momentum energy

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Submitted by email to retailenergyreview@esc.vic.gov.au

**Submission in response to the ESC's Draft Advice on the VDO**

Thank you for the opportunity to provide a submission in response to the ESC's Draft Advice on the VDO.

Momentum Energy is a 100% Australian-owned and operated energy retailer. We pride ourselves on competitive pricing, innovation and outstanding customer service. We retail electricity in Victoria, New South Wales, South Australia, Queensland, the ACT, and on the Bass Strait Islands. We offer competitive rates to both residential and business customers along with a range of innovative energy products and services. We also retail natural gas to Victorian customers.

Momentum Energy is owned by Hydro Tasmania, Australia's largest producer of renewable energy.

**Introduction**

Momentum is acutely aware of affordability issues in the Victorian retail electricity market. We agree with the findings of the Thwaites review and the ACCC's retail energy pricing inquiry that competition has failed to deliver positive outcomes to a number of consumers and acknowledge that action must be taken to tip the balance of power in the market back towards consumers.

Momentum's broad philosophy is that regulation should only occur in cases of a market failure however we agree that customer outcomes are paramount in the provision of an essential service such as electricity. We appreciate that in the current market positive consumer outcomes are not materializing for some and that firm action in the form of a regulated price may be warranted. It should be noted, however, we do not consider the current state of affairs to be a market failure, but rather a failure of the structure and regulatory framework in which the market operates. The piece meal changes that have occurred over the years have introduced a high level of complexity that have been well intentioned in isolation but combined have created more confusion for customers and increased the costs of supplying electricity.

We are disappointed that the regulatory settings which are being reformed to address this failure are not being given a chance to work before the extreme action of price regulation is imposed.  This approach causes considerable risk for industry and consumers, and is unlikely to lead to a VDO which represents a sustainably efficient price.

Given that the overall intent of the VDO is to improve customer outcomes, it is crucial that it be set at a level which facilitates this and is in line with the ESC's statutory objective to promote the long term interests of Victorian consumers. While it may offer lower prices to some customers in the short term, a VDO which does not allow retailers, particularly those who got to great length to base their operations completely in Australia, to recover costs will not be in the long term interests of Victorian consumers, particularly those who value a high standard of customer service. Failure to account for all retail costs will provide a 'sugar hit' to some customers through initially lower tariffs but ultimately result in a worse customer experience; a reversal of the positive outcomes achieved through other Government policies; and an increased cost of living for many Victorians.

Importantly, we concerned that the ESC does not have the required data to set a fair price for electricity when it has failed to account for the cost of recent industry reforms, and has yet to establish the likely costs to industry of a suite of reforms due to commence on 1 July 2019 and beyond. Like the Payment Difficult Framework  (PDF) before it, these coming reforms will provide customers some benefits, however they will come at a cost.

To illustrate this point, since Momentum commenced serving customers under the PDF, we have seen roughly a 40% (or around 2000 customer) increase in the number of customers on payment plans. The societal benefit which comes with ensuring that these customers are receiving the assistance that they require is not cheap, with our analysis showing that the cost to serve these customers is around 2.5 times the average. If the PDF continues to work as intended, the number of customers receiving this sort of support will increase, so will the average cost to serve.

As outlined below, we agree with the ESC's approach on a number of the cost elements and are not arguing out of self interest to see the VDO set at a high price. We firmly believe that the Draft Advice is fundamentally incorrect in its assumptions and its understanding of how retailers operate in the Victorian market and this will result in Victorian consumers being worse off than at present. This will manifest through higher prices for those customers who actively engage in the market, a decline in the standard of customer service and a reduction in the range of innovative products being offered such as Momentum's Solar Step-Up and MoveMate which cater to the needs of specific customer segments.

**Wholesale Costs**

While noting that there will always be risk attached to any forecasting of wholesale enrgy prices, Momentum is generally satisfied with the ESC's approach to wholesale inputs.  We do however reiterate the statements made in response to the Thwaites review and REPI that uncertainty in national policy is the key driver of high electricity prices. We are concerned that unexpected wholesale volatility may lead to higher prices, however these are more likely to occur in the warmer months towards the end of the calendar year and can be allowed for in the 2020 determination if required.

**Network and Environmental costs**

Similarly we consider that the ESC's approach to quantifying the network and environmental components of the cost stacke are relatively uncontroversial. In order to achieve lower energy prices for consumers, Momentum will participate in AER processes relating to network costs and we encourage the ESC to do likewise to ensure that downward pressure is put on this significant component of the retail price.

**Retail Operating Costs**

The ESC's Draft Advice has failed to adequately incorporate the costs associated with conducting the business of retailing electricity in Victoria. The decisions on cost components appear to be made without solid data or hands on experience of conducting the operation of an energy retailer. The Commission's previously stated goals of better customer service and protection is fundamentally at odds with its approach which seeks to drive the cost of electricity to unsustainably low levels. The consequences of this approach will see customers no better off than they currently are and will merely eliminate any of the benefits which competition has undoubtedly brought to customers.

Our rationale for this view is outlined below.

**The Typical VDO Customer**

Momentum has concerns with the ESC's interpretation of the Terms of Reference. While the principle that the VDO is cost effective and customers on the VDO should be neither the beneficiaries nor the source of cross subsidies appears reasonable on the surface, it demonstrates a lack of understanding of the structure and operation of the Victorian market and the profile of the customers who will be most impacted by the VDO.

As it stands, the overwhelming majority of customers on standing offers (ie, those who will immediately transition to the VDO on 1 July 2019) are comprised of three[1] groups.

- Customers in the Tier 1's encumbant base who have never entered in to a market contract;
- Customers who have reverted to a standing offer following the expiry of a market contract; and
- Deemed customers (or occupiers) who are taking supply at an address but have not provided the financially responsible market participant with their details.

The cost to serve each of these customer types is different and consequently cross subsidies are unavoidable if each cohort is charged the same rate. The principle also leads to an inherent inequity for different retailer types, namely an advantage to Tier 1 retailers at the expense of challengers due to differences in the profiles of their standing offer customer bases.

[1] Some customers may have explicitly entered in to a Standing Offer Contract however these customers are exceedingly rare.

Customers who have never entered in to a market contract are generally speaking the lowest cost to serve of customers on a VDO as they do not interact with their retailer and have a tendency to pay bills on time. While it is true that some of these customers could benefit greatly from lower prices as they have been incapable of engaging with the market, AEMC research[2] suggests that they are equally likely to be on standing offers as they are not overly price sensitive.

At the other end of the spectrum, occupiers cost retailers a considerable sum. Like the legacy customers described above, occupiers also rarely engage with their retailer however in this instance it becomes quite costly as the retailer is obliged under the Energy Retail Code to make attempts to ascertain the customer's identity[3]. Occupier customers also cost retailers considerable amounts in terms of bad debt as their annonimity makes collection of revenue particularly difficult.

In the middle of this continuum, the cost profile associated with those customers who are on expired market offers is more difficult to define. While they have demonstrated an ability to engage in the market, the fact that they have not sought a better market offer once their initial deal has lapsed suggests an element of unresponsiveness and a lower cost to serve. Momentum, and some other retailers do not have any customers in this cohort as we consider that the concept if the loyalty tax is unfair on consumers, however we acknowledge that this is a matter of retailer practice and therefore not especially relevant to discussions on matters of market structure.

By virtue of their status as the incumbent retailers at the time that full retail contestability was introduced in Victoria, Tier 1 retailers have a portion of customers in this first, lowest cost cohort described above. While it is true that they face the same issues as smaller retailers with regard to occupier customers, smaller retailers do not have the luxury of this ready made, low cost customer base who will cross subsidise the remainder of their VDO customers. The Victorian Government obviously considers that there is a significant number of these customers who are passively accepting high standing offer prices or there would be no need for this policy reform. The ESC can't have it both ways: if it doesn't believe that an incumbent standing offer base proffers the Tier 1s a significant advantage, then the benefits of the VDO have been overstated and claims about the savings available to households should be appropriately tempered to indicate how few Victorians will actually see savings of the quantum described in the draft advice and accompanying media.The difference in cost to serve between the different cohorts of Standing Offer Customers who will become the initial customers on the VDO come 1 July 2019 creates a fundamental paradox which the ESC will not be able to overcome if it wishes to stay true to its interpretation of the Terms of Reference.

Ultimately, we believe it is completely appropriate for Standing Offer/VDO customers to provide cross subsidies given the evidence from multiple jurisdictions that suggests that many quite affluent consumers remain on Standing Offers due to their insensitivity to price increases. What is clear however, is that the VDO, and in particular, adherence to the

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[2] AEMC 2013, Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales, Report, 3 October 2013, Sydney Page 33
[3] Energy Retail Code V12, Division 8

principle that cross subsidies should not exist will disproportionally impact smaller retailers and especially those, such as Momentum, who have sought to protect their more passive customers by not reverting them to a Standing Offer following the expiry of their contract or benefit period.

**The Customer Experience**

The ESC has outlined that it will take a benchmarking approach to the calculation of retailer costs. While it acknowledges the shortcomings of this approach, the draft advice shows that it did not take these shortcomings into account in its determination. Similarly, Momentum understands the merits and drawbacks of the benchmarkeing approach however we consider that it has not been utilized appropriately as the significant variations between retailers and indeed between jurisdictions have not been accounted for.

The concept of basing costs on the operation of an efficient retailer is, as a principle, completely reasonable. It raises the question however, of what an efficient retailer looks like. An efficient retailer will conduct its operations at the lowest cost, and in the case of the retail energy market, in many cases this has meant chosing to outsource its operations to take advantage of lower salary costs. This is only a good outcome for the consumer if it can equate to a high standard of service at a lower cost – and there is no evidence that outsourcing of operations delivers this.

The draft advice indicates that smaller retailers are able to take advantage of efficiencies by outsourcing operations[4]. This seems to indicate the ESC is content for the VDO to force retailers like Momentum (who has a 100 per cent Australian workforce) to send much of their workforce offshore. We do not believe however that this is consistent with the ESC's mandate to improve the customer experience. As recently as late February, the ESC lamented "A blowout in wait times"[5], however this will become the norm if retailers are forced to the lowest cost possible channels of customer service.

Momentum has made deliberate business decisions to maintain control of back office functions as we believe that this gives us greater control over the customer experience and leads to better compliance outcomes. We would be interested in any analysis which the ESC may have which compares the relative compliance and responsiveness to any breaches which may occur between those retailers who manage their own back office functions versus those who choose to do so 'more efficiently' by outsourcing operations.

Momentum is also curious as to how the ESC can be sure that its VDO represents an efficient cost for the service that customers should be getting? With the energy industry being the target of discontent for a number of years, if defies logic to set an effective price cap which ingrains the practices which have contributed to this discontent.

[4] Essential Services Commission 2019, Victorian Default Offer to apply from 1 July 2019: Draft advice, 8 March page 47

[5] Essential Services Commission 2019, Call wait times blow out while energy customers pay big for missing discount deadlines: Media Statement, 26 February.

While consumers have on one hand cried out for cheaper electricity, they have also indicated that they want a higher standard of service and more customer friendly practices. This is evidenced by the Canstar Blue's 2019 ratings which sees smaller retailers who lack the scale to be as efficient as the Tier 1s, take the top spots[6]. The 'efficient' Tier 1 retailers, EnergyAustralia, Origin and AGL languish in 10th, 11th and 12th spots respectively. The ESC's suggestion that smaller retailers look to emulate the costs and practices of the Tier 1s does not appear to be consistent with its calls for an improved customer experience.

Momentum does not claim to be the most efficient retailer in the market. We do claim to have a reputation for excellence in customer service (as evidenced by a raft of Mozo and Canstar Blue awards in recent years[7]), and have been a champion of positive consumer practices including zero discount products, no hidden fees or charges and no 'loyalty tax'. We understand that we will be able to set market offers above the VDO, however energy is not a luxury item and this increased level of service comes at the expense of margin rather than through the imposition of a premium on our rates. If we cannot offer this standard of service under a VDO customers will miss out.

We are always seeking to gain efficiencies in our business, and can do this in a number of ways. The first is to invest in capital to find better ways to service our customers and interact with them through lower cost channels. The second is to shift to a business model akin to that of the Tier 1 retailers and eschew our customer first philosophy, using the bare minimum requirements of the regulatory framework to guide our customer practices. There is no doubt that consumers will be poorer for it if Momentum (and other tier 2 retailers) are forced to take this second route to 'optimal efficiency'.

**Limitations of the Benchmarking Approach**

We appreciate that the ESC has acknowleged some limitations of a benchmarking approach to setting the VDO and that it may, in future periods, determine prices based on a bottom up approach. By this time retailers who do offer a better customer experience at a higher cost will likely have shifted to lower cost (ie, less customer friendly) models or simply exited the market. The damage will have been done and customers will be worse off for it.
In a time where consumers, regulators and policy makers have clearly signaled that they expect more from their retailers in terms of service, it is more important than ever that an adequate allowance for cost to serve is made.

To this point, the regulatory decisions included by Frontier Economics rely on data up to 12 years old, and do not adequately reflect the jurisdictional differences between the regimes or the changes that have been implemented in the intervening period. Further to this, it is Momentum's experience that the costs of operating in Victoria relative to the rest of the NEM have increased in recent years.

[6] Canstar Blue electricity retailer ratings 2019. https://www.canstarblue.com.au/electricity/vic-providers/ Viewed 3 April 2019.
[7] Canstar Awards for most satisfied customers in 2014, 2018 and 2019, Mozo Awards in categories of customer service and satisfaction in 2016, 2017 and 2018.

Although the ACCC estimated a difference of around $11 in operating costs between Victoria and the NEM states, as a retailer who was required to provide data to the ACCC, we can advise that although information on the matter was sought, there was no robust examination of the cost differential, which we consider to be much higher.

It should also be noted that the ACCC's investigation was based on retailer costs up to 1 July 2018. This did not include the impact of the Payment Difficulty Framework (PDF), or for that matter the cost impact of other impending regulatory changes. Among the ACCC's recommendations for lowering costs was for Victoria to join the National Energy Customer Framework. Not only has this not happened, but the divergence between the two regulatory regimes has accelerated.

While the cost of the PDF is acknowledged in the ESC's draft decision, the ESC would also be aware that throughout the development of the PDF, retailers were calling for a robust cost/benefit analysis (CBA) and considered that the reports eventually undertaken by KPMG and ACIL Allen were inadequate. As outlined at the time that the PDF was under development, "Data for the ACIL Allen retailer report was based on data collected by ACIL for the Hardship Inquiry from 9 retailers in 2015; data that ACIL Allen readily acknowledged was out of date".

Based on this, and other criticism, (readily available to the ESC through submissions received on the matter) industry concluded that "this CBA does not match even the most basic standards for a cost-benefit analysis as the concept is generally understood"[8]. It is our belief that is falls short of the regulatory impact statement that we believe is required under the Subordinate Legislation Act 1994 which seeks to apply appropriate governance to ensure that regulatory change is made for the benefit of Victorians.

The inadequacy of the CBA for the Payment Difficulty Framework notwithstanding, the industry has faced further cost increases through a range of reforms since the release of the Thwaites report in 2017. Momentum, and indeed a significant number of our competitors welcomed the reforms as being a key step in the path to improving customer outcomes. We can advise that these costs are significant and in fact, Victorian regulatory reforms are currently consuming in excess of 63% of our capital expenditure allowance. These funds are notionally allotted to projects which will help increase efficiencies through the lowering of operating costs, and to develop better service offerings for Victorian consumers. The slew of regulatory change which retailers have endured in recent times is benefiting a few customers at the expense of the many.

In its draft advice the ESC "consider it appropriate to include an additional allowance for recent regulatory changes, where they are material and can be reliably costed.[9]" We query where the determination of the materiality of these costs has occurred as no cost benefit analysis of the reforms to commence on 1 July has been undertaken. In the instance of the Payment Difficulty Framework the ESC actively claimed that it had no requirement to conduct analysis of this nature before finally embarking on the flawed KPMG and ACIL Allen

[8] AEC 2017, Response to the Revised Draft Decision: Payment Difficulty Framework, 16 June. sub

[9] Essential Services Commission 2019, Victorian Default Offer to apply from 1 July 2019: Draft advice, 8 March page 48.

work described above. To base its calculation of costs on these reports and a belief that "the PDF should reduce retailers' bad debt and debt collection costs"[10] which is not based on of the experience of industry does not provide Momentum with confidence the VDO cost setting is being appropriately undertaken.

**Undermining Policy Outcomes**

A VDO which does not facilitate competitive outcomes is in direct contravention of the Government's policy objectives. We appreciate that the ESC's role in policy making is limited however, consistent with the long term interest of Victorian consumers, it must be mindful of the role its decisions play.

Victoria was the first state in Australia to roll out advanced interval metering, in part to allow customers to participate in reducing network costs by changing their consumption patterns. Flexible pricing and cost reflective network tariffs provide customers with the ability to take control of their own costs and ultimately lead to lower costs for all consumers as the need for network investment is reduced.

While the take up of these mechanisms has not been strong, their ongoing success is dependent on customers engaging with the market and wanting to take control. A VDO, set at the levels determined in the ESC's Draft Advice will undermine the effectiveness of cost reflective pricing (and coincidentally ensure that $2.6B invested in the AMI rollout is never recovered) as it will provide customers with an 'easy, comfortable' flat tariff. We do not believe that engaging with the market should be difficult or uncomfortable, but when the 'do nothing' option is as cost effective for the customer as one which requires them to give some thought to their electricity supply there is no incentive for behavioral change. Undermining this policy does not accord with the long term interests of Victorians.

Similarly, an artificially low VDO risks obviating any benefit which may (or may not, as no cost benefit analysis has been undertaken) arise from the Building Trust Through New Customer Entitlements reforms scheduled to commence on 1 July.

As a customer, taking heed of advice on a bill that a better offer exists makes sense only where there is considerable price dispersion in the market. As the ESC itself acknowledges by virtue of its inclusion of a threshold figure for the Deemed Best Offer Notification, there is very little need for the customer to act if there are no savings to be had. This is the very likely outcome if the VDO is set, as per the draft advice, at a level which does not accurately reflect retailer costs. This submission has already made mention of the fact that the ESC has not adequately accounted for the cost of this reform in its determination of the VDO, but the issue is further compounded if the significant expense being outlayed on these changes is rendered unnecessary by an incorrectly set VDO.

**Costs Arising from the VDO**

As well as a failure to consider the cost impact of forthcoming regulatory changes which retailers are currently building for, the Draft Advice makes no mention of the direct impost

[10] Ibid

on retailers (and customers) as a result of the introduction of a VDO. By setting only a flat VDO, the ESC is exposing retailers and customers to some very real costs.

This submission previously discussed the issue of occupiers who will be transitioned to the VDO. A key tactic used by retailers to attempt to incentivise unknown consumers to enter into a market contract is to backdate the market rates from the time the deemed contract commenced. Given the price differential between Standing and Market offers, this can represent a significant saving to the customer, but only if they choose to engage. A VDO which does not allow sufficient room to price beneath it will completely remove this incentive to engage with the net result being an increase in the number of customers of Standing Offers.

While this may not concern that ESC as these customers will be billed at the 'efficient' VDO rate, this is actually a highly inefficient outcome. Even with the existence of the lever to incentivise customers to enter market offers, Momentum writes off 53% of all charges to Occupier customers as bad debt. The increase in the number of occupier accounts will increase bad debt and lead to higher costs in this area.

**Conclusion**

Retailers have sought transparent cost benefit analyses for regulatory reforms over a number of years. The ESC has claimed a mandate to proceed with reforms without the requisite investigations of how much these changes will add to the cost of energy for Victorian consumers. Retailers have found it disappointing that the ESC has on occasion stated a view that it is not required to undertake a CBA, much less a full Regulatory Impact Statement and can simply state that theu will "have regard to the costs associated with these reforms". It concerns us greatly that that having resisted efforts to cost its reforms, the ESC is now determining the efficient costs of operating a retail business.

The likely result is that, instead of prices which reflect the true cost of doing business in Victoria, prices will cluster around a lower, flawed and unsustainable price.

It will also mean that many active and engaged customers, who have found themselves very good deals in the market, will face price increases.

Moreover, the VDO set at an unsustainable price risks creating the most inefficient outcome of all: retailers having sunk millions in capital expenditure in an attempt to comply with the Victorian regulatory framework, only to be unable to recover these costs and ultimately withdraw from the market having made no return on this investment.

Unfortunately, the ESC's determination of the VDO price, if it does not have appropriate regard for the true costs faced by retailers, could actually deliver worse outcomes for customers and market failure in the form of higher prices and fewer competitors.

**Additional information**

If you require any further information with regard to these issues, please contact me on [redacted]

Yours sincerely

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