People Energy

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

Thursday, 4 April 2019

Dear Madam/Sir

RE: Victorian Default Offer – Draft Advice Response.

People Energy welcomes the opportunity to provide feedback on the Essential Services Commission's (ESC) Draft Advice Response for the proposed Victorian default Offer (VDO).

Our feedback is further detailed in this document but in summary we have concerns around the VDO in its current proposed format. Our primary concern is that it will have a negative impact on competition, impacting on innovation within the Victorian market place and will drive down customer service standards.

Commentary on issues we feel are critical follows.

Standing Offer versus VDO: We strongly believe that the Standing Offer is a redundant concept in the current market environment. The way it is defined in legislation has little bearing on pricing activity in the market. However, by default, it is a forward-looking value of "cost risk" in the industry. In our view, increases in the Standing Offer over the past few years substantially only reflect wholesale cost volatility.

We also understand the urgent need to eliminate standing offers in the market. People Energy does not actively promote market contracts with standing offers, nor does it have any active retail customer on a standing offer. With around 7-8% of Victorian of retail customers it should be a relatively simple exercise over a realistic period to move these customers to market offers.

A primary objective of the VDO process was to eliminate the standing offer

Recommendation: Actively promote the transfer of retail customers to market offers.

Promotion of competition: A success of the Victorian market has been the growth in Tier 2 and Tier 3 retailers that now account for approximately 30% of the market. This segment has promoted competition amongst all participants, better outcomes for customers; and must be given the continued support for growth. A constraining VDO will lead to retailer contraction which is not an outcome that the Victorian Government and the ACCC have encouraged.

The proposed VDO must consider the ongoing benefits of competition amongst retailers. A constraining VDO will limit competition and reinforce the market dominance of Tier 1 retailers which will result in poorer outcomes for consumers and limit innovation.

Recommendation: The VDO must be set at a level to maintain competition elasticity within the market. Price rigidity only dampens competition.

***The VDO value is skewed to larger Retailers**:* The draft calculation of the VDO is heavily biased towards a vertically integrated retailer's economics. It ignores the capacity for these companies to profit outside the retail component of the value chain. The VDO should take into account the economics of all retailers that by size incur significantly higher costs with respect to funding; and have limited avenues with regard to raising equity and debt. Setting the VDO benchmark solely against ASX 200 companies will leave some T2 and all T3 retailers at a material capital raising disadvantage.

The proposed VDO value stack is skewed towards the unit costs of larger retailers.

Recommendation: The VDO needs to consider the economics of the smaller retailers that account for approximately 30% of the market and will be materially disadvantaged.

Retailer Profits: We find it difficult to reconcile the fixed component of retailer profits. Assigning a 5.7% retail profit margin is not adequate for most businesses, including retail electricity, to provide capital for investment and risk return requirements. Retailers do not align their return and investment cycles. Alinta [1] correctly recognised this issue by stating:

"Historic retail margins used in previous regulatory determinations have been insufficient to stimulate robust competition and investment. Whilst also stifling new market entry and the viability of smaller retailers at risk of creating the potential for market exit."

Proposed VDO value stack retail margin of 5.7% is inadequate.

Recommendations: The VDO should consider varying retail margin components for each Tier.

Wholesale Costs: The draft calculation implies that the wholesale cost is a mutually independent determinant for the VDO that can be "levelised" by risk mitigation measures. We do not consider that it is mutually independent given the concentration of generation assets in Victoria. We strongly believe that the Frontier Economics method of applying curve fitting and a statistical algorithm is flawed and has little bearing on hedge strategies undertaken by retailers.

Wholesale prices have increased substantially after 2017, following the closure of Hazelwood Power Station. This single event caused an increase in wholesale prices in excess of 30% which is the fundamental change to the ability to deliver competitive prices to the end consumer. In the following two years we have seen sustained and unprecedented wholesale costs which do not reflect the underlying fuel mix. South Australia, which is significantly more reliant on expensive gas generation to produce electricity is now on par with Victoria. Victoria should be substantially cheaper because generation is mostly supplied from the lowest cost of energy in Australia (Brown Coal). In our analysis, the market should trend towards $65 per MWh (blended Short Run Marginal Cost) which is reflected in the electricity futures pricing in 2022. Beyond this forecast price of $65, new entrant renewables may bring this cost even lower. To put the wholesale issue in perspective: the average price in January 2019 for Victoria was $250.33 per MWh whilst the Queensland average price was $93.91 per MWh for the same period. This is a key issue that far exceeds retail margin effects to consumer prices.

In the current market environment, suppliers of retail services that are vertically integrated are in effect profiting substantially more from generation than from the retail component. In the proposed VDO, it is likely that non-integrated retailers will not be able to compete whilst the wholesale price remains high, and little or no margin is permitted under the proposed VDO. This is likely to reduce competition when non- vertically integrated retailers are forced to depart the Victorian market. Once this has occurred, there will be no real

[1] Alinta submission quote VDO Staff Paper January 2019

market drivers to reduce the overall cost to consumers, and any retail pricing in the future will have minimal downward pressure from competition. In effect, this means that as wholesale pricing reduces (assuming the market functions correctly), prices for end consumers are likely remain the same, and the gross margin will increase for remaining retailers.

The proposed VDO will lead to market dominance by a few with a low probability of prices reducing below the VDO price, even when wholesale prices reduce to industry standards.

Recommendation: Limit the market dominance of the larger vertically integrated retailers.

Customers are active: Our experience is that the customers are active in Victoria. We note from the AEMC 2018 Retail Energy Review Competition report that Victoria has the highest retailer switching rate of 27% and a product switching rate of 10%. The notion that the Customer Acquisition and Retention Cost (CARC) component should be modest because of a lack of customer engagement or growth does not reflect the commercial reality of the market. Sumo Power and Simply Energy expressed similar concerns in their respective submissions. Based on a 2018 residential customer base of 2.3 million customer activity would have produced approximately 850,000 CARC activities not including 140,000 of net migration. The cost of CARC should be reflected in the VDO stack as it is a material component to keep customers mobile and interested in the market.

The proposed VDO allowance for CARC is unrealistic and unsustainable.

Recommendation: adjust the CARC to better reflect the actual cost.

If you have any questions regarding this response, please contact the undersigned.

sincerely

Craig Mallory
Chief Operating officer