1stenergy.

04 April 2019

Essential Service Commission
Level 37, 2 Lonsdale Street
Melbourne
Melbourne VIC 3000

Sent via email to: RetailEnergyReview@esc.vic.gov.au

Re: Victorian Default Offer Draft Advice PUBLIC VERSION

I refer to your Victorian Default Offer draft advice (VDO) setting out a methodology for determining a fair and efficient price for electricity for Victorian residential and small business customers and provide thanks to the Essential Services Commission (ESC) for the opportunity to provide a submission.

1st Energy is a non-integrated, second-tier electricity retailer for residential and SME customers. Founded in April 2015, 1st Energy operates throughout the eastern states of Australia including New South Wales, Queensland, Tasmania and Victoria.

Energy is an essential service and the industry, regulators and governments have a collective responsibility to deliver reliable and affordable access. There is no single answer in responding to the nation's energy affordability challenges however, we recognise the Victorian Default Offer (VDO) provides an opportunity to present a fair price for customers that have either through circumstances or choice disengaged from the energy market balanced against retaining a market that retailers can continue to participate in.

In support of these objectives our submission focuses on two key areas:

1. The proposed pricing methodology and inputs for determining VDO prices
2. The long-term impacts on competition and consumers

We note that the matters set out in Appendix A, B and C in this submission are considered **confidential** and accordingly request Appendix A, B and C to not be published.

1. Proposed pricing methodology

Wholesale Electricity Costs

The ESC proposes a 'futures market' method to estimating the wholesale electricity costs included in setting the VDO prices and have engaged the services of Frontier Economics to perform the modelling.

The futures market method requires inputs for:

- The likely half-hourly load of the retailer's customers;
- The corresponding likely half-hourly spot prices the retailer will face;
- The cost of financial hedging contracts that retailers will face; and
- The hedging position a prudent retailer is likely to adopt.

Our key concerns with the modelling/formulas used by Frontier Economics in determining the wholesale electricity cost input are:

- There is a lack of transparency with the Frontier Economics model which doesn't enable us to back-test the numbers.
- We are concerned that the model is based on retrospective trading for cost optimisation averaged over 12 months and doesn't allow retailers to execute the hedging implied in the modelling. 1st Energy's view is that the wholesale input cost reflected in the VDO should be forward-looking – i.e. for the next incremental customer and set from the prevailing market price at the time of determining the VDO.
  Different methodology used compared to the approach taken to feed-in tariffs. The draft advice states that the "feed-in tariff is based on a 40-day average because that is the market's current expectation of what prices will be in the future". This logic should also be the basis of determining the wholesale energy cost for the VDO.
- The use of out-dated load profiles. Load profiles have shifted significantly over recent years with the increased uptake of roof-top solar. More weight should be given the load profiles of the past 2-3 years rather than dating back to 2012.
- Retailers manage their customers exposure to the volatilities of the wholesale market utilising various strategies. Retailers should be given appropriate time to implement their hedging strategy in-line with the VDO determined outcomes to ensure we can at a minimum achieve similar outcomes as determined by the ESC.

Given LRET and SRES targets for 2019 have been confirmed by the Clean Energy Regulator, we ask the Commission to incorporate the targets into the setting of the VDO. The SRES target has increased from 17.08% to 21.73% and the LRET target from 16.06% to 18.60% (levels that are higher than the analysis included in the draft VDO).

Our assessment is the wholesale price allowed for in the draft VDO has been set too low considering where the forward wholesale futures market sits today which is demonstrated in the wholesale chart set out at Appendix A. Basing prices from averaging the previous 12 months is likely to result in a material reduction in competition; favouring and increasing the market power of large vertically integrated retailers. The Draft Advice notes that "larger retailers tended to favour longer averaging periods". In setting the wholesale electricity cost below the current prevailing market price (which using a 12-month historical average would occur using the proposed WEC), smaller and new entrant retailers would not be able to grow their customer bases, consequently eliminating competition.

Retailer Operating Costs

1st Energy is supportive of the Commission setting the allowance for retailer operating costs (ROC) based on the actual ROC of existing retailers; and consideration of benchmarking against allowances for ROC in other regulatory decisions.

As currently set the Commission's proposed cost to service allowance of $104.50 is significantly lower than all recent regulatory reviews of ROC inputs. This is evidenced by the graph set out at Appendix B. The ACCC REPI did not incorporate figures from all retailers relating to cost to serve (1st Energy was not requested to provide information relating to ROC) and therefore is not a complete view of ROC across the industry. However, the REPI notes that there are large differences in cost to serve between large retailers and other retailers.

Our principle concern is the use of ROC/cost to serve figures produced by publicly listed retailers which include significant off-shoring of back office functions. Outsourced providers offer a lower cost to

serve and this utilisation assumption will lead to off-shore outsourcing and ultimately Victorian job losses.

Accordingly, 1st Energy asks for consideration of the following elements for inclusion in the Commissions proposed ROC allowance:

- A bottom-up approach to cost to serve of the actual ROC of existing retailers
- Customer service and back office jobs factoring in on-shore costs
- Allowance for a higher ratio of bad debt. Bad debt is a significant issue/cost to most retailers, and retailers carry the bad debt risk of the entire industry. As a recent entrant to the market, the customers 1st Energy supplies on standing offers are generally limited to deemed customer retail arrangements, commonly known as unknown consumers or occupier accounts. These are customers whom refuse or fail to take appropriate steps to enter into a customer retail contract as soon as practicable. The proposed pricing profile of the VDO doesn't reflect the pricing profile that is associated with these customers and the ongoing risk of these customers failing to pay. Appendix C highlights 1st Energy's observed payment performance of unknown consumers which results in significantly higher bad debt costs compared to market customers. As the VDO has no incentive for prompt payment, (which historically reflects a portion of bad debt) it could be argued the bad debt provision should be higher than average. Furthermore, we have grave concerns that the payment difficulty framework (PDF) will place significant upside risk on bad debt but this will be revealed over time in retailer's bad debt position.
- In the absence of a bottom up approach utilisation of an estimate of cost to serve in line with recent regulatory determinations

To assist the Commission with their calculation of the ROC, 1st Energy would welcome the opportunity to meet with the Commission and make evident our ROC.

Customer Acquisition and Retention Costs (CARC)

At a minimum, the CARC allowance should be based on Victoria and not a weighted national figure, as this is a better reflection of the dynamics of the Victorian market. The ACCC REPI did not include figures from all retailers (1st Energy was not requested to provide information relating to CARC). In the absence of this information we recommend that the Victorian CARC figures be included for the CARC allowance in the setting of the VDO.

2. Long-term impacts on competition and consumers

The existing price differentials can be a means of competing and of intensifying competition, conversely heavy regulation and a VDO set too low is likely to homogenise and stifle a market. The Grattan Institute paper December 2017 Competition in Australia *Too little of a good thing* discusses how competitive pressure is key to good economic performance. It pushes prices towards costs. It moves resources to their best uses. It can push firms to come up with good ideas. Conversely heavy-handed regulation can shape competition and add to the cost of doing business in a sector, particularly for smaller firms ultimately disadvantaging small firms.[1]

Price differentiation has provided lower prices to active customers, reflecting significant competition, not a lack of it. This is not to deny that differential prices, particularly those that may impact on some vulnerable customers may be a significant social or public interest concern. But a mechanism which

[1] https://grattan.edu.au/wp-content/uploads/2017/12/895-Competition-in-Australia-Too-little-of-a-good-thing-.pdf

1st Energy Pty Ltd, PO Box 1045, Hampton North, VIC 3188 | www.1stenergy.com.au

provides a false ceiling to force engagement across a broader customer base is a blunt tool to resolve an important issue and will not be in the long-term interests of customers.

The ACCC does not consider that the ESC should determine the efficient cost of supply in each jurisdiction or distribution zone, or that the ESC should set the VDO at an 'efficient' level. The ACCC considers that inefficiencies in the supply of electricity are better tackled by facilitating effective competition between retailers that drives prices down towards efficient costs. In the recent dynamic of advertising large headline discounts, facilitating competition between retailers will involve giving retailers room to discount well below the VDO. [2] If the ESC creates a flat, below cost tariff, effectively homogenising the market, then the market offers currently available must contract in response and existing customers maybe repriced and cross subsidisations occur. The spread and availability of market offers is diminished overall, and this will impact vulnerable customers and their accessibility to discounted rates and/or incentivised payment plans. Shrinking the number of options available to consumers doesn't provide them with better options—it limits them.

The introduction of a VDO as currently proposed is likely to lead to higher prices for engaged consumers, with market offers at the bottom end of the spectrum increasing; impacting vulnerable customers and those who shop around for the cheapest deal; consequently, penalising those that choose to engage in the market.

Price regulation is not something that can be simply "turned on" and then "turned off and it is our view that the implementation of the VDO as it currently stands will result in Tier 3 retailers exiting the market, a significant loss of employment, (both directly and indirectly), a restriction of competition and ultimately increased costs to consumers.

Lastly, given the complex nature of setting pricing and significant risks if the VDO is set too low 1st Energy strongly supports a mandatory annual review framework and a sunset clause for the VDO.

1st Energy thanks the Commission for the opportunity to provide a submission and would welcome the opportunity to meet with the Commission at their earliest convenience. For any queries regarding this response, please contact Aneta Graham, Head of Regulatory and Compliance,

Yours sincerely

Liam Foden
Managing Director
1st Energy Pty Ltd

[2] https://www.aer.gov.au/system/files/ACCC%20-%20AER%20Default%20Market%20Offer%20-%20Submission%20to%20Position%20Paper%20-%207%20December%202018.PDF