long-term and short term contracts, baseload, peak period and cap contracts as well as bespoke contracts such as load-following to help them manage the risk of their customers’ demand not matching predictions. Retailers buy electricity from the wholesale spot market, where prices are set every half hour and ranged from -500/MWh to \$9,000/MWh in 2016 according to Figure 4.

Price volatility is driven by complex market dynamics of generation supply, customer demand, temperature, and a range of other factors. The figure below represents the wholesale price in Victoria for the 2016 calendar year, highlighting the volatility of the spot market.

Figure 4: Victorian wholesale pool prices CY 2016 (\$/MWh)^{xv}



As is evident from the figure above, wholesale pool prices are volatile and are expected to become more volatile with the closure of the Hazelwood power station. Figure 5 shows the long term future contracts for energy in Victoria. The rise in contract electricity price in Victoria is due to the market response to a decrease in supply of dispatchable power and rising use of the remaining dispatchable power to provide power when wind and solar are not generating, and to wholesale spot price volatility.

Figure 5: Future Baseload Wholesale Prices CY 2017^{xvi}



Unanticipated price spikes can also be caused by several factors, including drought, plant outages or demand spikes. To manage this extreme volatility, retailers enter into forward hedging contracts. In recent years, retailers have also invested in significant generation capacity in an attempt to minimise risk and lock in their financial positions.

Over the last few years, retailers and generators have been trading in this inherently volatile wholesale electricity market, while facing increasingly intense retail competition, demonstrated by high customer churn rates and rates of new entry. Retailers incur significant costs in order to manage the timing difference between purchasing wholesale energy and receiving payments from customers, as the wholesale market settles on a weekly basis while customer bills are typically paid quarterly.

Each retailer has its own systems in place to manage the risks the closure of Hazelwood presents. If the cost impacts of Hazelwood's closure are found to be mild over time, then retail prices will reflect that in the medium term as retailers bring forward new offers. Conversely, in a regulated market, an overestimate of future costs would be borne by customers until the next price reset. An underestimate of future costs could be catastrophic.

Conclusion

The Energy Council submits that all the data and information indicates that competition is alive and well in Victoria. We anticipate that this review is likely to find that Victoria remains one of the most competitive energy markets in the world. The Energy Council appreciates the opportunity to make this submission and looks forward to further engagement with the Victorian Government on it.

Any questions about our submission should be addressed to Panos Priftakis, Policy Adviser by email to panos.priftakis@energycouncil.com.au by telephone on (03) 9205 3115.

Yours sincerely,



Sarah McNamara
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Australian Energy Council

ⁱ Department of Environment, Land, Water and Planning, 2017, "Review of electricity and gas retail markets in Victoria – Discussion Paper"

ⁱⁱ Australian Energy Market Commission, 2016, "2016 Retail Competition Review", 30 June 2016

ⁱⁱⁱ ibid

^{iv} Ibid (see page 46)

^v a combination of own generation, long term contracting, shorter-term contracting and trading, demand response, customers' own distributed energy resources and potentially some spot market exposure.

^{vi} <http://aemc.gov.au/getattachment/24b324a9-2114-4221-9b11-a1ede124b0a1/Final-determination.aspx>

^{vii} Australian Energy Regulator, 2017, << <https://www.aer.gov.au/retail-markets/retail-statistics/electricity-customer-switching> >>

^{viii} AEMC, 2016, Distribution Market Model Approach paper

^{ix} Australian Energy Market Commission (AEMC), 2016, "2016 Retail Competition Review – Final Report"

^x ibid

^{xi} Energy Consumers Australia, 2016, "The Energy Consumer Sentiment Survey – July 2016"

^{xii} Littlechild, S, 2015, "Regulation of retail energy markets in the UK and Australia" for the Energy Supply Association of Australia

^{xiii} ibid

^{xiv} ibid

^{xv} NEM Review program, globalroam

^{xvi} NEM Review futures, globalroam