Level 33, Rialto South Tower
525 Collins Street
Melbourne, Victoria 3000
Fax +61 3 8807 1199
simplyenergy.com.au

30 January 2019

Mr Marcus Crudden
Director, Price Monitoring and Regulation
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

Via email: RetailEnergyReview@esc.vic.gov.au

Dear Mr Crudden,

Re: ESC Staff Working Paper - Victorian Default Offer

Simply Energy welcomes the opportunity to provide feedback on the Essential Services Commission's (ESC) Staff Working Paper on the proposed Victorian Default Offer (VDO).

Simply Energy is a leading second-tier energy retailer with over 670,000 customer accounts across Victoria, New South Wales, South Australia, Queensland and Western Australia. As a leading second-tier retailer focused on continual growth and development, Simply Energy actively supports open market competition and energy affordability.

From Simply Energy's perspective, retail competition has provided Victorian electricity consumers more choice than ever before. Nevertheless, the relatively higher costs faced by some customers on standing offers is a concern requiring action by the Government. On this basis, Simply Energy understands the VDO is intended to provide a safety net for those supplied under a standing offer and to act as a reference point for market discounts.

With this in mind, Simply Energy's submission focuses on evaluating:

- the scope of and application of the VDO;
- the ESC's proposed methodology for setting wholesale and network costs; and
- the additional costs that will need to be factored in by the ESC in setting the VDO.

Before stepping through the matters above, it is worth taking the opportunity to assess the extent to which the ESC may be able to benefit from the work being undertaken by the Australian Energy Council and the Australian Energy Regulator.

While this work is in its preliminary stages, Simply Energy notes that both entities are examining ways in which existing market offers can be used to create a market generated default offer. For Victoria, it would seem possible to derive a VDO, for the State or by network, based on existing offers in the markets.

Simply Energy considers that a top-down approach based on a reasonable margin above the median price of generally available markets offer in each supply area is a more appropriate approach than trying to develop a cost stack. Such an approach is more likely to ensure that retailers are still able to manage their risk exposure, while also ensuring that those on a standing offer are not paying disproportionately more than other electricity consumers.

The extent to which the Government's decision to adopt the VDO as a temporary measure before transitioning to a comparison price based on the above methodology, in line with the agreed policy position of other States, also requires further consideration.

Scope and application of the VDO

Simply Energy believes the VDO would be most beneficial and least distortionary where it:

- is derived via a consistent methodology;
- does not vary unexpectedly; and
- is set at a level that allows retailers to recover efficient costs.

Simply Energy considers that the ESC must adopt a consistent approach to setting the VDO. Changing the methodology unexpectedly will create uncertainty for electricity retailers. Regulatory uncertainty ultimately undermines the ability of retailers to operate efficiently and effectively.

High variability in the rate of the VDO will also create financial risks for retailers that will be difficult to manage. Ease of implementation is an important consideration to ensure risk is reduced and that VDO customers can be managed in much the same manner as a retailer's existing customer base. For this reason, the ESC must only vary the methodology for setting the VDO subject to appropriate consultation and lead times.

It should also be kept in mind that increased risk may adversely affect retail competition and constrain the willingness of market participants to enter into long-term power purchase agreements required to underwrite new electricity generation. As the investment climate in the energy sector remains complicated any steps to ensure investor risk is not further increased would be welcomed by the broader industry.

In view of the above considerations, and for the purposes of workability, the VDO should be set at a level that allows electricity retailers to recover, as a minimum, their efficient costs of service delivery, while ensuring the policy intent is met.

Calculating operating costs

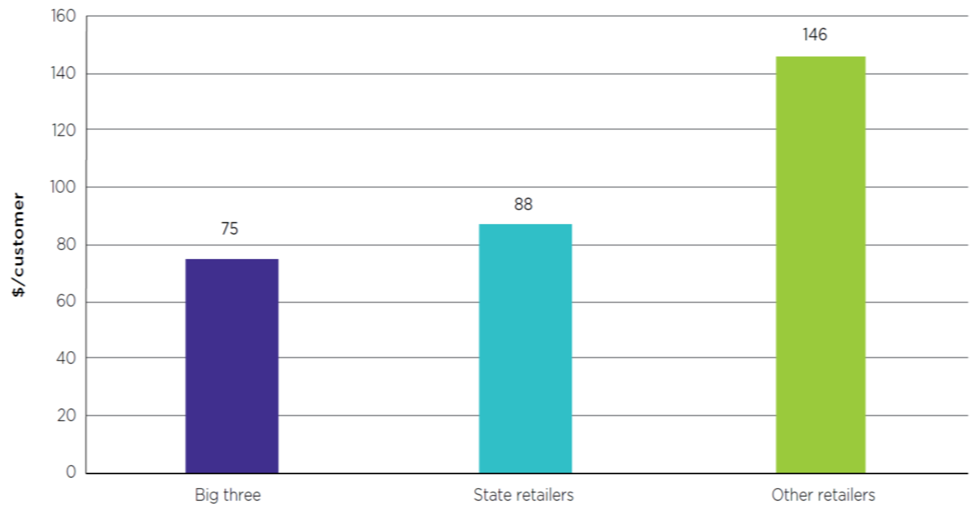
International experience has demonstrated regulated price caps can limit market incentives to offer competitive products and services. Indeed, if retailers are unable to recover sufficient profit margins, it is likely that some market participants will look to reduce their customer service options to remain commercially viable. This may, in turn, have adverse implications particularly for those customers most in need of additional support.

For this reason, Simply Energy does not support the inferred proposal in the ESC's Working Paper for the operating costs of the "Big 3" retailers to be used as part of the baseline calculations for the VDO. As the ACCC's recent inquiry demonstrated in Figure 1 below, the cost to serve for the Big 3 retailers does not reflect the experiences of other market participants.

Furthermore, using the operating costs of the Big 3 as part of the baseline calculations would contradict the proposed definition of an efficient retailer. The Working Paper makes direct reference to calculating the VDO in terms of a 'standalone retailer' that is one that 'is not vertically integrated.' Simply Energy considers that the ESC should evaluate the operating costs of smaller tier 2 and tier 3 retailers in benchmarking retail operating costs.

Failure to do so, could create an environment in which the very companies who are responsible for keeping competitive pressure on the Big 3 are handicapped by the VDO methodology.

Figure 1: NEM-wide cost to serve

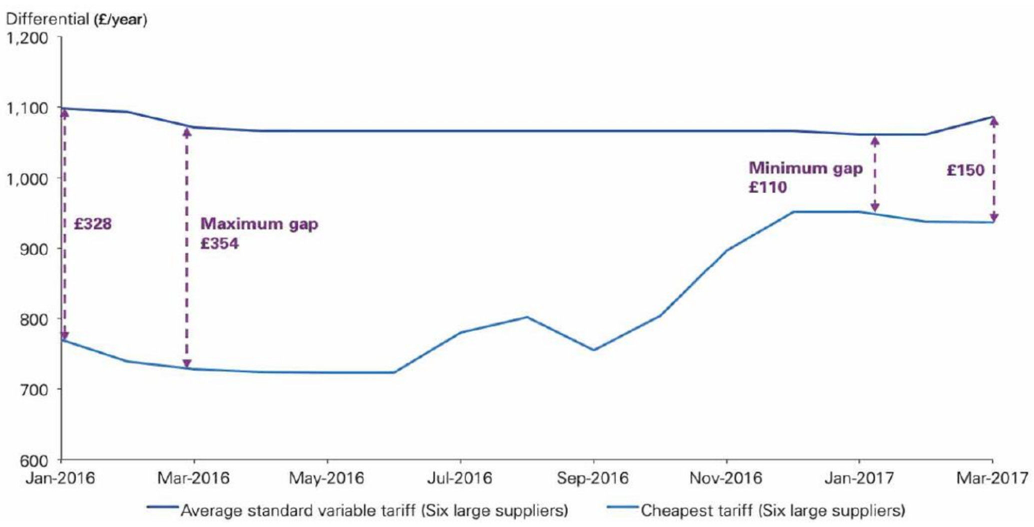


Source: ACCC, Restoring electricity affordability and Australia's competitive advantage, June 2018, Australia, 224.

Based on market responses in the United Kingdom following the announcement of electricity price re-regulation, it is also likely that pricing dispersion across the Victorian retail electricity sector will contract as a result of the VDO being introduced – see Figure 2.

Simply Energy is, therefore, of the view that unless the VDO allows retailers some additional margin to adopt flexible pricing strategies, it is likely that many of the best offers in the market will be withdrawn. This could, in turn, affect the ability of energy retailers to support vulnerable customers by offering lower price electricity offers that may be more appropriate to their circumstances. Building in margin to ensure market offer differentiation can continue to take place should not be viewed as headroom, but rather as a key component of customer acquisition and retention costs. The VDO will not be a standalone product, but rather one offer within a retailer's wider product suite.

Figure 2: Market response to the announcement of price re-regulation in the UK



Source: KPMG, What would a price cap mean for the UK?, June 2018, London, 5.

Additionally, the ESC methodology would be best served by taking into account the following risks when calculating retail operating costs:

- Customer profile: those customers who are likely to be signed up on the VDO will tend to be unknown consumers of an occupied site or customers with a poor credit history, who retailers are required by regulation to supply. This, in turn, means that retailers have a much higher risk of incurring bad debts through servicing such customers. To put this into perspective, Simply Energy has written off $1.13 million in bad debts associated with Victorian electricity occupier accounts since January 2017.

- Identifying unknown consumers: as a replacement for standing offer contracts, retailers will continue to incur higher costs in servicing unknown customers supplied under the VDO. There are additional costs in contacting unknown customers in terms of following-up communications and potentially initiating disconnection procedures as required.

Retail margins

Simply Energy also has some concern with the use of a selection of non-energy companies retail margins as a proxy for electricity retail margins. Given the inherently different risks faced by different sectors the ESC needs a high degree of confidence in nominating a specific retail margin. However, this is an issue which is difficult to address in the context of a public submission without the ESC revealing its proposed proxy data.

Wholesale and network costs

Together with operating and retail margins, Simply Energy considers that the other two major components of the VDO cost stack that could have the largest effect on retail margins and future operating activities in Victoria are:

- wholesale electricity costs; and
- network costs.

Wholesale electricity costs

As the ESC acknowledges in its Working Paper, retail hedging strategies differ considerably based on corporate strategy and risk appetite. It is, therefore, difficult to accurately replicate the wholesale costs incurred by retailer businesses on an individual small customer basis.

While futures data provides a publicly accessible indication of forecast wholesale electricity prices it does not cover the full range of risk management strategies and instruments used by retailers to manage their market exposure or mirror extreme events as they may be experienced by individual retailers.

In view of this, futures are an imperfect indicator of actual wholesale prices as they only relate to a point in time. If they are going to be used for the purposes of determining forecast wholesale costs as part of the VDO, a premium to account for volatility and varying hedging strategies will be required.

For example, a small new entrant retailer will experience hedging costs far different from a large integrated participant. This is because a new entrant retailer is unlikely to trade the same financial derivatives and does not have access to physical capacity. The new entrant is likely to require a small structured deal, potentially longer term and higher cost, and will not benefit from trading exchange traded futures, nor is it likely to have the required IT infrastructure or market experience to do so.

To overcome any potential issues with commercial risk, the ESC must set the VDO with regard to new entrant and stand-alone retailer hedging experiences, the risks associated with managing the price volatility of retail customers and the potential for wholesale price volatility in response to weather and supply events.

Network costs

From a simplicity standpoint, Simply Energy understands why the ESC is proposing to base the VDO on the flat residential and business tariff rates. However, such a simple tariff structure does not reflect a retailer's actual cost to serve, as properties may have differing network tariffs assigned. For this reason, Simply Energy considers that the network tariff component cannot be a simple price pass-through, as an additional margin needs to be built in to the VDO to allow for any network tariff charges that cannot be fully passed on to the customers.

As network price changes will come into effect on 1 January 2020, Simply Energy also considers that the ESC should take this opportunity to undertake a more robust analysis of its retail cost stack and use benchmarking as reference point to ensure that the VDO has been set at a reasonable level.

Benchmarking the overall cost stack

Finally, Simply Energy would like to emphasise that any regulated default offer will always be an estimate, and as such imperfect, and should not be seen as providing a substitute for market derived outcomes.

As such, to the extent that the ESC is not minded to adopt Simply Energy's alternative, then developing the alternative top-down approach in conjunction with a regulated cost stack to form a comparison point and sense check, will increase the rigour of the ESC's methodology.

Conclusion

Simply Energy sees itself as having a shared responsibility to working towards developing a market that meets the long-term interests of all energy consumers.

With this in mind, Simply Energy supports the ESC's focus on developing the VDO as a pricing safeguard for those customers who are not on a market offer, rather than using it as a means to establish a price ceiling that is likely to constrain future market competition and innovation.

Simply Energy welcomes further discussion in relation to this submission. To arrange a discussion or if you have any questions please contact Anthony O'Connell, Senior Regulatory and Compliance Officer, on, telephone, [redacted]

Yours sincerely

James Barton
General Manager, Regulation
Simply Energy