Submission to Victorian Default Offer to apply from 1 July 2019 – draft advice

4 April 2019

Retail Energy Review
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne, Victoria 3000

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

Dear Sir/Madam

Re: Victorian Default Offer to apply from 1 July 2019 – Draft advice

Tango Energy, in cooperation with and on behalf of Pacific Hydro, welcomes the opportunity to make a submission on the Draft Advice - Victorian Default Offer to apply from 1 July 2019 (**Draft Advice**).

Tango Energy is an active retailer across the National Electricity Market with a focus upon residential and small business electricity customers in Victoria. Tango Energy positions itself in the market by offering competitively priced products that are simple for consumers to understand. Pacific Hydro, the parent company of Tango Energy, is a global renewable energy owner, operator and developer. It operates a high quality, diversified portfolio of renewable energy with an installed capacity of 600MW in Australia. Pacific Hydro is an active investor in renewable energy projects, with current developments of in excess of 2GW potential capacity.

Of principal concern to Tango Energy is that the Victorian Default Offer (**VDO**), set at the rate currently proposed, is likely to adversely impact both the structure of the retail market in Victoria and deter future renewable energy generation investment in Victoria.

Tango Energy accepts that the Victorian retail market has not delivered outcomes to customers who choose not to, or are unable to, engage with the market. Tango Energy is supportive of any steps that facilitate customers engaging in a meaningful way with the competitive market. Tango Energy acknowledges the terms of reference provided to the Essential Services Commission (**the Commission**) oblige that a Victorian Default Offer be set for July 1. Tango Energy does however urge the Commission to revisit its decision and to fully consider the longer term impacts on competition in the retail market, the future investment needs for the Victorian energy sector and the overall impact for Victorian consumers in the medium to long term.

Operating costs that support competition

As noted by the ACCC in its Retail Electricity Pricing Inquiry, the difference between the Cost to Serve of the "big three" retailers and other retailers is large. It is generally acknowledged that the larger retailers benefit from their economies of scale.

Tango Energy considers that the proposition that other retailers "are able to manage their retail operating costs using innovative and outsourced business models" is too simplistic to justify the

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Commission's adoption of the amount of $104.50 as the proposed allowance for retail operating costs. The amount proposed is considerably lower than the actual operating costs of small, or even mid-sized, retailers. It is fair to expect that retailers should be able to lower their operating costs over time, but the process takes time. Adopting a retail operating cost benchmark that is too low in determining the VDO amount is likely to eliminate small retailers from the Victorian energy market before they are able to lower their operating costs sufficiently to withstand competitive pressure exerted by the three large retailers. As a result the market is likely to become an oligopoly and is hence much less competitive. Reduction in market competition is an adverse outcome for consumers, and cannot be said to be in the long term interests of Victorian consumers, the promotion of which is the objective of the Commission in performing its functions and exercising its powers (s.8(1), *Essential Services Commission Act 2001*).

As pointed out in the Draft Advice, the Commission considers, correctly in our respectful submission, the matters stipulated in section 8A(1)(a)-(c) of the *Essential Services Commission Act 2001* to be the most relevant matters regarding the Commission's advice on the VDO. Specifically, section 8A(1)(c) requires the Commission to have regard to "the degree of, and scope for, competition within the industry, including countervailing market power … ."

Tango Energy has a clear business strategy that relies upon operating costs falling as customer numbers grow. However, success of such strategy depends on Tango Energy having a fair opportunity (in the form of a reasonable period of time free of adverse interventions) to build and strengthen its market position. We submit that the same consideration applies to all small retailers generally, and that the Commission should take into account the need to increase market competitiveness and to avoid market dominance by a small number of large retailers. Tango strongly believes that the Commission should revisit its choice of retail operating costs to accommodate the business models of emerging retailers. It is these retailers which are more likely to deliver and innovate according to customer demands.

The terms of reference are clear in that it is the expectation of the Government that retailers will continue to offer competitively priced market offers. There is little risk to the market should the Commission take a cautious approach to retail operating costs. The retail operating costs selected by the Commission will have the effect of locking in the business models of the large three retailers (at the expense and to the elimination of smaller retailers) and locking in the customer service levels of the large retailers. This would be at odds with the Commission's expectation that the Government's policy intention is not to promote service outcomes under the VDO that are "cheap and nasty".

Tango Energy considers that in determining the amount of the VDO, it is helpful to have a detailed understanding of the actual cost to serve of small retailers. Accordingly a detailed breakdown of Tango Energy's retail operating costs and retail operating margins is provided in Appendix A in relation to our current operations in the Victorian Market. **Please be advised that the information in Appendix A to this letter is commercially sensitive and confidential; we request that the information be not published on the Commission's website or otherwise disclosed without our consent.**

Long term sustainable competition for the benefit of consumers

Tango Energy believes that customers who have shifted to Tango Energy by actively seeking out our market offers have benefited relative to those consumers who have chosen to remain with the "big three" retailers. This is evidenced by Tango Energy recently being awarded 5 stars by Canstar Blue for the most satisfied customers in Victoria.

The concern with the VDO being set at the proposed level is that we will gradually see the competitive market offers currently available to Victorian consumers gradually disappear. For a business such as Tango, offering lower prices can only be supported while growth continues. This is normal economic behaviour to ensure the market continues to innovate and disperse to ensure that customer needs are better met. While the VDO will benefit a small number of consumers in the short term, it is likely that competitive market offers offered by small retailers such as Tango will disappear from the market, to the detriment of Victorian consumers.

A competitive retail landscape supports ongoing generation investment

The ACCC recently noted that around 16% of the average customers' bills can be attributed to retail margin and operating costs. The other 83% of charges are charges not directly attributable to retailers; rather they constitute expenditure on networks, wholesale energy costs and green schemes. Many businesses, such as Pacific Hydro, aim to actively invest in renewable generation which is genuinely supported by an active retail customer base.

Investment in generation has long term horizons in terms of planning, constructing and operating an asset. There is much uncertainty in undertaking large capital investments. Underwriting generation capacity through an active retail business mitigates the risk associated with investment. Jeopardising retail business by price intervention that strangles competition will discourage the investment commitments of renewable energy investors.

Tango Energy notes the Victorian Government commitment to a renewable energy generation target of 45% by 2025. In fact the *Renewable Energy (Jobs and Investment) Act 2017* is intended to give the renewable energy sector the confidence to invest in the renewable energy targets and jobs. Tango Energy requests that the Commission consider what effects an unsuitable initial VDO price will have upon the retail electricity market. Setting a VDO that is too low in the short term could be detrimental to market structure. Conversely, a VDO set too high carries little risk as it only applies for 6 months, can be revisited in January 2020, and it will still allow competitive market offers to be available for consumers. Tango Energy believes that there is scope to be conservative in setting each element of the cost stack at the initial price setting of the VDO. The Commission has taken a narrow view and has selected a restrictive wholesale and retail component. There is a great risk that this price will become entrenched and unduly restrict the room for changes in future reviews.

A business like Pacific Hydro, that has shown a commitment and expertise in building, owning and operating renewable generation, could be expected to continue to contribute to Victoria's changing generation mix. The VDO, at the level currently proposed, will consolidate the current retail market structure. Given the current market positions of the large retailers as gentailers, and their current interests in the generation market, a question will arise as to which businesses will have the incentive to invest in the additional and necessary renewable energy generation to meet future renewable energy requirements of Victoria. A business like Pacific Hydro is willing to invest in Victoria's future generation needs, but a viable competitive retail market is an essential component in undertaking this investment.

Wholesale Costs

Tango Energy supports a more open, transparent and robust methodology for the calculation of wholesale costs, as it considers that the wholesale cost component to not adequately compensate for risk. In any event the wholesale costs model proposed by the Commission is a 'look back' model, when in fact the wholesale cost reflected in the VDO should be the cost of wholesale supply for the next incremental customer, a 'look forward' model. This is the typical approach used by retailers. Furthermore, the final wholesale component selected by the

Commission is static and does not adequately allow for the risks that a growing retailer encounters. The chosen methodology does not properly account for the interaction between the daily operation of the wholesale market and evolving strategies that retailers continually update as the market changes. Market movements, changing hedging or cap arrangements and constantly changing swap prices, when combined with fluctuating load and customer numbers, mean that the wholesale cost component should be revised to account for the reality of operating a retailer. The expectation that wholesale prices remain stable using the past 12 months data is contrary to how the market operates. Tango Energy considers the wholesale allowance currently proposed to be inadequate when compared against the risk and exposure faced by a small retailer.

It is noted that other small retailers have provided alternative methodologies to consider when setting wholesale energy costs. We submit that the Commission needs to consider these methodologies in full as an alternative to the less transparent methodologies referred to in the Draft Advice.

The Flat Price VDO is likely to distort efficient customer outcomes

The Commission's proposal to provide only a flat tariff for the VDO will potentially distort efficient customer outcomes. Tango Energy considers it imperative that networks are mandated to change the network tariff to a flat tariff should a customer opt to move to the VDO. Furthermore, encouraging consumers to move to a flat tariff, which is what the VDO potentially does, is at odds with the benefits prescribed in the roll out of smart meters in Victoria; much of the business case was premised on customers moving to 'time of use' tariffs and shifting consumption to low priced periods.

If you wish to discuss Tango Energy's submission in further detail, please contact Gus Poh, Legal, Regulatory and Compliance Manager at [redacted]

Yours sincerely

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