momentum energy

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

**Victorian Default Offer for domestic and small business electricity customers**

Thank you for the opportunity to provide a submission in response to the Victorian Default Offer for domestic and small business electricity customers Staff working paper.

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 acknowledges that some Victorian consumers are paying too much for energy. We do believe however that under an appropriate regulatory and enforcement framework competition will lead to continued product innovation, optimal customer service and the lowest prices. Thwaites recommendations 3-11 were the ideal vehicles for pursuing these objectives.

The Victorian Government has however decided to implement the full suite of recommendations, and in doing so in a contracted timeframe, placed the ESC in a difficult position in terms of its task in setting the VDO. Through its proposal to heavily rely on benchmarks, the ESC implicitly acknowledge that the timeframe imposed for the setting and commencement of the VDO is less than ideal. In order to achieve a VDO which provides the best possible results in the circumstance, any element of the retail cost stack which cannot be directly determined, or where a proxy or benchmark is used in lieu of actual data the ESC must assume a conservative stance.

As outlined in the ACCC's Retail Electriciy Pricing Inquiry final report (the REPI), regulatory costs in Victoria may be lead to retailers facing significantly higher prices than in other states. While these costs are difficult to determine, there is little question that since the finalisation of the REPI, these costs have increased.

The Payment Difficult Framework which commenced on 1 January 2019 has caused retailers to invest significant capital into the development of new systems and processes. In addition the cost associated with customer debt, one of a retailer's most significant costs, is likely to increase as a result of the reforms. This unique set of regulatory requirements almost completely invalidates any proposed benchmarking as there are costs to operate in Victoria which simply do not exist in other jurisdictions. Retailers, including Momentum, lobbied hard for a full Regualtory Impact Statement to be prepared for this reform, and while the the ESC eventually proceeded with some cost benefit analysis from ACIL Allen, this will be inadequate to determine the actual implementation and ongoing operational costs for the purpose of the VDO. It is unclear to Momentum how a regulatory framework which differs so markedly from any other in the country can be appropriately benchmarked.

Victorian customers face other costs as a result of a broad range of regulatory and policy decisions past and present which have not, and cannot be adequately costed. While Momentum is happy to discuss directly with the Commission the costs it has incurred in implementing a number of reforms, we are unable to provide any indication of the ongoing cost of decisions (such as the other requirements which will commence on 1 July 2019) as these are still subject to business decisions (many of which will be determined by the level at which the VDO is set) and will lead to changes in the market which cannot yet be predicted.

Ideally, any process to set retail prices would follow a period where the impact of each incremental change to the regulatory framework had been costed, and allow sufficient time to ensure that appropriate analysis could be undertaken rather permitting only a truncated process which relies on benchmarking. As an independent economic regulator the ESC must recognise the potential for significant damage to the industry, consumers and the economy more broadly if an incorrect VDO is determined.

In light of this environment where regulatory change is the only constant, we do not believe that an appropriate scientific basis for determining a fair price for electricity exists, and consequently the ESC should use look to the market, however imperfectly it is currently operating, as a guide. Recognising the ESC's unevitable position in being required to set a price where it is not possible to accurately determine each cost element, we believe that extreme conservatism in setting the VDO is warranted.

**Operating Costs**

The ESC must make a decision on how it wants customers to be treated under regime where the VDO serves as a reference price. All of Momentum's call centre operations are based in Australia in order to provide better customer service and greater visibility and accountability for compliance purposes. The decision to operate in this manner comes at the expense of retail margin as local call centres are invariably more expensive to run than those outsourced overseas. Not all retailers operate in the same manner as Momentum and an inappropriately low allowance for operating costs will almost certainly see more retailers look to offshore operations to reduce costs. This will have negative impacts for Victorian consumers as well as the economy more broadly as roles are moved out of Australia.

Similarly, retailers have made decisions on how they have implemented the Payment Difficulty Framework within the latitude provided by the ESC's final decision. It is unclear to Momentum how the costs of complying with the scheme will be accounted for. It seems logical that an 'efficient retailer' would implement on the basis of the least cost approach however, if this is assumed it will provide incentives to retailers who have gone above and beyond the requirements to provide support and assistance to consumers to revert to the 'tick the box' approach to compliance which the ESC has been attempting to shift the industry away from.

**Customer Acquisition and Retention Costs (CARC)**

Momentum is supportive of the Government's decision to partially head the ACCC's advice and incorporate customer and retention costs in the VDO. We are concerned however that the allowance is to be 'modest' rather than 'reasonable'.

We do not believe that the true nature of CARC is understood by regulators and policy makers. In addition to discounting, which Momentum agrees has not benefited consumers, one of the key product features retailers use to attract and retain customers is incentive credits. Rather than representing a dead weight loss of up to $50 per customer per year as some reports have indicated[1] a significant proportion of CARC spend is returned directly to consumers who enter into a new contract, or alternatively remain loyal to their retailer for a period of time. Paradoxically, if sufficient CARC is not allowed, a greater share of the overall retailer spend will be on items regarded by some consumer advocates as unproductive. This is because there is little value in offering sign on incentives to customers if retailers are unable to tell the market that these incentives exist, so CARC spend will be allocated largely to promotion and advertising rather than returned to consumers through incentives.

The argument that marketing and promotion is an unnecessary cost of competition and could be done away with would be more credible if not for the fact that distribution networks (monopoly elements of the supply chain) sponsor AFL matches and inundate television with advertising advising households to make friends with their local linesman. In a competitive market, the cost of marketing is the price paid to drive efficiency and innovation to provide a better experience for consumers.

Momentum would welcome an environment where they were able to more evenly compete with the larger retailers in terms of marketing spend to increase awareness of their brand. An inadequate CARC will however see smaller retailers further constrained in terms of competing with Tier 1's as even the lower cost marketing channels will become unaffordable. Retailers like Momentum will be out-shouted and the market will consolidate towards those retailers who can leverage their customer numbers to make their voice heard.

**Retail Margin**

[1] Wood, T., Blowers, D., and Moran, G. (2017). Price shock: is the retail electricity market failing consumers?. Grattan Institute. P 14.

In line with our comments regarding the inappropriateness of benchmarking, we do not see a suitable parallel to the Victorian retail energy industry for determining retail margin. Momentum do not defend the actions of some retail businesses, however, the risk that retailers face as a result of the constant stream of regulatory reform aimed at improving customer outcomes must be considered. The reports of generous retail margins in the Victorian market industry do not reflect the experience of retailers who do not have an incumbent customer base on Standing Offers or who effectively charge late payment fees in the form of missed pay on time discounts.

Dozens of small retailers have entered the market to try and limit the domination of the "the big three" as they are referred to in the REPI. All of these retailers have entered the market with a particular strategy which they hoped would see them make a reasonable return on investment. The changes in the regulatory framework have rendered many of these strategies unviable and led to capital costs being sunk. In an environment such as this a 'reasonable return' of 5.3-6.1%[1] is unlikely to be a enticing prospect for investors as the likelihood of such a return ever eventuating is slim. In a high risk environment such as the constantly shifting goalposts of the Victorian retail energy market, a margin of up to 11.2%[2] is not unreasonable. We further contend that if such margins are currently being achievd by retailers, which is not a given, the suite of reforms being implemented as per other recommendations of the Thwaites report ensure that this is no longer the case.

Momentum is not suggesting that it is appropriate for the providers of an essential service to make returns in excess of 10%. We contend that, this is the level that should be built in to the VDO as they will never actually be achieved. As demonstrated by the dispersion of retail prices in the market, for a net 11.2% margin to be achieved, some customers are clearly paying much, much more than this. Whatever the maximum margin allowed under the VDO, actual returns to retailers will be significantly lower. As the ESC has indicated that the VDO setting process will be refined over time, margin allowances can of course be adjusted for future periods if appropriate outcomes are not being realized.

**Treatment of Solar**

Momentum supports the Victorian Government's commitment to distributed renewable generation and acknowledges the part that the ESC plays in regulating solar feed in tariffs. We are however concered about the distortionary effect that government policy is having and are curious as to how the ESC plans to account for this distortion.

The terms of reference received by the ESC as part of its review of distributed generation contained an explicit instruction to ignore the costs associated with distributed generation[3]. Not only does the issue arise as to the quantum of these costs, but also whether any VDO genuinely does represent a 'fair' price for electricity if customers who are unable to install distributed generation continue to subsidise those customers who can.

[1] SFG Consulting 2013. Estimation of the regulated profit margin for electricity retailers in New South Wales, June

[2] ESC analysis of ACCC 2018. Retail price inquiry – Final report, July.

[3] Essential Services Commission 2016, The Energy Value of Distributed Generation, Distributed Generation Inquiry Stage 1 Final Report, August 2016. Appendix B

We appreciate that the Government's policy position regarding a prohibition on solar price discrimination is outside the ESC's remit, but we believe that the issue must be considered and brought into focus so that Victorians can see its impact on retail prices. It is appropriate for the ESC to make mention in its draft and final decisions that a VDO will not represent a fair price for energy as long as the current policy whereby the costs faced by retailers associated with distributed generation are taken into account.

The ESC has previously commented they "expect energy retailers will pass the cost of complying with the FiT legislation on to their customers through their retail electricity tariffs"[4] so we expect that these costs be built into the Victorian Default Tariff even though this would seem to undermine the policy principle of fairness.

**Conclusion**

Momentum is supportive of reforms to improve outcomes for Victorian electricity consumers and reintroduce an element of fairness which has been sadly absent. As the detail on Thwaites recommendations 3-11 have started to come to light however, we are increasingly firm in our belief that these recommendations are incompatible with the VDO as it is proposed.

Acknowledging that the ESC cannot dictate policy but is required to follow its Terms of Reference, we believe that the ESC should ensure that the VDO is set at a level which allows the competitive market to flourish. This approach is consistent with the Terms of Reference as they state that the ESC must act in accordance with its objectives under its governing legislation. The primary objective of the Commission under the *Essential Services Commission Act 2001* relates to protecting the long term interests of Victorians and must be facilitated by, among other things, ensuring efficiency in regulated industries and the incentive for efficient long-term investment; the financial viability of regulated industries; and effective competition and promote competitive market conduct. A price which does not capture all the costs which retailers face in the Victorian market will not satisfy this objective and the ESC should be mindful of this when determining the VDO.

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

Yours sincerely

Joe Kremzer
Head of Regulatory Affairs

[4] Essential Services Commission 2016, The Energy Value of Distributed Generation, Distributed Generation Inquiry Stage 1 Draft Report, April 2016. P29.