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Essential Services Commission

Sent by email: RetailEnergyReview@esc.vic.gov.au

VICTORIAN DEFAULT OFFER – DRAFT ADVICE

Introduction

The Victorian Default Offer (**VDO**) is arguably the most significant regulatory reform in the Victorian energy retail market since retail contestability was introduced.

As the state government has explained in its Terms of Reference to the Commission, the VDO “will provide a simple trusted and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the retail electricity market *without impeding the consumer benefits experienced by those who are active in the market.*” In doing so it will reduce the price paid by the less than 8% of Victorian customers remaining on standing offers.

Designing the VDO so that its introduction does not “impede the consumer benefits experienced by those who are active in the market” is the key task and it is one we believe the Commission in its draft advice to the state government has failed to deliver on.

If the VDO price is set too low, it will cause irreparable damage to the competitive landscape to the detriment of Victorian consumers in the medium to long term and will further entrench the dominance of the biggest three retailers in the market.

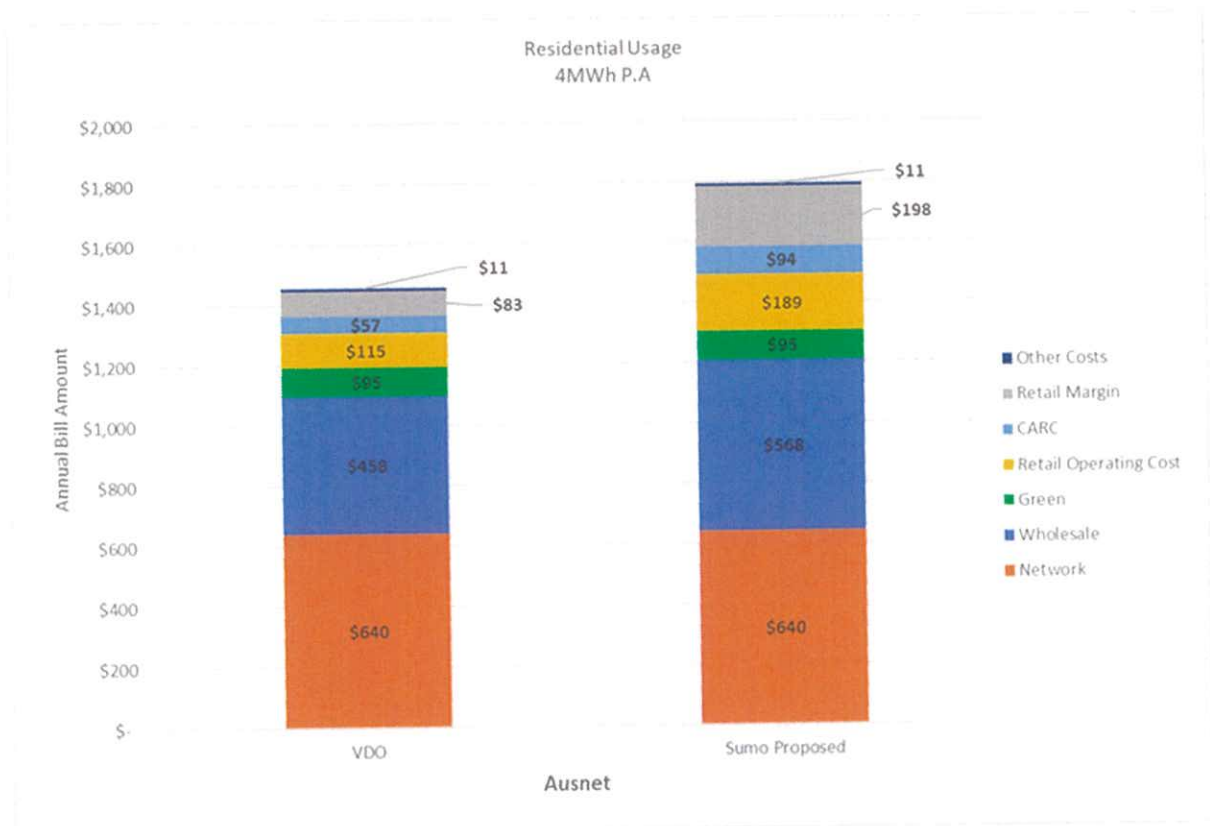
In our view:

1. the cost inputs in the Commission’s Draft Advice are manifestly incorrect, and the draft VDO price is way too low

We detail the errors in the draft methodology and cost inputs in this submission below. In brief:

- a. the allowance for wholesale electricity costs is far short of that which a prudent and efficient retailer would incur
- b. the allowance for retail operating costs is inadequate
- c. the methodology for determining customer acquisition and retention costs (**CARC**) is wrong
- d. the allowance for retail operating margin is significantly short of actual retail margins reported by the ACCC of 11% – given the highly competitive nature of energy retailing, the actual margins reflect the most appropriate reward for the risks of operating in the market

As shown in the illustrative cost stack below (for the Ausnet distribution area), the VDO price would need to increase by more than 20% in order to reflect a fair cost of servicing small Victorian retail customers. At this level, the VDO would deliver annual cost savings of up to \$250 for standing offer customers, but would also enable retailers to continue to operate and recover a fair margin.



2. the Commission’s Draft Advice fails to observe the Terms of Reference in a number of respects

We detail where the Draft Advice fails to meet the Terms of Reference below.

Retailer costs are being assessed against a standard that is not realistic. For example, assumptions used in setting wholesale costs do not adequately address wholesale market risks; retail operating costs and CARC do not reflect actual costs incurred by most retailers; retail margins do not reflect cost of capital and the risks of operating in the market. The assumptions used are at best only suited to the largest of vertically integrated retailers, who can control the wholesale market and have the balance sheet to withstand unexpected cost movements.

If the Commission advises the state government of Victoria to introduce a VDO set at a level that further entrenches this market dominance of the ‘Big 3’ then we would argue that the Commission has failed to deliver on the state government’s wish that the VDO does not impede the benefits experienced by those who are active in the market.

3. the Draft Advice would stifle competition and entrench market power

The VDO set at the levels proposed in the Draft Advice will decimate smaller retailers who do not have the strength of balance sheet to withstand low margins resulting from a poor VDO price decision. New entrants will be discouraged from entering the market. Existing retailers will exit the Victorian market in favour of other markets. The result in that the market power of the Big 3 gentailers will be further entrenched.

In the immediate term, the exit of a retailer will disrupt the customers they serve and reduce confidence in the retail market. In the longer term, the loss of challenger retailers will weaken competition. It is the smaller, challenger retailers that apply pressure on larger players to keep prices down and to continue to innovate. If you take the smaller retailers out of the picture, then prices will go up and innovation will cease.

The Australian Competition and Consumer Commission (**ACCC**) in its recent draft and final reports on the electricity market has repeatedly nominated the market dominance of the biggest three combined retail and generation businesses as the driver behind recent price increases, and ACCC chair Rod Sims has warned that governments should take steps to rein in the ability of those companies to influence wholesale prices. A VDO set at current levels will worsen this situation if it drives smaller retailers out of the market.

Wholesale Electricity Costs

The Draft Advice allowance for wholesale electricity costs is far short of that which a prudent and efficient retailer would be expected to incur. We would expect the wholesale electricity cost component of an efficient retailer to be around \$123.50 (using the baseline of \$79.50 flat, as referenced by the Commission).

As detailed below, the Draft Advice is wrong in respect of the wholesale electricity cost component because (among other things):

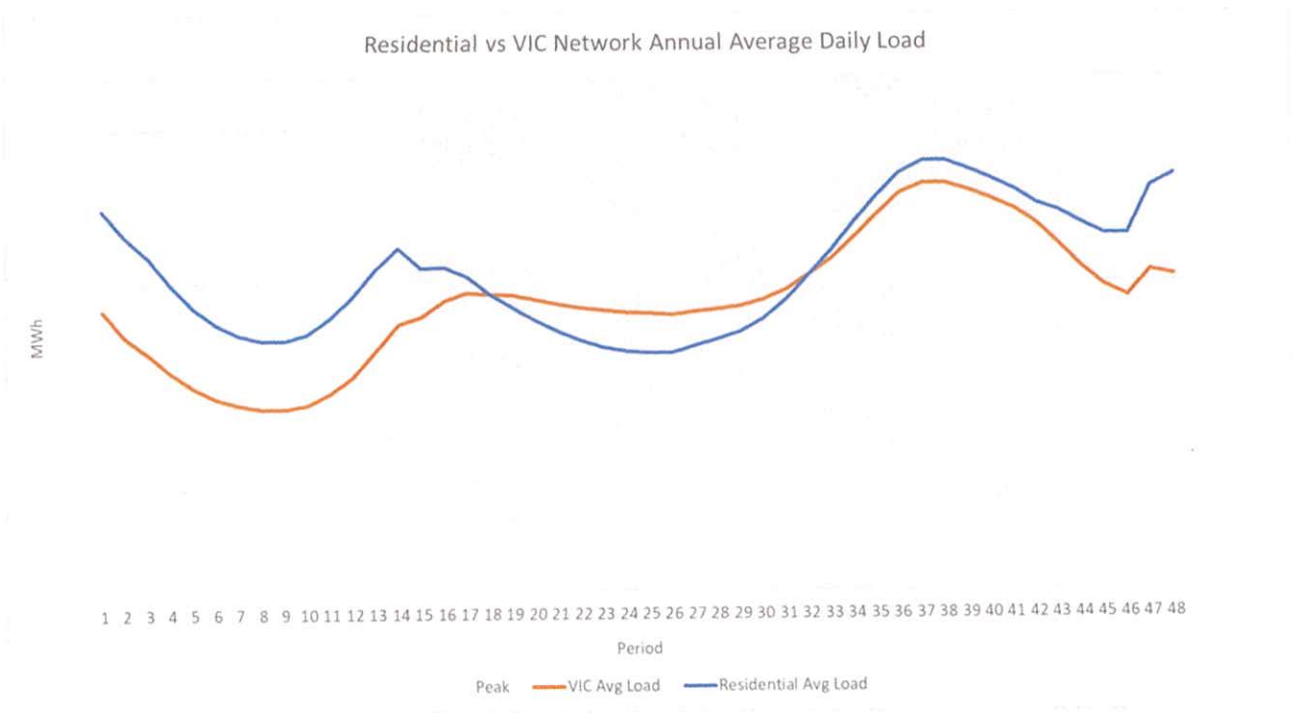
1. it adopts a far riskier hedge contract position than a prudent retailer would take – while this results in a lower hedging cost, it would also expose the retailer to unacceptable risk in periods of maximum demand;
2. it seems to adopt an approach of securing full year swaps and caps ahead of the regulatory period, rather than progressively purchasing swaps and caps by quarter – the proposed approach is unrealistic for a number of reasons, including low liquidity of futures, and the difficulty forecasting customer load, more than 12 months ahead;
3. in respect of residential customers, it adopts a load shape that does not reflect the volatility of the residential load;
4. it does not account for the working capital costs of providing credit support and meeting prudential requirements; and
5. it assesses costs for the financial year to June 2020 rather than the calendar year to December 2019, and so does not align to changes in network tariffs, which is when retailers typically vary their prices.

Consumption load data

The Draft Advice is to calculate wholesale electricity costs using MRIM data, which combines residential and business customer data (consumption up to 160 MWh per year). As we noted in our submission to the Staff Paper, the load shape for residential customers is very different to the load shape for business customers. Wholesale cost is sensitive to this difference in load shape.

The Commission notes that Frontier Economics has analysed data provided from the CitiPower and Powercor distribution zones and has advised that the difference in wholesale electricity costs for residential and small business customers would be small compared to the MRIM data (around two percent higher or lower than the estimated wholesale costs). With respect, it is difficult to understand how they reached this conclusion.

The graph below shows how an average residential customer daily load shape (blue) compares to the Victorian average daily load shape. While the capacity factor (maximum demand divided by average demand) of the residential load shape is broadly similar to the capacity factor of the Victorian average load shape, the capacity factor during the peak period is significantly higher than that of the Victorian load shape (+13%). The impact is that a retailer with a residential customer load needs to purchase peak swaps and caps for a much larger load relative to the total load. On average from 16 Feb 2018 to 15 Feb 2019, peak FY20 prices were 127% higher than flat (\$100.42 vs \$78.78). Depending on the cost attributed to purchasing peak contracts in the Draft Advice (which we do not know), we expect that purchasing the additional peak contracts to cover this additional peak load would add around \$8-\$9 per MWh to the VDO Draft Advice WEC component for residential customers.



Contract position

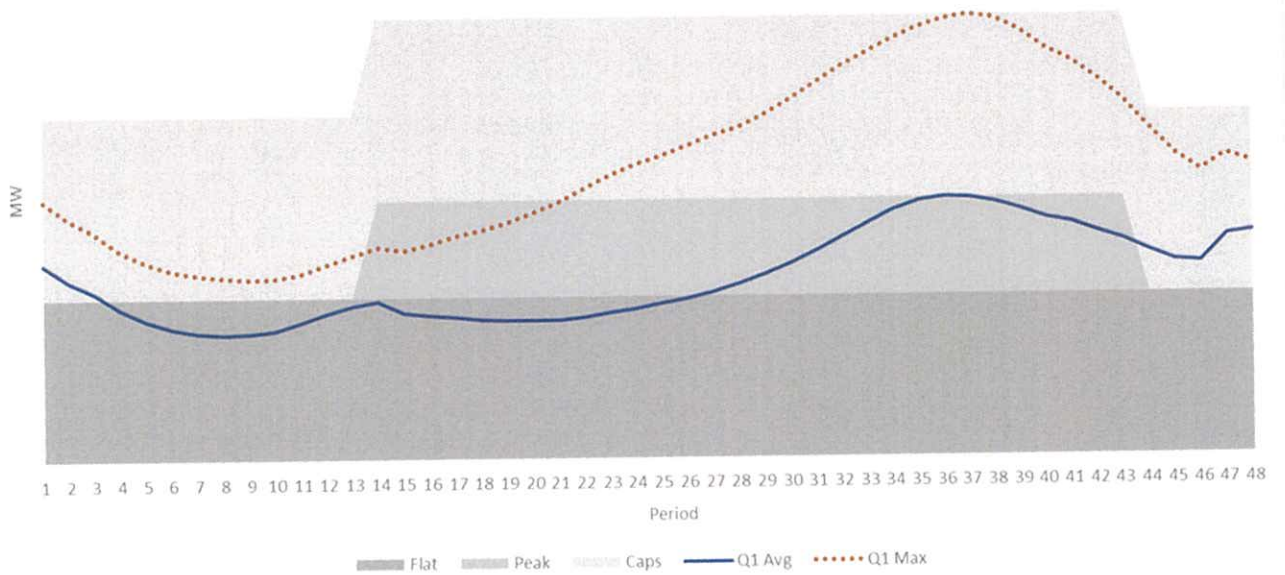
The contract position adopted by Frontier Economics using its STRIKE model is not disclosed, so it is difficult to provide specific commentary. However, some comments in the Draft Advice give cause for alarm.

First, it states that the approach involves:

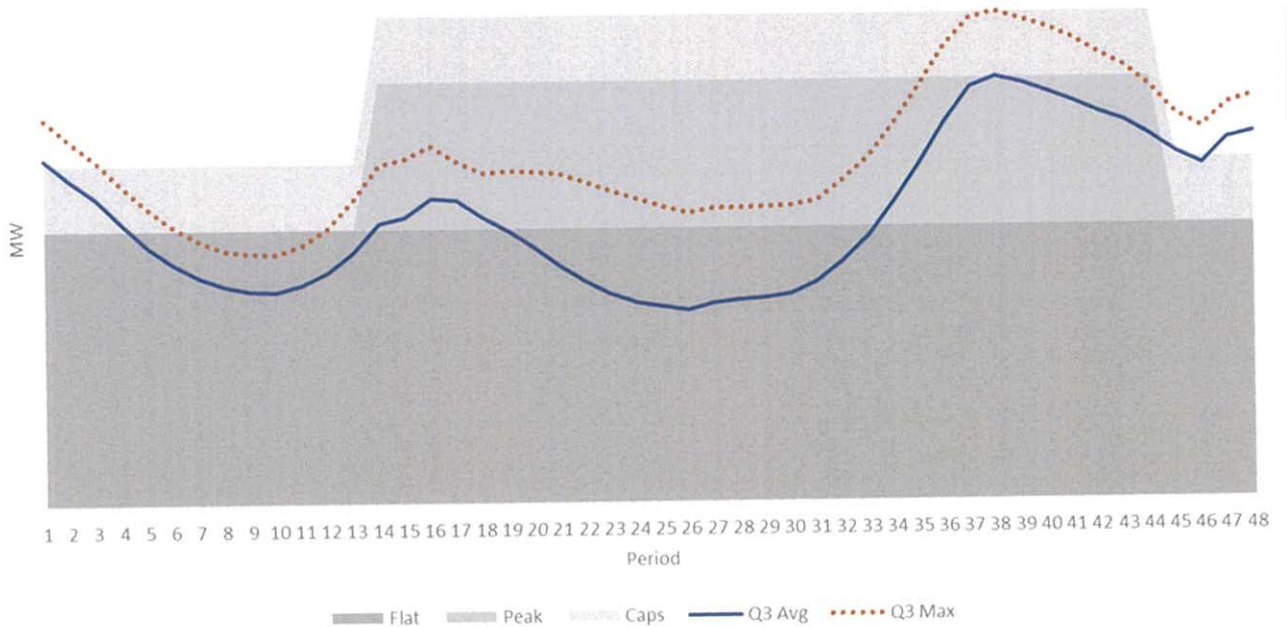
- o purchasing swaps to cover (approximately) average demand, and
- o purchasing caps to cover (approximately) peak demand, and
- o incurring a small amount of pool exposure at absolute peak demand times

By only purchasing swaps to cover average demand, and caps to cover peak demand, a retailer would be exposed to \$300 prices for any load in peak periods that exceed average demand. This exposes a retailer to unnecessarily high prices for a significant amount of its load. Rather, in addition to purchasing swaps to cover average demand, a prudent retailer would also purchase swaps to cover average peak demand, and caps for load in peak periods to protect against high prices for maximum demand. This contract position is illustrated in the two graphs below (the first representing Q1, and the second representing Q3). As above, this peak demand for residential customers is particularly volatile. Peak caps for a residential customer load shape need to cover load that is about 40% higher than average peak demand for Q1 and 15% higher for Q3.

Residential Avg vs Caps Contracts for Hedging Q1



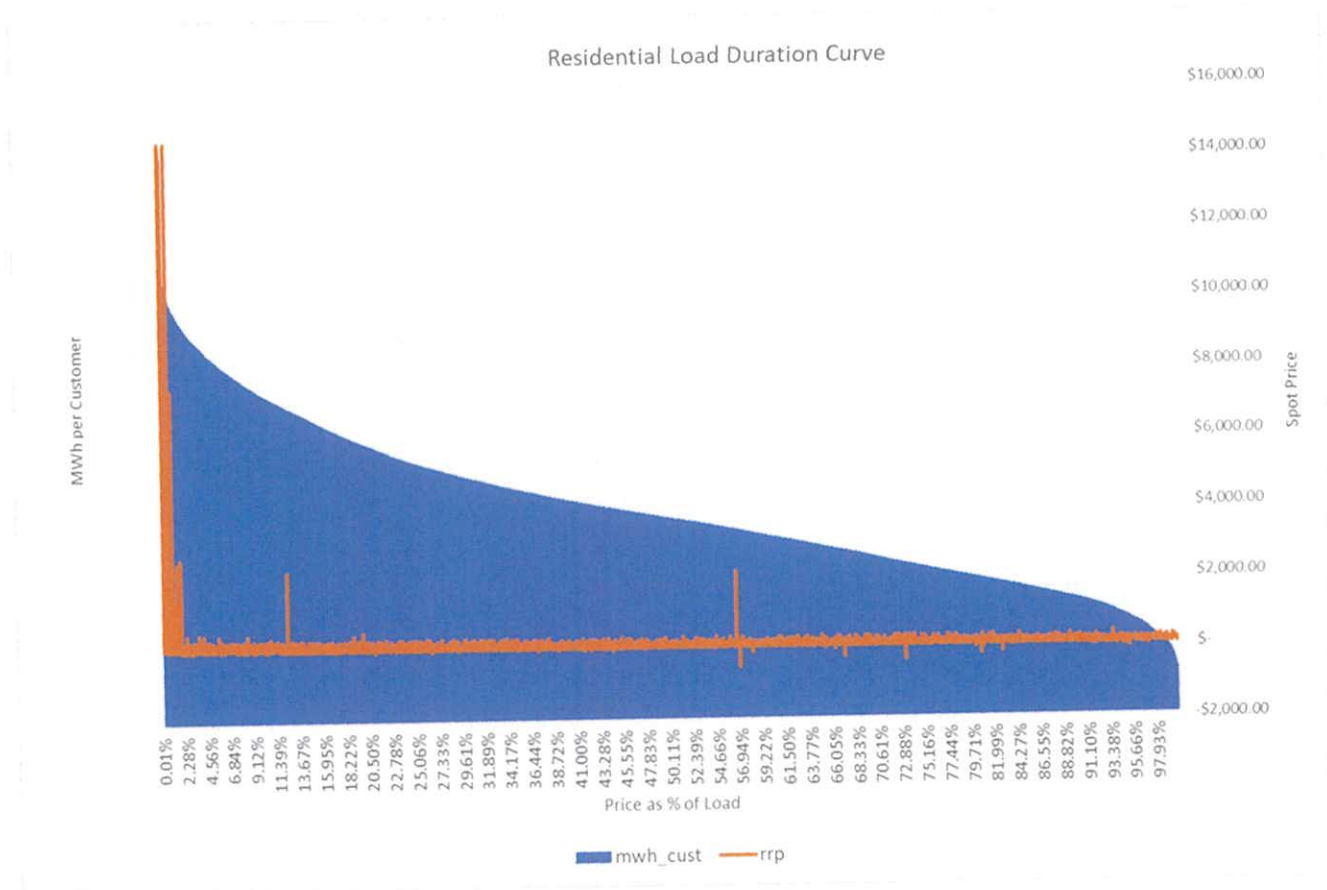
Residential Avg vs Caps Contracts for Hedging Q3



A prudent retailer would never deliberately incur pool exposure at absolute peak demand times. The highest demand correlates with the majority of the high price events. In fact, 23% of the spot market value comes during the 1% of the year (87.6 hours) when demand is at its highest (see graph below). A prudent retailer cannot let itself be exposed to this much risk, and so would ensure it fully hedges this maximum load by purchasing caps.

Before 24 January 2019, the cost of procuring caps to hedge against the increased demand would have added approximately \$7.45 per MWh to the VDO Draft Advice WEC component for residential customers. Since that time, Q1 2020 cap prices have moved to \$39.50, leading to an additional cost

of \$2.30 to \$9.75 per MWh. The trend continues upwards. The VDO needs to allow for future movements in forward prices for load which, as discussed below, would not be fully hedged at the time the VDO price is finalised.



Futures purchasing time period and profile

Sumo supports the Draft Advice position of using a 12-month purchasing period for electricity futures. However, the Draft Advice / Frontier Economics approach appears to expect that a retailer would purchase swaps and caps at full year FY20 prices, and would have hedged 100% of its load for the FY20 period by 15 February 2019. This is not realistic.

Retailers typically purchase hedges by quarter. The time horizon for purchasing each quarter is independent and staggered. So, as at 15 February 2019, it would be reasonable to expect that a retailer's hedge profile is:

- Q319: 100% hedged – 12-month average of Q3 forward prices
- Q419: 75% hedged – 9-month average of Q4 forward prices
- Q120: 50% hedged – 6-month average of Q1 forward prices
- Q220: 25% hedged – 3-month average of Q2 forward prices

What this means is that, if setting a VDO price for wholesale costs over the financial year July 2019 to June 2020, the efficient retailer won't yet be fully hedged. For the regulatory period July-December 2019, this can mostly be addressed by instead looking at the wholesale costs over the calendar year 2019. In fact, retailers typically hedge across a calendar year rather than a financial year.

There are a few reasons why hedging in this way is sensible:

- liquidity for contracts any earlier than 12 months ahead is very low

- the buy-sell spread gets narrower over time, and so the transaction cost also reduces over time. A small retailer with low credit standing and low liquidity has little choice but to wear this transaction cost for crossing the spread. We consider that this amounts to an additional \$1-\$3 per MWh, which has not (and needs to be) factored into the VDO
- a retailer cannot secure its final load until it has adequate certainty as to its customer load for the quarter. It won't have adequate certainty until close to the quarter in question. If it were to hedge a full year out, then the actual customer load may differ materially from the hedged load, exposing the retailer to unacceptable risk. This is a particular issue for small retailers with strong growth, but is equally problematic to larger retailers facing variable churn.

This difference in approach will have a material difference in cost. See table below:

	Quarterly hedging	Annual hedging	Delta
Q319	\$ 81.62	\$ 79.19	\$ 2.43
Q419	\$ 79.85	\$ 69.73	\$ 10.12
Q120	\$ 117.72	\$ 95.22	\$ 22.50
Q220	\$ 83.69	\$ 74.09	\$ 9.60

Given the forward wholesale prices over these periods, for the regulatory period this adds about \$12.10 per MWh to the VDO WEC component (load-weighted). This assumes the hedge contracts for the balance of unhedged load is purchased at these prices (as at time of writing) – of course, the prices will change, and have been trending upwards.

Working capital

The Draft Advice appears to make no allowance for the costs of working capital to support credit support and prudential requirements in the wholesale electricity market. This is a significant omission.

Retailers must meet counterparty credit support requirements. For futures purchased on the ASX, the retailer will incur an initial margin (which varies between about 11% and 17% depending on the quarter in question) and variation margins (which have been high in recent times given high forward price volatility). Assuming a contract position as described above and a WACC of around 9%, the working capital to support the initial margin when hedging 12 months in advance would cost approximately \$3.40 / MWh. An appropriate variation margin reserve (assuming the preferred progressive approach to purchasing futures described above) is \$2.60 per MWh. In actual fact, the Draft Advice contracting position would require initial margins to be provided up to two years ahead, which would increase this working capital cost even more.

AEMO also requires retailers to post prudential capital to support wholesale settlements, which can mostly be offset by entering into reallocations arrangements. The market cost of reallocations is approximately \$1.60 per MWh.

Retail operating costs

The retail operating costs allowance in the Draft Advice is far too low. In Sumo's view, retail operating costs should be at least \$172 to reflect the realistic costs of servicing retail customers.

The Draft Advice proposes to use a benchmarking approach to determining efficient retail operating costs. This approach seems to be the only one available to the Commission in the time available, but is unacceptable given that available benchmarks are not sufficiently well understood.

For instance, no reliance should be given to cost to serve numbers reported publicly by AGL and Origin, as it is not publicly known what is included those benchmarks. The retail operating costs reported by the ACCC in its REPI Final Report reveals a huge difference between operating costs for the 'Big 3' (\$75) and 'Other retailers' (\$146). The difference in these numbers is not yet understood. It

is dangerous for the Commission to attempt to make a judgement call as to which of these benchmarks reflects the costs of an efficient retailer, because it has no actual cost data from which to base this judgement. Recent decisions of price regulators in similar jurisdictions such as ICRC, OTTER and QCA give a range of \$124-\$144 per customer. However, these regulatory decisions will not take into account the additional costs of retailing in Victoria which, as detailed below, are material.

Of course, the retail operating cost of smaller retailers is much bigger. This is because smaller retailers do not have the efficiencies of scale of larger retailers, and smaller retailers face higher bad debt rates. The Commission dismisses the impact of scale in its Draft Advice, noting that 'we consider other retailers are able to manage their retail operating costs using innovative and outsourced business models'. With respect, this explanation is completely without justification. If it were the case, then small retailer operating costs would, in fact, match that of larger retailers. The data published in the ACCC REPI Final Report shows that this is not the case. We would welcome any actual data or information from the Commission that shows where these cost efficiencies can be or have been obtained.

One way small retailers could seek to approach the economies of scale enjoyed by larger retailers is by sending their retail operations offshore. This is not necessarily an appealing option, for retailers, customers or the Victorian economy. In any event, a smaller retailer still needs to contend with fixed overheads, which must be spread over a smaller number of customers.

Retail costs are continuing to rise. A significant contributor to this is customer bad debts, which are rising as households face increasing financial pressures. Note that bad debts for residential customers are much higher as a percentage of revenue than bad debts for small business customers. The VDO cost component for retail operating costs must therefore be higher for residential customers than for small business customers, in part because of higher bad debts (and also because small business customers contact their retailer less than residential customers).

The VDO price, being the price paid by standing offer customers, must have the highest allowance for bad debt. This is because a retailer will not be permitted to refuse taking on a standing offer customer on grounds of poor credit.

We also see bad debts increasing over the short-to-medium term as a result of the Commission's new Payment Difficulty Framework, which increases the time customers will have to pay their energy debt.

A small movement in bad debts can lead to a significant increase in retail operating costs. For example, a 1% increase in bad debts would increase operating costs by approximately 10%.

We also consider that the Commission has underestimated the costs of operating the new Payment Difficulty Framework, noting the following factors will drive increased cost:

- sending additional customer collateral
- longer handling time on calls, requiring more and far better trained resources to handle calls
- deferred cash receipts as numbers of payment arrangements and hardship participants increase
- higher number of energy audits
- additional complexity of handling ombudsman complaints

Other regulatory reforms will also increase costs, such as the costs of implementing the 'best offer' entitlements package, and changes to publication of energy price fact sheets.

We have provided the Commission with information about Sumo's operating costs in the **confidential attachment**.

Customer acquisition and retention costs

The Draft Advice proposes to benchmark CARC against the average for competitive markets published in the ACCC REPI final report (\$48). This is considerably less than the CARC reported by the ACCC for Victoria (\$59), and is far lower than what is reasonably required to market to residential

and small business customers in Victoria. An appropriate (and modest) CARC would be in the range \$75-100.

As above, the Terms of Reference require the Commission to allow for actual CARC, based on current marketing standards and approaches in Victoria. It is therefore not acceptable for the Commission to adopt as its benchmark costs incurred in other jurisdictions which are lower than the costs in Victoria.

In any event, as we explained in our response to the Staff Paper, we believe the benchmark used is the wrong one. The data taken from the ACCC REPI Final Report is the CARC 'per customer' (i.e. as spread across a retailer's entire customer base). This means that the number will vary considerably depending on the number of customers a retailer has, and will therefore be far lower for a very large retailer or one with low growth, and higher for a small retailer or one with relatively high growth. This explains why the ACCC REPI reported only \$40 for the Big 3, but \$87 for other retailers. That the number would vary so much depending on the size of the retailer suggests it is not an appropriate number.

The CARC 'per acquired customer' tells a very different story (\$283 for the Big 3 vs \$198 for other retailers). Arguably, this would not reflect a 'modest' cost, and should not be reflected in the cost stack for all customers because in fact it only applies to those acquired customers.

CARC is very sensitive to customer churn. Higher churn in a market will lead to higher costs to acquire and retain overall, all else being equal. Given this, a better approach is therefore to amortise the actual average cost of acquiring or retaining an individual customer over the expected tenure of that customer. So, if it costs say \$300 on average for a large retailer to acquire and retain a customer, and customers stay with the retailer for four years on average (which would be the case where market churn is at 25% per year – lower than the Victorian average), then the CARC per customer would be \$75 per year. Churn for second-tier retailers is necessarily higher than the market average, suggesting customers do not stay with those retailers for as long as four years on average. So, although smaller retailers may report lower CARC per acquired or retained customer than the larger retailers, that CARC would be amortised over a shorter period. For example, if a retailer is able to acquire and retain a customer for \$200, but its customers stay on average only two years before switching away, that retailer will have a CARC of \$100. For this reason, we consider that the CARC allowance should be in the range \$75-100 per customer.

Sumo's actual CARC is shown in the **confidential attachment**.

Victorian Government policy is to ban D2D and cold call marketing in the energy industry. We expect this will add to CARC, as retailers increasingly rely on less efficient and expensive forms of marketing. By contrast, the policy of banning retention and win-back activity would reduce CARC across the industry. The outcomes of these and other measures on CARC should be monitored for future regulatory price periods, but should not be taken into account for the 6-month period to December 2019.

Retail operating margin

The retail operating margin must fund a number of additional costs, including interest on debt finance, tax, depreciation and amortisation.

The cost of capital will differ markedly across different retailers, depending on their scale and risk profile. Sumo has provided its cost of capital in the **confidential attachment**.

We note that the ACCC REPI Final Report found that retailers EBITDA margin in Victoria is around 11%. Given the highly competitive nature of the Victorian retail market, it stands to reason that this margin reflects the risk of operating in the market, and therefore the actual return expected by market participants. It is therefore the most appropriate number for the Commission to use as the retail operating margin component of the VDO.

Failure to meet Terms of Reference

The Commission's Draft Advice fails to observe the Terms of Reference. In particular:

- the Victorian Government's clear intention is that it wants the VDO to be an 'option that safeguards consumers unable or unwilling to engage in the retail electricity market *without impeding the consumer benefits experienced by those who are active in the market*' (emphasis added). The Commission wrongly disregards this point as being policy intent. Although in theory the VDO will not prohibit retailers from making other offers available to customers, in the real world the draft VDO price would absolutely inhibit market offers. The draft VDO price has been positioned at the average market offer price, which means that half the market offers available today would be more expensive than the VDO and could not be sustained
- the VDO price should 'be based on the efficient cost to run a retail business' – as above, our analysis of the draft VDO price is that it would not enable a retailer to recover its efficient costs
- the VDO 'include an allowance for a maximum retail profit margin' – the profit margin allowed by the draft VDO is negligible, and would not reflect the cost of capital of most retailers in the market today (particularly not of a smaller retailer). The idea that the VDO should allow for a *maximum* profit margin suggests it should allow for bigger returns than the draft advice allows, more closely resembling net retail margins identified in the ACCC's Retail Electricity Price Inquiry Final Report of around 11%
- the VDO 'include a modest allowance for customer acquisition and retention costs' – too much has been read into the word 'modest'. The VDO must allow for customer acquisition and retention costs, and this must mean actual costs. That is, the Commission must allow for actual CARC incurred by an efficient retailer, but not excessive CARC. The VDO should not go beyond what is reasonably required to acquire and retain a customer, but nor should it assume a utopic world in which 'customers are highly engaged and rapidly switching to better priced offers as soon as they become available', presumably at little to no cost
- the VDO must be 'based on current marketing standards and approaches' – again, this means that the Commission should assume a market in which existing sales channels, and the existing levels of marketing activity, prevail. On this, our observation is that the proposed ban on D2D and cold call marketing activity is likely to *increase* marketing costs, as retailers move to more expensive alternative channels
- the Commission have regard to its objectives under the *Essential Services Commission Act*, being to promote the long-term interests of Victorian consumers, having regard to the price, quality and reliability of essential services – in other words, the Commission must ensure the VDO price doesn't deliver a short-term sugar hit, to the longer-term detriment of consumers
- the Commission have regard to its objectives under the *Electricity Industry Act*, which include to promote the development of full retail competition and to promote protections for customers – meaning the Commission must look out for consumers, but not disregard the impact of the VDO on the health of the competitive landscape. The VDO price must not inhibit competition, as the Draft Advice VDO price would

Please contact me if you would like to discuss any aspect of this submission.

Yours faithfully



Alex Fleming
GM – Legal & Regulatory