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PacificHydro

17 October 2019

Mr Marcus Crudden
Director, Price Monitoring and Regulation
Essential Services Commission
Level 37, 2 Lonsdale Street
MELBOURNE VIC 3000

Submitted via Engage Victoria

Dear Mr Crudden

Re: Victorian Default Offer to Apply from 1 January 2020 – Draft Decision

Tango Energy welcomes the opportunity to provide its feedback and views on the Essential Services Commission's (ESC) draft decision on the Victorian Default Offer (VDO) to apply from 1 January 2020.

Tango Energy is a rapidly growing electricity retailer supplying over 75,000 customer accounts across the National Electricity Market (NEM). As an emerging retailer, Tango Energy is committed to offering energy consumers competitively priced products that are simple to understand.

Tango Energy's emergence in Australia has been supported by its parent company, Pacific Hydro. Pacific Hydro owns a diversified portfolio of renewable energy generation assets in Australia and abroad with an installed capacity of 900 MW. As the energy market evolves, Pacific Hydro is committed to investing in Victoria's future needs, but it is vital that this investment is underpinned by a competitive retail energy market.

In order to sustain competition in the Victorian energy market over the long term, Tango Energy is of the view that the ESC's VDO cost stack needs to provide adequate margins to ensure that standing offer prices are cost-reflective for all electricity retailers, regardless of their size or scale. With this in mind, the following submission addresses:

- The ESC's proposed methodology for setting wholesale costs.
- The complexities associated with the ESC's proposed approach to setting non-flat tariffs in line with the VDO maximum bill.
- The reasons why retail operating costs should reflect those incurred by emerging second and third retailers as opposed to the 'Big 3'.

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1. WHOLESALE AND ENVIRONMENTAL COSTS

In setting the VDO cost stack, the ESC needs to keep in mind that over 80 per cent of a retailer's cost base is made up of wholesale, network and incidental regulatory costs. These costs are largely outside a retailer's control, meaning that retailers are primarily price takers. For this reason, it is imperative that the ESC has regard for the current cost exposures faced by Victorian electricity retailers in making its final decision.

1.1 Wholesale costs

In terms of wholesale costs, Tango Energy is concerned about the variance in the methodology that the ESC is using to determine the correlation between consumer demand and wholesale spot prices. In providing its final advice to the Government earlier this year, the ESC relied on two years of historical MRIM data. However, for its 2020 determination the ESC is looking to base its forecasting on data for the period 1 July 2016 to 30 June 2019. Tango Energy is concerned that varying the modelling to incorporate three years of historical data could misrepresent underlying costs, particularly given recent spikes in wholesale price volatility.

Recent events are reflective of increasing wholesale volatility. This volatility is likely to continue in 2020 with the Australian Energy Market Operator preparing for potential capacity constraints across Victoria.

In view of this, Tango Energy considers that in setting the VDO the ESC should be taking into account the incremental wholesale costs for supplying customers based on prevailing conditions rather than relying on older market trends. The ESC's approach to determining wholesale costs ultimately does not factor in the increased financial risk exposure that electricity retailers are currently facing.

Market volatility means prudent retailers are continually adapting their hedging strategies to account for market, customer usage and risk changes. It is imperative that the ESC's approach to determining the wholesale cost component of the VDO cost stack is revised to more accurately reflect actual retail operations. While the ESC may not be able to fully account for the dynamic and varying nature of retail hedging strategies, it must at the very least ensure that its approach is reasonably realistic and justifiable based on the actual wholesale costs faced by Victorian electricity retailers.

1.2 Environmental costs

Similar to wholesale costs, Tango Energy considers that environmental cost assumptions, particularly the costs of complying with the Large-scale Renewable Energy Target (LRET) should be set based on actual retail practices rather than based on assumed compliance costs. As observed in Figure 1 below, the costs associated with Large Generation Certificates (LGCs) have decreased considerably over the past two years with prices dropping by around $50 per certificate since mid-2018. These prices are likely to continue to drop owing to the fact that there is a sufficient number of renewable energy projects in the pipeline to exceed the Australian Government's 2020 target under the *Renewable Energy (Electricity) Act 2000* (Cth).

Figure 1: LGC prices from January 2017 to February 2019

Source: Clean Energy Regulator, Large-scale generation certificate market update – February 2019.

Despite this, many prudent retailers purchased LGCs over a long term horizon as part of power purchase agreements. It is, therefore, likely that some retailers will have an overall portfolio cost for LGCs above the amounts that these certificates are currently being traded for in the open market. In view of this, Tango Energy would encourage the ESC to critically evaluate all data provided by retailers about their LGC costs and then use this information as a basis for evaluating a select cross-section of retailers to fully understand the industry's actual costs of complying with environmental scheme requirements.

Tango Energy encourages the ESC to bear in mind that an efficient retailer is not one that acquires its wholesale and environmental needs at the lowest possible price. Rather, it is a retailer that has rational and effective measures in place to balance its risks and costs exposure over both the short and long term.

RECOMMENDATION 1

ESC should reconsider its approach for setting wholesale and environmental costs to align with prevailing market practices.

2. NETWORK COSTS

Accounting for network costs as a direct pass through is the most equitable means of incorporating network costs into the VDO cost stack. In saying that, Tango Energy would like to emphasise that there are considerable financial risks and administrative complexities associated with using the flat tariff VDO as the basis for capping price incurred by customers on non-flat tariffs. As the ESC would appreciate, retailers could be left financially exposed if they are unable to adequately recover underlying network costs associated with supplying customers on non-flat tariffs. Indeed, given the requirements for retailers to provide best offer information on bills and associated price change notices, it is likely that some customers would be advised to switch to a capped-priced VDO to limit their exposure to peak electricity prices.

Having said that, Tango Energy does not support the ESC's proposal for retailers to set their own non-flat tariff rates. There is insufficient time after the release of the ESC's final decision for retailers to undertake necessary commercial modelling to set VDO tariff rates in line with the ESC's maximum bill. Moreover, requiring retailers to set their own rates based on the maximum bill will result in inconsistent VDO pricing structures for non-flat tariffs.

It must be kept in mind that the VDO is intended to be a simple safeguard offer. Its rates should, therefore, apply universally to customers regardless of which retailer is responsible for providing electricity supply. For this reason, the ESC should prescribe the VDO rates for non-flat tariff customers. These VDO tariff rates should be in line with the representative usage profiles as set out at page 68 of the Draft Decision.

For simplicity and ease of administration, there should be a requirement for any non-prescribed VDO tariff rates to be set in line with the flat tariff VDO rates. This would mean that retailers who supply customers on complex tariff structures would be required to set demand-based variables at zero to remain compliant. This would, however, necessitate the ESC factoring in a cost premium to account for the network cost risk that a prudent retailer would have otherwise been able to avoid by effectively setting retail tariffs to cover customer usage during peak demand periods.

In saying that, Tango Energy considers that this approach should only be adopted for the 2020 regulatory pricing period as an interim step to provide the Victorian Government time to work with industry to ensure retailers are not exposed to network costs that cannot be directly recovered from electricity consumers. Indeed, the most effective means of achieving this end would be for the Victorian Government to implement legislation requiring network service providers to mandatorily reassign all VDO customers to flat network tariffs.

RECOMMENDATION 2

ESC should set the VDO rates for non-flat standing offers based on the representative customer usage profiles published in its draft decision.

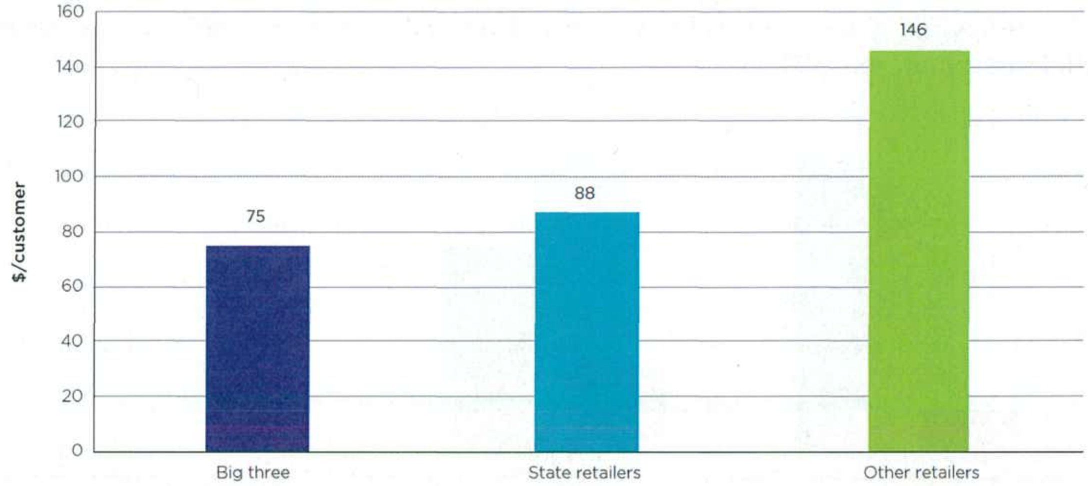
The ESC should also factor in a cost premium to account for the fact that this approach will not adequately allow retailers to recover the full network costs incurred by non-flat tariff VDO customers.

3. RETAIL OPERATING COSTS AND CARC

3.1 Retail operating costs

In setting retail operating costs, the ESC should have regard to findings of the Australian Competition and Consumer Commission's (ACCC) Retail Electricity Pricing Enquiry that indicated a substantial difference in the operating costs of the 'Big 3' retailers compared to other market participants (refer to Figure 2 below).

Figure 2: NEM-wide cost to serve



Source: ACCC, Restoring electricity affordability and Australia's competitive advantage, June 2018, Australia, 224.

Despite there being a substantial variance in retail operating costs, the ESC has set a $134 baseline figure for retail operating costs, as this is consistent with the historical price setting by other economic regulators. It, however, needs to be acknowledged that operating conditions in the regulated jurisdictions that the ESC has analysed may not reflect the conditions in more mature competitive markets, such as Victoria.

Indeed, retail competition in jurisdictions like Regional Queensland and the Australian Capital Territory has not prospered to the same extent as other jurisdictions across the NEM owing to regulated pricing controls constraining new entrants from making commercially viable returns.[1]

Tango Energy, therefore, considers that the ESC needs to critically review the cost information provided by retailers as part of its VDO information request rather than relying on past regulatory decisions as the basis for setting retail operating costs. On reviewing this data, the ESC needs to be mindful that the operating costs of smaller retailers are likely to be higher than those of more established businesses. The operating costs of smaller retailers will inevitably decrease as they gain market share and scale. However, the ESC needs to provide a sufficient operating allowance to facilitate the growth and development of emerging retailers.

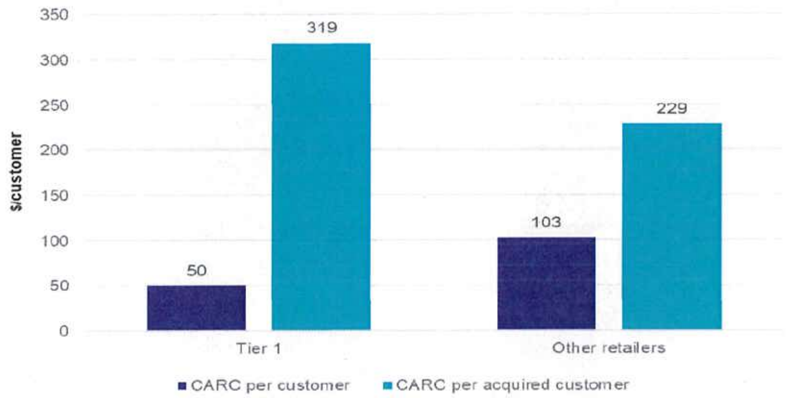
Failure to do so could reinforce the dominant position of the State's largest retailers, creating an oligopoly which would reduce incentives for the market to innovate in meeting the needs of consumers. It is ultimately emerging retailers that are more likely to drive innovation as they strive to achieve market share and differentiate themselves from their competitors.

[1] See AEMC, 2019 Retail Energy competition Review, 28 June 2019, 33.

3.2 Customer acquisition and retention costs

Like retail operating costs, Tango Energy considers that Customer Acquisition and Retention Costs (CARC) should reflect the actual costs incurred by small and mid-sized retailers. A review of the ACCC's findings in Figure 3 indicates that it is actually the large incumbent retailers who are spending on average the most on attracting new customers. Tier one retailers, such as the 'Big 3', spend on average $319 for every customer they acquire. Conversely, other retailers spend an average $229 per customer, 72 per cent of the amount spent by large tier one retailers. In spite of this, small and mid-sized retailers have demonstrated an ability to grow at this level of spending.

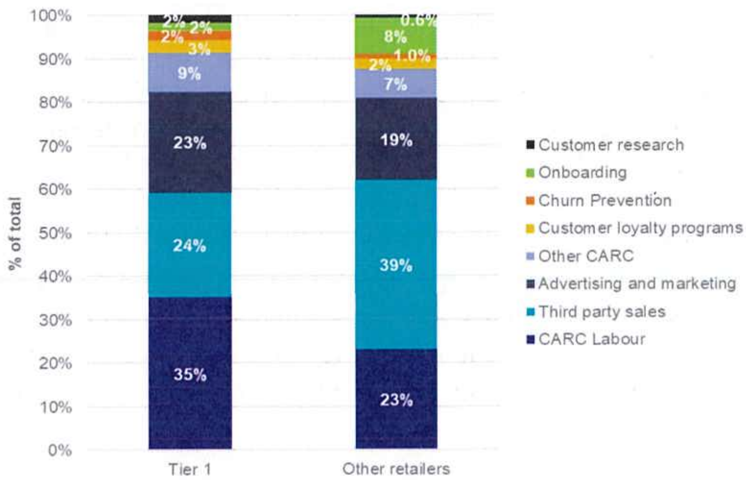
Figure 3: NEM-wide CARC 2017-18, $ per residential customer and per acquired residential customer, ex. GST



Source: ACCC, Inquiry into the National Electricity Market August 2019 Report, 110.

It is also important to point out that relative to the tier one retailers, small and mid-sized retailers spend a larger portion of their CARC allowance on generating sales and onboarding new customers. This reflects the substantial costs emerging retailers incur making the public aware of their offerings and signing-up new customers compared to larger retailers, which spend more on staffing and customer research activities (refer to Figure 4 below).

Figure 4: NEM-wide CARC Categories by retailer tier, 2017-18, $ per residential customer



Source: ACCC, Inquiry into the National Electricity Market August 2019 Report, 111.

For a business such as Tango Energy, it can only continue to offer lower prices relative to its competitors while growth continues. For this reason, Tango Energy does not consider that customer acquisition costs should be based on the average CARC across the NEM in 2013-14. The market has changed vastly since this time and retailers need sufficient scope to be able to compete on a level playing field. With this in mind, Tango Energy considers that a modest CARC should reflect the costs incurred by second and third-tier retailers for the reasons set out below.

Given their large customer base allows them to spread costs, continuing to set CARC allowance at $38 will only serve to increase the gap between what the tier one retailers are able to spend on acquiring new customers compared to the other retailers. Over time, this will further entrench the position of the largest retailers in the market. This is reinforced by the fact that customer acquisitions in the Victorian electricity sector are primarily driven by brand awareness and reputation. Historical structural reforms have meant that the 'Big 3' retailers have retained considerable brand and market presence. If the ESC continues to constrain the ability of smaller retailers to promote and sell their offers, then energy consumers may not be sufficiently aware of alternative retailer options, which could in and of itself hamper competition and market growth.

RECOMMENDATION 3

It is recommended that the ESC provides a CARC allowance with sufficient margin to allow emerging retailers to generate sales and onboard new customers.

This will ensure that the VDO does not adversely impact market competition and growth across the sector.

4. OVERALL VIEWS ON THE VDO

In accordance with its objectives under the *Essential Services Commission Act 2001* (VIC), the ESC's fundamental objective in performing its functions and exercising its powers is to 'promote the long term interests of Victorian consumers.' In achieving this objective, the ESC must have regard to among other things:

- Efficiency in the industry and incentives for long term investment.
- The financial viability of the industry.
- The degree of, and scope for, competition in the industry, including countervailing market power.

It ultimately needs to be kept in mind that there is risk that customers will become less engaged and will not actively seek to evaluate alternatives if there is an overarching presumption that the VDO presents them with a fair price. This is something that the Victorian electricity sector can ill afford given that 74 per cent of residential customers are held by four large vertically-integrated businesses: AGL, Energy Australia, Origin and Red/Lumo Energy.[2]

[2] Essential Services Commission, Victorian Energy Market Report 2017-18, 25.

It must also be recognised that such high volumes of customers being serviced by four major players could have negative implications on generation investment. Investment in generation is undertaken over a long term horizon with regard for planning, construction and the operating of assets. There are, nevertheless, considerable risks associated with large capital investment activities. Such risks can be mitigated by underwriting generation capacity through an active retail business. In view of this, jeopardising the emergence of retail businesses through price interventions in a manner that has the potential to constrain competition will only discourage future generation investment in Victoria.

Tango Energy would, therefore, encourage the ESC to think critically about its overarching policy objectives and the future needs of Victorian energy consumers. While the VDO may provide a simple safeguard, the ESC has a legislative duty in line with section 8A of the *Essential Services Commission Act 2001* (VIC) to have regard for the flow-on implications that capping electricity prices has on the Victorian energy sector as a whole.

5. CONCLUDING REMARKS

In closing, Tango Energy looks forward to continuing to work with the ESC in ensuring that the Victorian retail energy market continues to serve the long-term interests of energy consumers through promoting robust competition and innovation. To this end, Tango Energy encourages the ESC to make its final decision having regard to all reasonable costs incurred by Victorian electricity retailers, as failing to do so could not only jeopardise competition, but it could also increase electricity prices for all Victoria consumers in the medium to long term.

Tango Energy welcomes further discussion in relation to this submission. To arrange a discussion, please contact Gus Poh, Legal, Regulatory and Compliance Manager, by telephone on (03) 8621 6300 or email at gpoh@tangoenergy.com.

Yours sincerely,

per
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