30 January 2019

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Dear Commissioners

**Victorian Default Offer for small electricity customers - ESC staff working paper – December 2018**

EnergyAustralia is one of Australia's largest energy companies with around 2.6 million electricity and gas accounts in NSW, Victoria, Queensland, South Australia, and the Australian Capital Territory. We also own, operate and contract a multi-billion dollar energy generation portfolio across Australia, including coal, gas, battery storage, demand response, wind and solar assets, with control of over 4,500MW of generation in the National Electricity Market (NEM).

The Victorian Default Offer (VDO) is intended to deliver price reductions for customers on standing offers while preserving the benefits to customers of engaging in the competitive market. We consider that other policy interventions being contemplated, including best offer notifications and Victorian energy fact sheets, will better serve the long-term interest of Victorian energy consumers by reducing complexity and empowering them when dealing with retailers. The VDO is a blunt instrument that presents real risks to competition in the Victorian retail market.

The Commission has an invidious task of setting a regulated price in a short timeframe. While the Commission's role is limited to determining the value of the VDO, it will share the accountability for market outcomes and must lead all stakeholders towards a common objective. For these reasons we encourage the Commission to articulate its own view of how the VDO will improve upon current market outcomes alongside an assessment of potential risks.

We recommend the Commission adopt a cautious approach in setting the first VDO to apply from 1 July 2019. Prices for subsequent periods will be set with more confidence as the Commission refines its methods and obtains better data over time, and the VDO's impact on the market is better understood.

Our response to the Commission's staff paper is attached. If you would like to discuss this submission, please contact Lawrence Irlam on [redacted].

Regards

**Sarah Ogilvie**
Industry Regulation Leader

## The Commission should state its objectives and adopt a cautious approach

The Government's terms of reference reflect its intention to protect disengaged customers from facing unreasonably high standing offer tariffs, while at the same time retaining an incentive for them to move off the default offer onto market offer contracts. Despite these objectives, the Government requires the Commission to set the VDO equal to efficient costs, with only a 'modest' allowance for customer acquisition and retention costs (CARC) and no allowance for 'headroom'. Because of this, the degree of competition in the Victorian retail market is likely to be dulled, and the net effect on the market may not be in the long-term interests of Victorian consumers.

The Commission should clearly articulate its view of how it expects the VDO will affect the Victorian retail electricity market over time alongside various other interventions about to take effect. Our recommendation is that, within the constraints of the Government's terms of reference, the VDO should be set towards the highest end of efficient costs to preserve incentives for customers to switch to market offers. The Commission should consider the risks to retailers and customers involved in setting its first VDO with limited time and information. The Commission should initially adopt a cautious approach, in anticipation of refining its methods and data over time.

These points are elaborated below.

### The VDO should be a safeguard and not interfere with pro-competitive reforms

The Government's terms of reference define the VDO as follows:

> *The VDO will provide a simple, trusted and reasonably priced electricity option that safeguards consumers unwilling or unable to engage in the retail electricity market without impeding the consumer benefits experienced by those who are active in the market.*

We consider that competition is the best means to place downward pressure on prices, and that market offers in Victoria reflect workably competitive outcomes. We support a VDO that moves more customers off standing offers as well as encourages those on market offers to regularly shop around for the best deal. We recognise that competition has produced perverse outcomes in creating numerous confusing offers and associated high transaction costs (for consumers as well as retailers), breeding a general distrust of energy companies. We support the introduction of a reference rate to reduce this confusion and empower customers when engaging with retailers. Related reforms in Victoria including best offer notifications and Victorian energy fact sheets will also encourage more customers to seek out better deals.

We see a role for the VDO where it acts as a safeguard for customers that cannot genuinely engage in the market, rather than as something that delivers efficient pricing for those that are simply unwilling to engage. We recognise that standing offer tariffs create affordability concerns and have taken targeted action in all jurisdictions to protect customers who are vulnerable or facing financial difficulties. This includes:

- providing an automatic ongoing 15% discount from 1 January 2019 to concession customers on standing offer tariffs, saving them an average $270 a year on their electricity usage and $145 on gas

- contacting customers on our hardship program through multiple channels to encourage them to switch to our best in market offer for electricity and gas. Where we have been unsuccessful in gaining their explicit and informed consent, we are applying an automatic discount that reflects our best market offer in each jurisdiction. Recipients are reviewed every 6 months to ensure they receive the best market discount

- writing to all our standing offer customers at least once in the past year informing them that there are better offers available

- adopting a practice to not move customers onto a standing offer tariff at the end of their benefit term.

Over the past 4 years, we have successfully moved over 200,000 customers off standing offers nationally. Victoria has the lowest proportion of standing offer customers in all contestable retail markets of around 7 per cent. This is expected to decrease given the degree of competition in this market. Of this proportion, as noted by the AEMC, there is likely to be a 'natural' or frictional amount (around 2 to 4 per cent) of customers who are only on a standing offer for a short period of time, for example when they move house or create a new connection and have not yet selected a market offer.[1]

### The VDO risks negatively affecting competition

The Thwaites review recommendation to impose price regulation reflected concerns around prices in the market generally, not just for standing offers. The subsequent policy decision, embodied in the Government's terms of reference, is that the VDO is to be based on efficient costs. The Commission has been directed to exclude any allowances for 'headroom'. The allowance for CARC must also be 'modest', which we interpret to mean less than efficient costs, in line with the concerns around CARC expressed in the Thwaites review. We consider these features conflict with the objective to preserve competition. For example, in recommending price regulation in non-Victorian jurisdictions, the ACCC has stated that regulated prices need to be higher than efficient costs to preserve the benefits to customers of engaging in the market.[2]

The ACCC's findings and the recommendation for the Default Market Offer (DMO) were targeted at the problem of unengaged customers on standing offer tariffs. By contrast, the Thwaites review and associated Victorian Government endorsements do not distinguish between standing and market offers. The Thwaites review panel was also not concerned with preserving competition and its intended price cap, by excluding CARC, was intended to set prices at a level below what competition was delivering and realistically could ever deliver. By directing the VDO to include only a small amount of CARC and exclude headroom, the Government has made the VDO a challenging "half-way house" for the Commission to implement.

### The Commission needs to articulate the net benefit of the VDO for consumers

The Government has not articulated a clear view of what the VDO is intended to achieve, including possible unintended consequences. For example, it is not clear whether the

[1] AEMC, *Customer and competition impacts of a default offer*, Final report, 20 December 2018, p ii.
[2] ACCC submission to AER position paper on default market offer price, 7 December 2018. Available at https://www.aer.gov.au/system/files/ACCC%20-%20AER%20Default%20Market%20Offer%20-%20Submission%20to%20Position%20Paper%20-%207%20December%202018.PDF

VDO is meant to be a transitory measure or will work alongside competition in perpetuity. While the VDO directly limits standing offer prices, this will have some impact on market offers and broader market development, particularly as the VDO will become the reference price for comparisons. Some of these effects will be unanticipated and negative.

In discharging its functions, the Commission will need to consider how to implement the VDO in the long-term interests of consumers, having regard to various matters including the efficiency, financial viability and scope for competition in the electricity market, as well as the benefits and costs of regulation. The Government's terms of reference to set a price cap in line with efficient costs does not absolve the Commission from these considerations. The Commission will also be held accountable for the resulting customer outcomes and managing expectations of these outcomes.

Our view of the likely impacts of the VDO, including costs and benefits, are set out below, in part informed by the AEMC's findings in relation to the DMO:[3]

- the benefits may be small
    - Victoria has lowest proportion of customers on standing offers that would directly benefit from the VDO, and this proportion is declining
    - retailer price reductions and rebates from 1 January 2019 reduce the scope for further bill reductions from the VDO
    - while the Thwaites panel considered otherwise, and retail margins appear highest in Victoria, the ACCC's analysis did not find that retailers were making excessive profits (including in Victoria)
    - there has been no systematic analysis of whether retail margins in Victoria reflect inefficiency, including from different customer segments and potential cross subsidies
- the VDO may deliver efficient pricing outcomes but to the detriment of engaged customers
    - if a price cap on standing offers simply removes any cross-subsidies between active and inactive customer segments, this is arguably an efficient outcome
    - conversely, a price cap will remove the ability of retailers to efficiently price discriminate between customer segments
    - a more practical consideration for the Commission is the distributional impact of any rebalancing of prices between standing and market offers. In the current policy environment, customers (and policy-makers) may be more sensitive to price increases than decreases. This is also true where market offer customers are more aware of price changes than standing offer customers.

[3] AEMC, pp. iii-ix.

- Our analysis of our customer base indicates the majority of standing offer customers are above the Victorian median income. The ACCC's findings also suggests there is a low proportion of standing offer customers that are facing hardship or are on payment plans.[4] Any price rebalancing because of the VDO could therefore have perverse effects from a welfare perspective.

- As it will incorporate a single anytime usage tariff component, the VDO will not expose standing offer customers to cost-reflective price signals.

- there is a risk of dampening competition

    - forced price reductions for standing offer customers will reduce the payoff to retailers of attempting to gain those customers via attractive price offerings

    - from a customer perspective, the VDO is being explicitly set at efficient costs. If this is known to customers, it could make those on standing offers more complacent and difficult to entice into the market. At the extreme, it could encourage customers to move off market offers and onto the VDO

    - as with all price regulation there is a risk of setting the VDO too low. Some retailers may be unable to absorb volatility in costs or have costs that are above the price cap, causing them to exit the market.

### The Commission should adopt a cautious approach for 1 July 2019

Like the AEMC, we consider that there are a range of other interventions (for example, measures to improve the comparability of offers) that should be implemented before resorting to direct price regulation.

Noting the Commission must develop a VDO to apply from 1 July 2019, our primary recommendation is that the Commission adopt a 'soft start' and select a VDO price that is at the higher end of the plausible range of efficient costs. Another reason for adopting a conservative position, at least for the first VDO determination, is that the Commission is currently limited to using public data and is also time constrained. We will continue to engage with the Commission and furnish it with information that should improve its decisions over time. To benefit this further engagement, the Commission should consider releasing its analysis of retailer information that was supplied previously in the development of the reference price.

## The Commission should focus on price outcomes not the notional retailer

The Government's terms of reference require the Commission to determine the efficient cost to run a retail business. As discussed above, we consider this conflicts with the desire to preserve competition.

[4] ACCC, *Restoring electricity affordability and Australia's competitive advantage* - Retail Electricity Pricing Inquiry—Final Report, June 2018, pp. 244-5.

The Commission's choice of a notional efficient retailer will presumably guide its decisions on whether the VDO is higher (benefiting retailers/ preserving competition) or lower (benefiting standing offer customers). We consider that, where there is a range of possible outcomes, these decisions should reflect a balancing of interests of retailers and consumers, including the allocation of regulatory risk. That is, the Commission should be guided by where the VDO sits relative to existing standing and market offers, and therefore the real impact on customers, rather than determine outcomes from an abstract discussion of the notional efficient retailer.

The Commission will need to see beyond the political focus on prices and deliver outcomes that are sustainable for the long-term. We recognise that current market outcomes were partially the result of large headroom allowances in standing offers at the time the Victorian market was made contestable. There is a risk, however, that current interventions significantly lower standing offer prices. If this simply results in a rebalancing of prices between market and standing offers, this will represent a wealth transfer and not a genuine benefit to customers. There is also a risk of retailers exiting the market which could reduce competition and discourage innovative product offerings. These effects could place additional pressure all along the energy supply chain at a time where investment decisions are already being hampered by unprecedented political uncertainty and technological change.

### Market offers could provide better information than published cost data

In practical terms it is not clear how the notional retailer construct will inform the Commission's use of published information e.g. the ACCC's Retail Electricity Pricing Inquiry, which reflect an average or aggregation of retailer data. Benchmarks used by other regulators will reflect an examination of costs for a different set of retailers at different times and in different market conditions. The Commission will need to apply careful judgement in using or adjusting these data.

The Commission should inform its decisions by also examining existing market offers in Victoria. That is, market offers are likely to reflect workably competitive outcomes and could at least provide a sense check on bottom-up or benchmark costs. In some cases, prices will be higher or lower than efficient costs given loss-leading and other pricing practices, and because costs will fluctuate while prices are fixed in contracts. The Commission may also infer the extent of potential cross subsidies by examining where market offers sit relative to standing offers for similar customer types. Over time, the Commission should also monitor retailer cost information and how this translates into market offers, including whether pricing strategies are adversely affected by the VDO.

### Efficient costs could undercut market offers for smaller retailers

Setting cost reflective prices is a challenge regularly faced by the Commission when dealing with individual regulated monopolies. The VDO has the added challenge of being a uniform price across a large number of businesses, who each have differing cost structures and degrees of efficiency.

In addressing its terms of reference, the Commission's staff paper suggests a range of characteristics of the notional retailer, which would generally result in the VDO matching the costs of the larger incumbent retailers:

- Economies of scale — this will clearly skew pricing outcomes to be in line with what larger retailers should charge.

- Stand-alone/ not vertically integrated — the staff paper suggests the notional retailer's costs would be higher without access to economies of scope, which is more aligned to smaller retailers. As an aside, there appears to be some expectation that vertical integration provides retailers a cost advantage in having access to 'natural' hedges, while there is another conflicting view that integrated entities inflate costs via transfer pricing to extract rents from their retail arm.

- Serves domestic and small business in Victoria/ the NEM — this would tend to reflect costs of larger retailers

- Can offer both standing offer and market offer contracts — all retailers are obliged to have standing offers so the cost implications of this assumption are not clear, however larger incumbent retailers are more likely to have standing offer customers

- Defends an existing customer base — again reflects the larger incumbent retailers

- No loss leading to acquire new customers — smaller retailers are likely to engage in loss leading and aggressive customer acquisition for a larger proportion of their customer base.

Setting the VDO in reflection of the costs that are generally incurred by the largest incumbent retailers may be appropriate given most standing offer customers are with these retailers. However, the VDO will operate as a price cap across the market as retailers will be unable to make market offers that have prices above the regulator's 'efficient' price. Retailers with costs above the larger incumbent retailers may have their market offers undercut by the VDO. We are also concerned that the VDO will be lower than our existing market offers if the Commission, despite its intentions, sets prices below efficient costs because of limited data or some other shortcoming.

### Typical challenges in bottom-up analysis

The Commission will face the typical range of challenges in undertaking a bottom-up assessment of costs. This includes validating claims from retailers that they are all different and are all efficient, and in constructing robust benchmarks that accommodate changes in costs over time.

As the Commission appreciates there is a reasonable degree of certainty in some elements over time and across retailers, but not others:

- Retail costs are relatively stable/ predictable (although still difficult to benchmark)

- Network costs are well known and common to all retailers (noting some issues around different retailers' customer load profiles)

- Fees, green costs, losses – also relatively predictable and variations will not be as material as changes in other elements

- Wholesale costs from year to year will materially diverge across retailers and are discussed separately below.

The Commission will need to engage in a fair degree of detail to support its decisions, however it should be guided by the resulting pricing outcomes and the inevitable need to exercise judgement in the long-term interests of Victorian consumers.

## Estimating wholesale electricity costs is particularly challenging

We support in principle the use of futures prices and an assumed hedging approach to construct a wholesale cost benchmark. This is more closely aligned to retailer practices than alternatives including market modelling and long-run marginal cost (LRMC). The Commission may, however, face some challenges regarding wholesale cost estimation in terms of some of the criteria set out in the staff paper:

- Representativeness in terms of costs — there is no single optimal or correct approach to dealing with wholesale market risks. The Commission's construct of a notionally efficient retailer may not provide guidance here.

- Transparent, replicable and understood — several elements of Frontier's modelling are likely to reflect proprietary methods, and otherwise will have limited understanding outside wholesale market experts.

- Well-accepted and rely on familiar estimation techniques — Frontier's estimation methods may be familiar but 'acceptance' may imply use by retailers, which is unlikely to be the case.

Pending the Commission's timing and resource constraints, use of market modelling and LRMC methods could provide useful supplementary information or cross checks on a futures market approach. This might be in the form of the direction or magnitude of cost changes from year to year, or a guide to upper or lower bounds of reasonable costs. Market modelling can also identify the effect of uncertain events or scenarios.

### There is no 'right' or optimal approach

Under a futures market approach, as the Commission appreciates, it is not possible (and probably imprudent) to develop an efficient or optimal risk management strategy for benchmarking purposes. Each retailer will have different risk appetites and resulting contracting approaches that are prudent in their circumstances, including their scale of purchases, access to contracts and customer load profiles. The Commission's approach could unfairly penalise some retailers if these differences are not accounted for.

In terms of the parameters guiding the futures market approach where the Commission staff paper asked for specific feedback:

- Time period for purchases — we support an assumed period of 2 years ahead of the period of energy delivery

- Time versus trade weighted contract prices — we support use of trade weighted prices as this better reflects the contract prices participants are likely to be exposed to in delivering electricity

- Contract purchasing profile/ rate of purchases — we support an exponential approach

- Load profile — we support the Commission's proposal to use the most recent year of interval meter data.

Information from futures contracts should be relied on where there is sufficient liquidity in the particular contract. In the past, Frontier has supplemented "missing" contract data by escalating historic contract prices by a premium/ discount derived from market modelling. We note the need to do this is minimised using a longer book build period and an exponential purchase profile.

### Frontier's calculations need to be validated, including for 'shaping' costs

Frontier's modelling has been used by regulators in the past, including by IPART. In consultation on IPART's retail price determinations during 2012 and 2013 we had the opportunity to examine outputs of Frontier's modelling. We hope to work with the Commission and Frontier in the coming weeks to examine its data and methods in detail.

Our prior examination of Frontier's modelling outputs identified instances of price and demand forecasts that, taken together, would have underestimated wholesale purchase costs. Specifically, the separate estimation of demand and spot prices resulted in outputs where high prices did not coincide with high demand, which is typically not seen in the market. This was material to the calculation of energy purchase costs as these high spot prices occurred at periods of low mass market load when retailers would be significantly long to the market. The assumed hedging approach, where retailers minimise exposure to high prices during high demand moments, inadvertently resulted in a one-off payout to retailers, thus lowering the overall energy purchase cost calculated.

A general challenge with modelling wholesale costs is that there are relatively few historical observations for very high price and demand events to robustly estimate statistical relationships. Our experience suggests that cost modelling may also not adequately capture 'shaping' costs, where particular customer loads give rise to different underlying energy costs and exposure to spot price volatility.

## Environmental costs

Use of futures market prices will not be appropriate for retailers (such as us) who obtain large-scale generation certificates via long-term power purchase agreements. Because of the declining cost of renewable technologies, certificates coming from older agreements will cost more than more recent projects and forward certificate prices.

On the small scale renewable energy scheme, we support use of the clearing house price of $40 per certificate. Observed deviations below this price are transitory as the technology percentage is reset every year. We expect the percentage used by the Commission to be reviewed yearly.

## We will provide further feedback on retail costs

The Commission has indicated it has a preference to develop a benchmark of retailer costs using public information and has asked retailers to verify this with their own information. We will engage with the Commission on its benchmark costs in due course.

Our previous input to the Commission expressed support for bottom-up analysis and benchmarking of retailer costs, with the following cautions:

- both methods require access to accurate data
- the Commission should focus on changes in retail costs over time rather than rely on historic averages
- there are a range of investments and other costs being incurred to accommodate regulatory interventions that are Victorian specific, however it may be difficult for retailers to produce accurate cost information for some of these
- best to separate out retail costs for residential and SMEs
- in the event the Commission prescribes individual tariff components (which we disagree with), retail costs should be allocated to the fixed component of the regulated tariff. Retail costs are more correlated to customer numbers than energy delivered.

Competition in the Victorian retail electricity market is robust. Retailers are incurring significant CARC in competing for active customers and defending existing customer bases. We welcome the Commission further examining CARC from an efficiency standpoint. We interpret the reference to a 'modest' CARC allowance to mean 'less than efficient'. The Government or the Commission should clarify this, including what the expectations are for retailer marketing practices.

## Retailer margins should be based on a range of information

We support the suggestion in the Commission's staff paper that allowances for retailer margins be progressively reduced over time. This is in line with our overall suggestion for the Commission to adopt a cautious approach in setting the VDO initially.

Our prior feedback on retail margins during the Commission's reference price consultation was that:

- IPART's margins haven't been updated since 2013, while the risk of retail operations is increasing
- the Commission should examine a range of approaches (e.g. expected returns, bottom up and benchmarking)

- it should also consider expected and actual returns for other industries. More weight should be given to the most recent information from listed entities that have comparable risk
- care should be taken in drawing information from listed electricity entities:
    - costs may be differently allocated and reported
    - customer numbers can also be reported differently
    - data may reflect different approaches to capitalisation, reflect large once off items etc
    - costs for new entrants are likely to be higher i.e. paying today's prices
    - data for public companies may be insufficiently disaggregated to allow standardisation.

## The Commission should not set prices for individual tariff components

The form of the price constraint should be some sort of weighted average price or applied as a dollar per customer amount.

Allowing regulated entities to set individual prices involves a better allocation of risk (i.e. in the face of uncertainty, the entity should align prices to costs to minimise profit risk) than does a price cap on individual components. The Commission will be limited in its ability to accurately determine how benchmark or efficient costs should be allocated to fixed and variable components, particularly where the regulated tariff is applied across a potentially diverse customer base. Capping the average price or bill potentially allows retailers to offer multiple tariff components, including those that mirror network tariffs that are not 'flat' in structure.

That said, we support the VDO being a flat tariff structure, as standing offer customers are unlikely to want or respond to other, more elaborate tariffs. There are also drawbacks in setting the VDO as an average price or bill amount, including having to make assumptions on sales volumes, and managing bill impacts for customers with usage profiles that inevitably diverge from these assumptions.

## There are many matters yet to be resolved that warrant a delay

The public forum held on 21 January highlighted a range of implementation issues that are still yet to be resolved. The process for resolving these is not entirely clear but we will continue to work with the Commission and the Government over the coming months. Some of these issues present a challenge for us in planning around the impact of the VDO, including how it might affect market offer contracts and generally communicating change to our customers.

We consider it is in the interest of consumers to delay the implementation of the VDO until 1 January 2020 and will be raising this with the Government. The Commission should identify, in its recommendations to the Government, the limitations of developing a VDO in a compressed timeframe and how it has accommodated these. We consider there are no overwhelming public demands to immediately reduce standing offer prices. As outlined above, we and other retailers have already taken recent action to reduce the energy bills of customers on standing offers. A range of other reforms will be implemented on 1 July for the benefit of customers without the need to rush the imposition of a price cap.

The expected reduction in standing offers prices, without necessarily affecting prices paid by market offer customers, reduces the value of any discounts when expressed relative to standing offers. This apparent loss of benefit will cause customer dissatisfaction and is a real cost for us in managing customer expectations. There is also the prospect of the VDO being set below some existing market offers, requiring price changes for these customers.

It is not yet clear if or how the VDO, as a basis for retail discounts, will affect discounting practices in Victoria. Several recommendations from the Thwaites review relating to discounting (i.e. recommendations 3A, 4A, 4D and 4E) have been endorsed by the Government. In undertaking this work, we encourage the Commission to consider the interplay between the VDO and these recommendations.

Additionally, the VDO is being implemented during a time of significant regulatory change in how we communicate our offers to our customers in Victoria. From 1 July 2019, we will be required to ensure:

- customer bills and summaries include a 'best offer' message
- all tariffs, fees, prices and charges are to be expressed in GST inclusive terms only
- customers receive prior notice of any price or benefit changes that could affect their bill
- customers are provided with key information prior to signing up for a contract (clear advice entitlement)
- a new energy fact sheet is available which will include a comparison tool to help customers compare plans based on how much they would cost per annum for a range of typical customers.

We have established internal processes to ensure full regulatory compliance and minimise customer disruption in relation to new policies and programs. However, we are challenged by the sheer number and scale of these reforms. We are concerned that an additional change, developed in a compressed timeframe, will create further confusion for customers and increased complaints, particularly if the VDO impacts market offers.

We support the VDO applying for calendar years, in line with Victorian network price determinations. The Commission should make provisions for cost pass throughs in the same way as those for other price regulated industries e.g. genuinely uncontrollable costs, materiality etc.