PO Box 4136
East Richmond VIC 3121
T 131 806
F 1300 661 086
W redenergy.com.au

PO Box 632
Collins St West VIC 8007
T 1300 115 866
F 1300 136 891
W lumoenergy.com.au

4 April 2019

Dr Ron Ben-David
Chairperson
Essential Services Commission
2 Lonsdale Street
Melbourne VIC 3000

Submitted electronically: RetailEnergyReview@esc.vic.gov.au

Dear Dr Ben-David,

Re. Draft Advice Victorian Default Offer to apply from 1 July 2019

Red Energy and Lumo Energy (Red and Lumo) provide the following submission to the Essential Services Commission (the Commission) on their Draft Advice for the Victorian Default Offer (VDO) to apply from 1 July 2019 (the Draft Advice).

Red and Lumo have grown their customer based in Victoria over time, offering a genuine alternative to incumbent retailers in terms of competitive pricing, added value and service levels. We support retail competition and consider that the introduction of the VDO may jeopardise the current market and impact the range and value of offers that are available to consumers in the future. We accept that the ESC must implement the VDO, therefore provide our submission from the viewpoint of ensuring customer outcomes and experiences in the retail energy market are not negatively impacted by the VDO.

Customer impact and Commission approach

The Commission must ensure that it strikes the right balance in determining the level of the VDO between allowing recovery of reasonable costs and protecting consumers who haven't sought out competitive market offers. We believe the Commission must ensure that positive aspects of a competitive market continue under the VDO while meeting its legislative requirements.

We believe that the Commission can achieve a better balance and reduce the potential for consumer detriment with some clarification and amendments to its Draft Advice. We recommend a more conservative approach given the Commission's use of proxies, incomplete information and assumptions about retailers' operations to develop the VDO. The more aggressive the Commission is with its assumptions about retailers' costs under the VDO, the more likely there will be consequential detriment for consumers who have been more active in the market up to this point. Similarly, the lower the VDO, the less consistent it is with the Commission's legislative objectives with respect to full retail competition, incentives for long term investment and the financial viability of the industry.

Of most concern is that Victorian consumers misunderstand the intent of the VDO. Consumers who have taken advantage of the benefits of the competitive market may switch to the VDO and in fact be worse off. Alternatively, actual savings for other consumers will usually be less than what the Commission estimates, depending on their current contract. We urge the Commission to take the lead in ensuring consistent

LE446.ALL.0915.e

accurate messaging regarding the VDO from the Victorian Government, consumer groups, retailers, financial counsellors and other stakeholders.

Wholesale component

We welcome the update from the Commission that steps are underway to obtain disaggregated meter data from networks, to obtain a more accurate load profile, one that better aligns with the VDO's coverage (described at the recent public forum as an 'active area of investigation'). The Draft Advice states that Frontier believes the impact of using aggregated MRIM data is minimal. This view was not supported by non-incumbent retailers at the public forum. We strongly support the Commission using the most accurate data available to ensure that the VDO reflects the consumers that it will apply to. We note that Tier 1s are more likely than smaller retailers to support the up to 160MWh data as this reflects their larger and broader customer base, therefore they are better placed than other retailers to absorb this impact.

The Commission using a 12 month average of forward contract prices, rather than 40 days, as was flagged earlier in the review helps achieve the balance in its determination for consumers. As it is aligned with actual retailer practice, it is a more pragmatic approach to estimating efficient wholesale costs. We recommend that the Commission should extend this approach to LGCs.

We note that the Commission's staff issues paper suggested that the price outputs would be representative, well-accepted and transparent. However, we remain unclear about the risk management assumptions that Frontier uses in its STRIKE model to determine the hedge position of a prudent retailer. Frontier's report to the Commission on the calculation of efficient wholesale costs describes its approach referring to the following:

- The use of its portfolio optimisation model – STRIKE – to determine the efficient mix of hedging products that a prudent retailer would likely adopt.
- That STRIKE calculates an efficient frontier, which are contracting positions that provide the lowest energy purchase cost for a given level of risk.
- STRIKE applies a Minimum Variance Portfolio approach to hedging a retailer's exposure to wholesale spot prices. STRIKE applies the concepts of portfolio theory to evaluate the contribution of each asset to the risk of the portfolio as a whole.
- STRIKE selects a 'conservative' point on the efficient frontier, which reflects the contract position that achieves the lowest risk given the projected state of the world that is input into STRIKE.
- In the event that different states of the world were input into STRIKE, the model would find a different contract position.
- Load forecasts and price forecasts (and their correlation) are important to the costs that retailers face in supplying regulated customers, and Frontier claims to use '*the best available information to develop load forecasts and price forecasts that are consistent with the observed peakiness of historic load and historic prices*.'[1]

While this description at first read appears to describe a reasonable theoretical approach, the STRIKE model remains a black box that appears to make assumptions

[1] Frontier Economics (2019), *Wholesale Electricity Costs: A Report for the Essential Services Commission*, page 29

on top of assumptions. This results in no genuine opportunity for retailers to analyse these inputs and assumptions, or assess the sensitivity of outputs to different inputs.

On this basis, we must take it on faith that the STRIKE model is a reasonable representation of actual retailer behaviour in a competitive market. However, there is real potential for error that could penalise all retailers or disadvantage particular hedging strategies. Moreover, the lack of detail about the precise working of the STRIKE model and its inputs, contradicts some of the Commission's own criteria for developing the VDO methodology.

Data sources

We welcome the Commission's advice that it will incorporate final regulatory determinations into the final VDO advice. This will include (at a minimum):

- retailers' liabilities under the Renewable Energy Target for both the Large-scale renewable energy target and Small-scale renewable energy schemes
- Reliability and Emergency Reserve Trader (RERT) for 2018/19
- Marginal Loss Factors for 2019/20
- EWOV fees
- cost of minimum feed in tariffs above wholesale cost allowances.

Through the use of timely and accurate data sources the Commission is ensuring that the most appropriate and fair VDO is set for consumers. A VDO that reflects the actual costs incurred on behalf of consumers by retailers, ensures that there are no surprises when the VDO is reset. However, we note that the Commission will need to consider how to maintain this fair approach as it sets the 1 January 2020 VDO when the transition to a bottom up model occurs.

Building block methodologies for retail price regulation generally allow a regulator to look backwards at the end of a period and then adjust the future price path to include allowances for actual cost movements. A miscalculation of the cost of complying with environmental schemes for example in year 1 can be corrected in year 2.

We note that while this aligns to the timing of the Australian Energy Regulator's (AER) determination of annual prices for the Victorian electricity distribution networks, but creates an issue with environmental costs and the minimum feed in tariff that the Commission itself sets. They may change materially during the second half of the 12 months over which the VDO applies.

Retail Component

The timeliness of data sources is also relevant for the estimation of retailers' operating costs and for customer acquisition and retention costs (CARC). As the Commission is aware, the ACCC's Retail Electricity Price Inquiry (REPI) Final Report was finalised in June 2018 and the data inputs were for the 2016/17 financial year. While the most recent and comprehensive publicly available dataset, the Commission must consider the changes since 16/17 and adopt a conservative approach when applying that data to the 1 July 2019 VDO.

From a consumer perspective, the Commission must set the VDO as a fair price, including all costs and risks that retailers are covering on behalf of consumers. This will ensure that the Commission meets its balanced outcome, not setting the price too high or too low. We note that since the REPI was released, the most substantial changes to Victorian retailer operating costs have been the Payment Difficulties

Framework (PDF) and the numerous regulatory initiatives to implement the recommendations of the Independent Bipartisan Review of Electricity and Gas Retail Markets, including:

- best offer on bills obligation
- clear advice entitlement
- advance notice of price changes and end of fixed benefit notices (which include additional prescribed content such as a best offer calculation) and
- require to express all tariffs, fees, prices and charges only in GST inclusive terms
- changes to energy price fact sheets.

Looking ahead, the Commission is proposing to develop new rules for retailer contracts, will review the Energy Retail Code and Distribution Code, and is developing a framework to offer improved protections for customers affected by family violence. At the national level, retailers are working to implement the industry's move toward five minute and global settlement.

We do not challenge the policy intention of these measures. However, they come at material cost, which wasn't projected at the time of the ACCC's analysis or previous regulatory determinations that the Commission identifies in Figure 7 of its Draft Advice. These initiatives have and will generate additional costs for retailers in terms of implementation and ongoing compliance, which we urge the Commission to consider in its final determination similar to the PDF.

A further consequence of these recent regulatory initiatives is that they prevent retailers from investing in additional capability, innovation and services for the customers or in measures to substantially reduce cost to serve.

Additionally, the Commission's treatment of business development costs and investments in systems to maintain and upgrade systems - to ensure regulatory compliance, for example - is unclear. The Staff Working Paper made reference to business development costs as an element of CARC, however, there is no mention in the Draft Advice. We note that retailers provided data to the ACCC for the REP but the allocation of costs between CARC and operating costs differs from retailer to retailer (including the allocation of business development costs).

We expect that system and/or capital development costs of publicly listed retailers are excluded from both operating costs and CARC and are in corporate overheads. However, for smaller retailers, business development represents the investment required to operate. We seek confirmation that the Commission will include business development and other investments in systems as part of its estimation of retailers' costs, either in retail operating costs or in CARC, noting its statement that '*the terms of reference note that the VDO will reflect the terms and conditions for standing offers. We have assumed therefore, that the government expects no deterioration in the quality of service experienced by customers.*'[2]

Payment Difficulties Framework
We welcome the Commission's decision to include a specific allowance for complying with the PDF. However, its precise impact is highly uncertain and the contribution to operating costs may exceed this amount, particularly when the impact of bad and doubtful debt is taken into account.

---

2 Essential Services Commission (2019), *Victorian Default Offer to apply from 1 July 2019: Draft advice,* page 12

LE446.ALL.0915.e

While we support the PDF, the Commission must take a realistic view of its contribution to cost. The Commission explains that it has been specifically designed to reduce retailers' bad debt and the costs associated with debt recovery. This may occur, but in our view it is equally likely that the PDF will add to retailers' bad and doubtful debt risk by virtue of its broad coverage and its parameters; this cannot be known until it has been in place for some time. Retailers are now obligated to offer defined assistance, including staged payment plans, at an early stage and at prescribed points. Similarly, they must offer repayment options over defined timeframes and must take additional steps prior to disconnection for non-payment.

The incentive effects are not yet known. Consumers could de-prioritise energy payments as a result (or be encouraged to do so) and may take longer to repay energy debt than they otherwise would have (two years rather than six months, for example). As a rule, debt becomes less certain and recoverable the longer it is held.

Victorian retailers can also expect to see a higher volume of queries from customers and ombudsman cases in the early stages of the PDF (and potentially the clear advice entitlement). This occurs as all parties come to better understand how the scheme operates in practice, as they assess its impact and whether outcomes align with policy objectives. The Commission acknowledged this point in its final decision for the PDF, in which it stated that '*while the new framework beds down, we expect there may be an increased caseload for the Energy and Water Ombudsman (Victoria)*' and that its guidance note would need to '*evolve over time in response to how the framework is implemented in practice.*'[3]

We also note the Commission's suggestion that the VDO and other reforms will see fewer customers on 'over priced retail contracts', which should '*prevent customers accumulating debt from which they cannot recover and which must be written-off by their retailer*'.[4] There is no basis for believing this will have a material impact on retailer debt. It is arguable (if not highly likely) that customers on relatively highly priced contracts are not sensitive with respect to price and tend to pay their bills on time and in full.

In summary, there is real potential for the PDF to add to operating costs to a greater extent than the Commission anticipates.

Customer acquisition and retention costs (CARC)

The Commission has been instructed to include a modest allowance for CARC. From a customer perspective, the experience that Victorian consumers have come to expect is numerous offers and products available, some with benefits that extend beyond providing energy. Essentially, CARC funds choice, choice delivers commercial pressures that deliver better value to consumers. As a result, the more modest the Commission considers CARC, the less choice there is likely to be in the market for every Victorian consumer and the less rivalry to deliver better outcomes for consumers.

3 Essential Services Commission (2017), *Payment Difficulty Framework: Final Decision,* page 109 and page 83

4 Essential Services Commission (2019), op. cit., page 48

Retailer margin

We do not believe the proposed margin of 5.7% represents reasonable compensation for investors for the risks associated with the Victorian retail electricity market, particularly given the extent of regulatory change. The Commission states that this reflects recent regulatory decisions, particularly IPART's determination of regulated retail electricity prices in NSW in 2013. As noted above, the Commission must consider the timeliness of data sources. The most recent publicly available data from the ACCC's REPI report noted an average margin in Victoria of 11% and NEM-wide of 8%.[5] While the Commission dismisses the Victorian-specific margin, the NEM-wide margin represents that of both deregulated and price regulated jurisdictions.

The Commission will be aware that IPART considered a number of approaches to develop a feasible range, including:

- Expected returns approach, leading to a range of 3.9% to 4.8%
- Benchmarking approach, under which the retail margin for an electricity retail business should be 'broadly consistent with those for other comparable retail businesses, leading to a range of 6.3% to 6.6%. In our view, the energy market is riskier than many other retail sectors - such as pharmaceuticals, food and beverage, apparel, broadline, home improvement and specialty retailers, which Frontier identified as possible benchmarks - largely due to the nature of the regulatory framework and reduced ability to diversify to minimise risk.
- Bottom up approach, leading to a range of 5.6% to 7.0%.[6]

The 2013 IPART determination on margin also reflected its decision to include an allowance for CARC to promote retail competition. As IPART states:

> *We agree that the retail margin allowance should account for retailers' systematic risk only as we account for specific risks retailers face through the other cost allowances and additional regulatory mechanisms. We also agree that cost allowances should be based on efficient costs. The level of regulated retail prices will have a significant effect on the development of the competitive market. In our view, our Determination needs to have regard to the costs of acquiring and retaining customers in the competitive market if it is to promote competition. This includes providing supply side incentives for retailers to enter the market and compete for customers and demand side incentives for customers to engage in the competitive market and seek out competitive offers. These costs will be provided via the appropriate CARC allowance for the 2013 period.*[7]

In contrast, the Commission's Draft Advice flags further reductions in CARC in future determinations, in addition to the inherent uncertainty about retailers' ability to recover all costs and account for future cost movements under price regulation. This implies that a higher margin can be justified in Victoria. Even if the (implicit) policy intent is to reduce the number of viable retailers in Victoria and increase market concentration, the allowable margin appears inadequate.

---

5 Australian Competition and Consumer Commission (2018), *Restoring electricity affordability and Australia's competitive advantage: Retail Electricity Pricing Inquiry—Final Report*, page 59

6 Independent Pricing and Regulatory Tribunal (2013), *Regulated electricity retail prices - 2013 to 2016*, pp. 88 – 96

7 Ibid., page 95

Comparisons with other components of the energy supply chain can be problematic but we note recent AER determinations on the allowable rate of return for electricity distribution networks in Victoria and elsewhere:

- Draft determinations for the 2019-24 regulatory period for the three NSW electricity network businesses of 5.96%.

- Determinations for the 2016-2020 regulatory period for the Victorian electricity network businesses of:
    - 6.37% for Jemena and United Energy
    - 6.31% for AusNet Services
    - 6.11% for Citipower and Powercor.

As the Commission knows, these determinations on the cost of capital are for low risk, regulated monopoly businesses, who can apply to pass through the cost of unforeseen regulatory events. Retailers' cost of capital - an input to the calculation of margin under the expected returns approach - would be considerably higher than this and almost certainly higher than the WACC that Frontier used under its expected returns approach for the Commission[8] - even in a more concentrated market.

This discussion illustrates the challenges in selecting an efficient value for retailer margin. At the very least, we encourage the Commission to reassess the allowable margin and adopt a more conservative approach, particularly given the transitional nature of this VDO and the time available to the Commission and others to analyse this issue. We strongly urge the Commission to reconsider its position on the retail margin proposed, to ensure it reflects the right balance for investors and consumers.

Finally, we restate the view of the AEMC on the likely impact of the Default Market Offer - and the threat of price regulation - influences retailers' funding costs and the availability of capital. It stated that '*higher risks to retail businesses are already starting to be observed in the market. For example, financial market analysts are now suggesting caution on investment for publicly listed retail companies.*'[9]

Other matters

Red and Lumo remain concerned about the cross-subsidisation of network tariffs between customer segments. As noted in our previous submission, this raises the broader issue of retailers' exposure to network costs under the VDO in future years. Retailers will be obligated to offer a flat rate VDO to all customers, including - we assume - those to whom the distribution networks have assigned cost reflective tariffs. More complex network tariffs, including maximum demand charges, are currently offered on an opt-in basis in Victoria but we are aware the Victorian networks are currently considering more complex tariff structures and associated assignment policies for the next regulatory period.

At the public forum, the Commission requested specific feedback on the split between fixed and variable costs. We are comfortable with the methodology that the Commission has adopted on this matter. Further, we note that Victorian small business customers with a controlled load are priced the same for controlled load as a residential

8 Frontier Economics (2019*), Retail Costs and Margin: A Report for the Essential Services Commission,* page 59

9 Australian Energy Market Commission (2018), *Final Report - Advice to COAG Energy Council; Customer and Competition Impacts of a Default Offer*, page 43

controlled load by the networks. On this basis, we are comfortable with the inclusion or exclusion of the controlled load component for small business customers.

In relation to the embedded network customers, we consider that on-market customers (i.e. those that have chosen a traditional retailer product) should be able to continue on their existing market arrangements like other customers. However, customers in an embedded network without retailer choice (i.e. off-market customers) should not be priced above the VDO, consistent with the General Exemption Order. To do otherwise creates a separate class of consumers which neither competition nor regulation can protect from monopoly pricing damaging industry reputation.

About Red and Lumo

We are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria, New South Wales, South Australia and Queensland, and electricity in the ACT to over 1 million customers.

Red and Lumo thank the Commission for the opportunity to respond to the Draft Advice. Should you have any further enquiries regarding this submission, please call Geoff Hargreaves, Regulatory Manager on [redacted]

Yours sincerely

Ramy Soussou
General Manager Regulatory Affairs & Stakeholder Relations
Red Energy Pty Ltd
Lumo Energy Australia Pty Ltd