Trimming the fat from electricity prices

Response to the Essential Services Commission staff working paper on the Victorian Default Offer methodology

January 2019

The Victorian Council of Social Service is the peak body of the social and community sector in Victoria.

VCOSS members reflect the diversity of the sector and include large charities, peak organisations, small community services, advocacy groups and individuals interested in social policy.

In addition to supporting the sector, VCOSS represents the interests of Victorians experiencing poverty and disadvantage, and advocates for the development of a sustainable, fair and equitable society.

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A fully accessible version is available online at vcoss.org.au/policy/

VCOSS acknowledges the traditional owners of country and pays respect to past, present and emerging Elders.

This document was prepared on the lands of the Kulin Nation.

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Executive summary

The Victorian Council of Social Service (VCOSS) welcomes the Essential Services Commission's (ESC) staff working paper on the proposed Victorian Default Offer (VDO) methodology.

The VDO will be offered unconditionally to all residential and small business customers and:

- be set for each distribution zone
- be based on the efficient cost to run a retail business
- be the basis for discounts
- include an allowance for a maximum retail profit margin
- include a modest allowance for customer acquisition and retention costs (i.e. marketing costs)
- not include a headroom allowance (i.e. allowance for the risks/costs of new retailers).

VCOSS supports the VDO, and its implementation by 1 July 2019. Victorians are paying the highest retail charges in the country as part of their electricity bills, including a bloated average retail margin of 11 per cent, which is well above other retail sectors and approximately double what regulators have considered fair when setting electricity prices.

A deliberately confusing and complex electricity market is allowing retailers to charge Victorians more than they would in a market with effective competition. Excessive electricity prices particularly hurt Victorians on low incomes—energy costs take up much more of their budgets than middle-income households, and they are most at risk of long-term energy hardship.[1] Price regulation, in the form of the VDO, is warranted.

Designed well, the VDO should prevent excessive pricing for people unable to engage with the market, and constrain pricing across the market as a whole, by providing a reference point for discounts. The VDO can still allow room for competitive, lower priced offers, including for concession holders and people in hardship programs.

Given wholesale electricity costs are expected to reduce over coming years, having a regulated price in Victoria helps ensure retailers pass on any savings.

This submission comments on:

- desired outcomes of the VDO
- features of the 'efficient retailer'
- the need for the VDO to substantially reduce marketing costs and retail margins
- communication and monitoring of the VDO.

[1] Australian Energy Regulator, *Annual Report on Compliance and Performance of the Retail Energy Market 2017-18*, 117; Victorian Council of Social Service, *Battling On: Persistent Energy Hardship*, November 2018, 18.

Recommendations

Prevent excessive pricing

- Develop a Victorian Default Offer that prevents excessive pricing, passes on wholesale cost reductions, and allows room for lower priced offers.
- Consider shifting the cost of premium feed-in tariffs to the Victorian Government budget.

Ensure the 'efficient retailer' can serve diverse people

- Model an 'efficient retailer' that precludes heavy customer segmentation or wholesale costs inflated by excessive transfer pricing.

Put a lid on marketing costs and retail margins

- Remove excessive customer acquisition and retention costs and retail margin, and ensure retailers can deliver a high-quality service.

Allow people to benefit from lower prices

- Implement the Victorian Default Offer by 1 July 2019, and ensure people are able to easily identify the Victorian Default Offer and its nature.
- Monitor the Victorian Default Offer to ensure its purpose is being achieved.

Prevent excessive pricing

Recommendation

- Develop a Victorian Default Offer that prevents excessive pricing, passes on wholesale cost reductions, and allows room for lower priced offers.

The Terms of Reference state 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.

Consistent with the Terms of Reference, the VDO can prevent egregious pricing and retailer gouging, especially of people who cannot engage with the market and switch to lower priced offers. While people should be supported to switch where they can, significant barriers will remain for some people, including a lack of internet or phone access, low English literacy levels, widespread lack of trust in energy retailers, difficult life circumstances, and exclusion from better priced offers, including due to poor credit histories. We support the Victorian Government's decision to shield people on standing/default offers from excessive pricing, and give people bewildered by or excluded from the market the VDO option, in the knowledge it is reasonably priced.

Currently, Victorian standing offer customers appear to be paying too much for electricity, at an average price of 39.2 c/kWh. This is approximately 30 per cent higher than the average 30.3 c/kWh price for the Victorian market as a whole.[2] Reducing this price will particularly benefit customers of the 'big three' retailers (AGL, Origin and EnergyAustralia), who have a much higher proportion of standing offer customers than other retailers.[3] Most Victorians use the big three retailers, which have a combined market share of approximately 60 per cent.

Lanfen's story

The VDO will help people like Lanfen, a woman in her 80's who moved from China 13 years ago to be near her daughter. She has very limited English language proficiency (her comments for this case study were interpreted by a Mandarin speaker). Lanfen lives alone in a high-rise public housing flat and has a heart condition that is sensitive to extreme temperatures.

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[2] Australian Competition and Consumer Commission, *Restoring electricity affordability and Australia's competitive advantage*, June 2018, 11.
[3] Ibid 141.

> Lanfen always pays her electricity bills on time. She has noticed the cost of her electricity has increased and sees this as consistent with other areas of daily life. "The prices of grocery shopping are going up all the time. So similarly, I felt it's only normal to see the electricity go up as well". Sometimes Lanfen receives a "much larger bill than the usual".
>
> Lanfen has never heard of pay-on-time discounts, negotiated her rates or changed her electricity supplier.
>
> "I have never done that. I'm not aware of such possibility… I thought they are [a] large and reputable company, so I chose them… Similarly, for the telephone company, I'm also able to choose between different companies to provide a service to me, but I've never exercised such discretion or such right. Because we're not good at computer to do research about that. We don't read English either."[4]

The Terms of Reference also state the VDO will be the basis for market offer discounts. This is welcome, as the ACCC found standing offers are priced excessively to enable high discount rates.[5] This can give a misleading impression of a good value deal. The VDO can benefit two customer groups: people paying too much on standing offers, and those on market offers who have been hoodwinked into poor value 'discount' deals based on heavily inflated standing offers. The VDO provides a reference point for people to assess the value and competitiveness of discounts and helps reduce the risk of people overpaying.

As a benchmark for market offer discounts, the VDO should help constrain pricing across the entire market and benefit all energy users, not just the small proportion of Victorians on standing offers/the VDO.

The VDO provides discipline to the entire market. Prices appear to be higher than necessary, across both standing and market offers, and retail charges seem to be the main reason for excessive pricing. While wholesale cost rises have been the main cause of Victorian electricity price increases over recent years, retail and environmental scheme costs have been the main driver of price increases over the past decade. Victoria has the highest retail costs component in the National Electricity Market (NEM) at 21 per cent. Victoria's retail costs component (including margin) jumped from $225 per year in 2007-08 to $315 per year in 2017-18.[6]

Victoria's 'costs of competition' and regulatory regime cannot entirely explain high retail costs. Looking at retail margins alone, Victoria's are the highest in the NEM and some of the

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[4] Victorian Council of Social Service, *Power Struggles: Everyday Battles to Stay Connected*, August 2017, 20-21.
[5] Australian Competition and Consumer Commission, *Restoring electricity affordability and Australia's competitive advantage*, June 2018, v.
[6] Ibid 8-9..

highest in the world, at 11 per cent of the average electricity bill and average electricity price.[7] Margins have increased over recent years, despite Victoria being the most mature competitive market in the NEM.[8] The theory of competition—increased efficiency and downward pressure on margins—has not translated into reality.

The big three and mid-tier retailers enjoy the largest margins, at approximately 9 per cent and 12 per cent respectively. Other retailers have margins of 4 per cent.[9]

Victoria's retail margins are higher than other retail sectors and approximately double what regulators have considered fair when setting retail electricity prices.[10]

The market, without a measure like the VDO, does not appear capable of constraining retail charges and ensuring efficiencies are passed on to customers.

Ensure people benefit from wholesale cost reductions

Over the coming years, the VDO can help ensure wholesale cost reductions are passed on to customers. Victorian wholesale prices are forecast to fall over the next two years because of more renewable generation capacity.[11] The Australian Energy Market Commission expects price drops to flow through to customers, but given past experience we cannot be confident this will happen. Over the past decade, Victoria enjoyed fairly flat wholesale prices until the Hazelwood power plant closure, but nonetheless experienced significant retail price increases.[12] Without a VDO that tracks wholesale price changes, we may once again see a disconnect between wholesale prices and retail prices, given electricity is an essential service, has captive customers, and the market is very complex. Retailers are aware many customers will 'accept' price increases and not switch or demand lower pricing.

Leave room for lower priced offers

We support the VDO not impeding benefits to active customers. The VDO can be priced to give people an incentive to engage in the market and access lower priced offers. The VDO should allow room for lower pricing for hardship customers, concession customers, and people accessing the highest level of support under the payment difficulty framework ('Tailored Assistance 2'). Tailored Assistance 2 is for people who cannot pay their ongoing energy consumption costs, and entitles people to advice about any lower priced offers available from their retailer.

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[7] Ibid 8-9, 25-26.
[8] Ibid 145.
[9] Ibid 146.
[10] Tony Wood and David Blowers, *Price Shock: Is the Retail Electricity Market Failing Consumers?*, Grattan Institute, March 2017, 17-20.
[11] Australian Energy Market Commission, *2018 Residential Electricity Price Trends Review*, 21 December 2018.
[12] Australian Competition and Consumer Commission, ***Restoring electricity affordability and Australia's competitive advantage***, June 2018, 32-34; Tony Wood and David Blowers, *Price Shock: Is the Retail Electricity Market Failing Consumers?*, Grattan Institute, March 2017, 8.

Minimise people's payment of solar subsidies

Recommendation

- Consider shifting the cost of premium feed-in tariffs to the Victorian Government budget.

The VDO will include all costs retailers pass on to customers, including payments to household solar exporters. VCOSS recommends the Victorian Government use the VDO process to examine the costs passed on to non-solar households as a result of legacy premium feed-in tariffs and the 2.5 c/kWh payment to household solar exporters.

VCOSS supports the ACCC's recommendation that state governments, rather than energy users, bear the costs of legacy premium feed-in tariffs.[13] Premium feed-in tariffs were introduced to encourage household solar installation and greater scale and lower prices in the household solar market. Some of these tariffs were exceptionally generous—the highest Victorian tariff was 60 c/kWh. Premium feed-in tariffs are paid by other energy users through their bills, and significantly exceed wholesale and retail electricity prices,[14] meaning other Victorian energy users are paying too much for this energy.

While premium feed-in tariffs are no longer open to new users, 88,000 Victorian households will receive the 60 c/kWh tariff until 2024.[15] These tariffs therefore impose ongoing, excessive costs on other energy users, particularly vulnerable households that are less likely to have solar installed.[16] They can be funded by government rather than passed on under the VDO and market offers.

[13] Australian Competition and Consumer Commission, *Restoring electricity affordability and Australia's competitive advantage*, June 2018, 218-220.
[14] Ibid 214.
[15] Ibid.
[16] Ibid 218.

Ensure the ‘efficient retailer’ can serve diverse people

Recommendation

- Model an ‘efficient retailer’ that precludes heavy customer segmentation or wholesale costs inflated by excessive transfer pricing.

The ESC proposes the efficient retailer will be one that:

- has achieved economies of scale (i.e. one that has an efficient cost base)
- is a standalone retailer and is not vertically integrated (i.e. does not have economies of scope)
- serves domestic and small business customers in Victoria and potentially across the NEM
- currently can offer both standing offers and market offers
- has an existing customer base that it defends
- does not adopt a loss leading pricing strategy to acquire new customers.

VCOSS supports these assumptions but notes the number of Victorian retailers and their varying market shares and profiles make modelling an ‘efficient retailer’ more challenging than in other jurisdictions.

Preclude heavy customer segmentation

In an essential services market, an efficient retailer should not be one that heavily segments customers, including low-income customers and those with payment difficulties.

Efficient retailer modelling should also take into account retailers’ obligation to offer the VDO to any customer who seeks it. We understand this will mean people cannot be denied the VDO because of poor credit histories, outstanding debts or other reasons.

We support retailers being obliged to offer the VDO. At the moment, a competitive market does not really exist for customers who are considered ‘undesirable’ or low value because they are denied retailers’ best offers, or an offer at all. This includes women who have experienced debt abuse as part of family violence and have poor credit histories, and people with intermittent or insufficient incomes who struggle to pay bills. The VDO can therefore operate as a safety net for people excluded from the competitive market who need a reasonably priced electricity offer. It is appropriate for the ‘efficient retailer’ to take into account this restriction on customer segmentation under the VDO.

Manage the risk of excessive transfer pricing

VCOSS supports the 'efficient retailer' being a standalone retailer that is not vertically integrated. Vertically integrated retailers are able to inflate transfer pricing (sales from the wholesale arm to the retail arm) and this should not be reflected in the VDO.

However, the VDO cannot prevent vertically integrated retailers inflating transfer prices. This can inflate wholesale price estimates. The ESC should consider options for managing this risk, including estimating underlying generation costs.

Excessive transfer pricing is a risk in the current market. Some wholesale businesses apply a very high premium when transferring electricity internally, which is passed on to customers through retail pricing. The ACCC noted:

> the size of the largest transfer prices in the data set raises concerns about the ability of vertically integrated businesses to shift substantial profit into the wholesale business. As one vertically integrated player put it in an internal document, 'there will always be a goal for owners of generation to maximise returns from their assets in a market where retail is effectively a wholesale pass through in terms of pricing.'[17]

The ACCC concluded the 'combination of relatively high retail margins for the big three and a persistent ability to set transfer prices above generation costs suggests that the retail market is not imposing a significant competitive constraint on the big three'.[18]

[17] Australian Competition and Consumer Commission, *Restoring electricity affordability and Australia's competitive advantage*, June 2018, 125-128.
[18] Ibid 147.

Put a lid on marketing costs and retail margins

Recommendation

- Remove excessive customer acquisition and retention costs and retail margin, and ensure retailers can deliver a high-quality service.

VCOSS supports the proposed benchmarking approach to estimating retail costs, which will use publically available data (e.g. annual reports), previous regulatory decisions, and the ACCC's costs data collected from retailers. The ESC intends to verify the benchmarking data with information from Victorian retailers, but should avoid building existing inefficiencies and excess retail costs into the VDO.

Limit customer acquisition and retention costs

The VDO will include a modest allowance for customer acquisition and retention costs (CARC), such as marketing, business development, promotions and sponsorships, and the costs of transferring customers to and from other retailers.

CARC is highest in Victoria, at an average of $59 per customer per year. ACCC analysis shows there is correlation between switching rates and CARC, and suggests high levels of switching increase CARC.[19] In particular, discounting strategies are most developed and widespread in Victoria. Discounts are complex and difficult to compare, 'which enables retailers to compete less aggressively on price'.[20] We query how much CARC is allocated to the development and promotion of inefficient and deliberately confusing marketing strategies such as discounts.

The Victorian Government's 'Energy Fairness' reforms, once implemented, should reduce a significant amount of CARC in subsequent VDO pricing. This includes the ban on door-to-door energy sales and energy cold-calling, and restrictions on sales performance bonuses for retailer marketing.[21] Third party acquisition channels make up a large part of CARC, especially in Victoria, and are a major driver of CARC increases. Those channels include commercial comparators and other brokers and door-to-door sellers.[22] We request the ESC considers whether retailers will reduce commercial comparator use/costs before these

[19] Ibid 230.
[20] Ibid 264.
[21] Victorian Labor, 'Fact sheet: Cracking down on dodgy energy retailers—Labor's Energy Fairness plan'.
[22] Australian Competition and Consumer Commission, *Restoring electricity affordability and Australia's competitive advantage*, June 2018, 231.

reforms are implemented, given these services are becoming unviable for some retailers. The ACCC found:

> a selection of retailers indicated that the costs have become so high that those acquisitions are close to unprofitable unless the customer remains with the retailer for an extended period (and customers acquired through comparators tend to switch regularly).[23]

The ‘Energy Fairness’ reforms also include a ban on ‘save’ and ‘win back’ offers, i.e. aggressively priced offers to prevent customers leaving or win them back. These offers are generally not advertised in the market. The ACCC found a significant amount of CARC could be avoided by reducing save and win-back activity. This activity results in wasted acquisition costs for smaller and new retailers, which then have to be recouped through higher prices across the customer base. A number of smaller retailers estimated to the ACCC that approximately 20 per cent of newly acquired customers are lost to saves or win-backs. [24]

The ban on saves and win-backs should also reduce larger retailers’ costs by removing duplicated CARC—‘both the retailer who has temporarily “won” a customer and the retailer who has saved or won back the customer will have incurred costs in this activity’.[25]

We request the ESC considers whether Victorian retailers have greater CARC efficiencies than other jurisdictions because they operate in the most mature competitive market. Having been in the market longest, Victorian retailers are more likely to have refined and efficient CARC strategies. If that is the case, care needs to be taken in using benchmarks from NSW and other jurisdictions that have deregulated pricing more recently than Victoria. The VDO methodology should take any unique Victorian retailing efficiencies into account.

Over the long-term, the Victorian government should continue to expand Victorian Energy Compare (VEC) use to reduce retailers’ CARC and remove these costs from consumers. Increased VEC use ‘will likely lead to customers switching directly with their preferred retailer, rather than using more expensive channels such as commercial comparators, leading to CARC savings over time’.[26] VCOSS would like to see VEC become the main electricity comparator site in Victoria, given retailers’ marketing is often confusing and complex, price competition is the main form of competition, the product is homogenous and difficult to differentiate, and there is relatively little competition in service and innovation.

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[23] Ibid 231.
[24] Ibid 142, 232.
[25] Ibid 232.
[26] Ibid.

Set reasonable costs to serve

'Costs to serve' include service costs such as billing, enquiries, debt management and regulatory compliance. Victorian costs to serve are only slightly above the NEM average at $92 per customer per year (compared with the $90 average across the NEM). Victoria's separate regulatory regime does not appear to significantly increase costs to serve—the difference is estimated at $4 per customer per year (assuming costs are spread across all customers in the NEM) or $11 per customer per year (assuming only Victorian customers bear the cost).[27]

The ESC should carefully examine the payment difficulty framework's costs. Over time, the framework may result in lower bad debts and reduced compliance costs, achieved through greater debt prevention and improved debt management. If this eventuates it could significantly reduce costs to serve, as bad debts appear to be one of the biggest drivers of costs to serve.[28] Moving customers to more affordable offers should also help reduce bad debts over time, including via best offer notifications.

Retailers' costs to serve should assume high-quality service delivery, including an acceptable hardship program and payment difficulty assistance, convenient customer communication methods (such as reasonable call centre hours and response times), investment in staff training, and services for vulnerable customers.

Incorporating quality service costs into the VDO enables costs to be shared across the customer base rather than recovered as additional charges to customers with more intensive service needs (e.g. payment difficulty assistance or relatively frequent call centre use).

Reduce retail margins

VCOSS supports the proposed benchmarking approach to estimating retail margins, based on publically available data and previous regulatory decisions.

Compared with current average margins, we expect to see significant margin reduction under the VDO, given incumbents have 'benefited from large parts of their customer base being inactive or disengaged from the competitive market', and their high margins appear to reflect this.[29]

Smaller retailers' margins are much lower at around 4 per cent NEM-wide. This is partly due to higher per customer costs, but also results from smaller retailers having fewer sticky, 'passive' customers that do not switch to better deals.[30] Smaller retailers' margins appear closer to the margins found in retail markets with effective competition.

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[27] Ibid 223-227.
[28] Ibid 225.
[29] Ibid xi.
[30] Ibid 147.

Monitor tariff structures

The ESC proposes a simple tariff structure for the VDO, comprising a supply charge presented as dollars per day, and a usage charge presented as cents per kilowatt hour. Depending on the amount of each charge, the tariff structure may disadvantage customers with certain consumption profiles (e.g. high use customers that benefit from a low usage charge and a higher supply charge).

VCOSS supports initial use of a simple tariff structure, but the ESC will need to monitor any customer disadvantage. The ESC should also monitor whether a single-rate tariff causes any problems for customers, and whether a time of use tariff should also be offered.

Allow people to benefit from lower prices

Recommendation

- Implement the Victorian Default Offer by 1 July 2019, and ensure people are able to easily identify the Victorian Default Offer and its nature.

Ensure timely implementation

VCOSS supports the proposed 1 July 2019 implementation date, allowing sufficient time for the ESC to develop a baseline VDO that can be refined over time. The VDO is not entirely without precedent; the ESC will be able to draw on existing cost benchmarks used by NSW and ACT regulators, the ACCC's analysis of retailers' costs, and the ESC's previous reference price work. We support VDO review after 6 months and a new VDO potentially commencing on 1 January 2020.

Facilitate good use of the Victorian Default Offer

The Victorian Government can develop policy to ensure people can move onto the VDO where they are currently paying more than the VDO price, such as customers with expired benefit periods who have defaulted onto high-priced market offers. This can include using the 'best offer' notification on bills to alert people to the VDO where it is lower than the price of their current deal.

VDO implementation can include a government information campaign clearly communicating the VDO's nature. People should not be misled into thinking the VDO constitutes the best price or one of the better prices in the market, which is a risk of a government-regulated price and may be used by retailers to their advantage. People should be informed the VDO is a 'reasonable' price for electricity and a basis for cheaper, discounted offers available from their retailer and elsewhere in the market.

Communications should particularly target groups that pay the highest electricity prices, including low-income households, those with limited or no internet use, public rental households and non-English speaking households.[31]

Ensure clear and consistent retailer terminology

Retailers should use clear, consistent terminology once the VDO is implemented, and should not be able to apply their own branding to the offer. This will provide people with a

[31] Ibid 294.

clear reference point for discounts and enable better identification of the VDO among retailers' offers.

Monitor the Victorian Default Offer

Recommendation

- Monitor the Victorian Default Offer to ensure its purpose is being achieved.

The VDO will require careful monitoring to ensure its purpose is being achieved, including tracking:

- any changes to market offer pricing
- the number of customers moving to the VDO and whether they experience lower or higher prices than their previous deal
- any market offers or effective unit prices set above the VDO
- whether any VDO customers are disadvantaged by the proposed tariff structure
- the features of the 'efficient retailer' and whether these need to change to better reflect retailer efficiencies
- retailers' margins.

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