

12 August 2019

By email: retailenergyreview@esc.vic.gov.au

Dean Wickenton
Senior Regulatory Manager
Essential Services Commission

Dear Dean,

Victorian Default Offer to apply from 1 January 2020 Issues Paper

Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to comment on the Essential Service Commission's (ESC) *Victorian Default Offer to apply from 1 January 2020 Issues Paper (Issues Paper)*. We support the Victorian Default Offer (VDO) intervention in the Victorian electricity market as this regulated price is needed to ensure that those who are not actively engaging in the market still pay a fair price for their essential electricity usage. The VDO also provides a useful consistent reference point for what is fair for those that do engage. These protections are only effective where the pricing independently set by the ESC reflects what is efficient.

In general, we support the approach to the first reset of VDO pricing that is discussed in this issues paper, however throughout the submission below we highlight areas where the ESC must go further to ensure that elements of the price setting process align with consumer's interests.

A summary of our recommendations is available at **Appendix A**.

About Consumer Action

Consumer Action is an independent, not-for profit consumer organisation with deep expertise in consumer and consumer credit laws, policy and direct knowledge of people's experience of modern markets. We work for a just marketplace, where people have power and business plays fair. We make life easier for people experiencing vulnerability and disadvantage in Australia, through financial counselling, legal advice, legal representation, policy work and campaigns. Based in Melbourne, our direct services assist Victorians and our advocacy supports a just marketplace for all Australians.

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General Comments

The VDO must be an efficient price to be effective and fair

Prioritise efficiency instead of encouraging competition for competition's sake

As discussed in our joint submission in relation to the ESC draft advice to the Victorian Government on the VDO pricing to apply from 1 July 2019,¹ the ESC must prioritise providing all Victorians with access to a fair price for energy. This means the ESC should prioritise protecting consumers by only including efficient costs in the pricing for the VDO.

Retailers have previously made arguments that competition will decrease if the VDO price is set at the level ESC has determined as efficient. If competition requires households to pay more than what is efficient and fair for their essential energy services, then competition is not delivering good outcomes.

The independent review into electricity and gas prices in Victoria² and the ACCC Retail Energy Price Inquiry (REPI)³ have both determined that competition during Victoria's full price deregulation did not deliver effective outcomes for all consumers. By setting the VDO only at efficient rates, the VDO intervention sets strong parameters and focuses retailers on competing in the interests of Victorian households by finding greater efficiencies.

RECOMMENDATION 1. The ESC must focus on delivering an efficient price when setting the VDO.

Signal expected pricing

The Issues Paper states that the ESC may not indicate the estimated pricing that would result from the draft determination decision. We accept confusion may have been an issue during the last VDO price setting process, when there was a \$75 on average increase between draft and final advice. This was a result of changes in market data between the ESC's draft and final advice.⁴

However, at the draft determination stage of the 2020 pricing determination it will be useful for the ESC to set out what prices would likely look like in a way that is easily comparable to current VDO pricing. The ESC should also signal what underlying information is to be released between the draft and final determination that is likely to affect the price and give an indication as to what extent the ESC expects this will increase or lower the VDO price.

Many consumer groups will have limited capacity to engage in this process. Simple information like this will aid their ability to quickly understand the proposal. Information like an indication of pricing should be helpful in aiding households and consumer groups of how changes to the VDO price may impact them or the wider community.

RECOMMENDATION 2. The ESC clearly outlines the estimated pricing for the VDO and what could change when more information is released at the draft determination stage

Require retailers to justify costs

There is an information asymmetry between retailers, the ESC and other stakeholders such as consumer advocates with respect to components of the retail cost stack. Retailers will always have access to more detailed

¹ VCOSS, CALC, COTA & FCRC, 2019. *Fair energy outcomes for Victorians; Response to the Essential Services Commission draft advice on the Victorian Default Offer Methodology*. Available at: https://vcoss.org.au/wp-content/uploads/2019/05/VCOSS_CALC_FCRC_COTA-submission-VDO-draft-advice-4-April-2019.pdf

² Faulkner, P. Mulder, T. Thwaites, J. 2017. *Independent Review of the Electricity & Gas Retail Markets in Victoria*.

³ ACCC, 2018. *Retail Electricity Pricing Inquiry – Final Report*.

⁴ ESC, 2019. *Victorian Default Offer to apply from 1 July 2019; Advice to Victorian Government*, p.5

information than the ESC about their own operating costs. The ESC can obtain data on a compulsory basis but use of this avenue is limited due to the cost and time involved in preparing an information request and other factors.

Retailers often provide additional information to the ESC on a voluntary basis as an input to the regulatory process (for example, to assist with cost stack estimation). However, there are incentives to provide information which is likely to increase cost estimates, and not to provide information which would tend to decrease cost estimates. Due to these imbalanced incentives, relying on voluntary data provision by retailers without cross checks of this information could lead to overestimation of costs, leading to this component of the VDO being set inefficiently high.

One way to create an incentive for retailers to provide accurate cost stack information is for the ESC to tend in the first instance toward adopting the lower figure in any range of estimates for a given cost stack component. This is consistent with the definition of productive efficiency (supplying services/goods at lowest cost) and puts the burden of proof on retailers to justify costs, which they should be able to do, if the higher figure indeed reflects some additional productivity and/or change in costs outside of their control.

RECOMMENDATION 3. Where there is variation in the data, giving rise to a range of reasonable estimates for any given cost stack component, the ESC should tend in the first instance towards the low end of the range. The burden of proof should sit with retailers to provide information demonstrating why a higher figure should be used.

Outstanding issues not addressed in the issues paper

Access to the Victorian Default Offer

Victorian households should be able to 'set and forget' without paying an unfair price for essential electricity services. While those who were previously on flat rate standing offers were automatically transitioned to the VDO on 1 July, many others who had disengaged from the market that could be paying unfair prices well above the VDO may continue to do so until they switch. Switching is something many of these households have indicated that they are unable or unwilling to do. Complimentary policy needs to be put in place to make the VDO an effective protection that ensures all are paying a fair price for essential services, whether engaged with the market or not. After all, the VDO is called a 'default' offer—it should benefit anyone that doesn't choose or hasn't made a choice in the market for some time. More work needs to be done to ensure the VDO is really a default offer.

It should also only take one phone call to access the VDO from any retailer. To simply access a fair price for their essential electricity services, households should not have to go through an arduous process. This process can involve consumers being 'knocked back' by a retailer for a market offer, having to get their head around the process for determining their financially responsible market participant (**FRMP**), successfully calling their distributor to find out which retailer is their FRMP and then calling that retailer to access the VDO. This process provides many unnecessary barriers.

How consumers access the VDO may be out of scope with this specific process, but the ESC is able to signal to the Victorian Government where there are gaps preventing the desired outcomes of the VDO interventions.

RECOMMENDATION 4. The ESC recommend that the Victorian Government improve disengaged consumers' access to VDO protections and oblige all retailers to offer the VDO to all Victorian households who request it.

Overpayments and true-ups

Modelling has limitations in an electricity services supply chain that has many variables. We trust that the ESC will do everything possible to model all the inputs for the VDO price accurately. However, as the VDO price is set in advance, price determinations may over-estimate some aspects that make up an efficient price for electricity. Where it is found that costs vary, such as wholesale prices being lower than anticipated, households on the VDO should be refunded overpayments. These overpayments should not be kept by retailers as additional margins.

RECOMMENDATION 5. Refunds are provided to households in scenarios where modelling means households are burdened by unnecessary costs.

Wholesale transfer costs

There is a risk that some retailers with wholesale arms (known as 'gentailers') may transfer electricity internally at excessive prices, then charge these prices to households. This practice could enable gentailers to mask higher margins by increasing margins in their wholesale business where they are capped by the VDO in their retail business. As stated in a joint submission to the previous VDO price setting process,⁵ we encourage the ESC to consider options for managing this risk, including estimating underlying generation costs.

RECOMMENDATION 6. The ESC considers options for managing the risk of excessive wholesale transfer costs.

Specific responses to the Issues Paper

Environmental scheme and other regulatory costs

Does this cover all environmental and other costs? Are there other more relevant sources or evidence we should consider?

We support the ESC continuing the approach taken in its final advice for the VDO to apply from 1 July 2019. However, when presenting the information we request that the ESC present more granular information (than a total amount per household per annum) about the impact and interaction between the cost of Feed In Tariffs (FiT) and Premium Feed In Tariff (PFiT) on the VDO price, if it is available. The ESC should conduct more research in order to better understand and present that information if necessary.

Many Victorian households face significant barriers to using solar technology.⁶ If FiT and PFiT increase the VDO price over time, more information as to what causes this would help us to understand whether this cost recovery is appropriate and/or proportionate to a reduction in wholesale charges that those who don't have easy access to solar should expect.

RECOMMENDATION 7. The ESC must present more detailed information about the Feed In Tariff and Premium Feed In Tariff's costs for Victorian households on the VDO.

⁵ VCOSS, CALC, COTA & FCRC, 2019. *Fair energy outcomes for Victorians; Response to the Essential Services Commission draft advice on the Victorian Default Offer Methodology*, p.9. Available at: https://vcoss.org.au/wp-content/uploads/2019/05/VCOSS_CALC_FCRC_COTA-submission-VDO-draft-advice-4-April-2019.pdf

⁶ Examples include renters who have no control over their ability to utilise this technology and those without access to capital or suitable finance to purchase systems.

Retail operating costs

Selection of benchmarks

Between the draft advice and final advice for the previous VDO price setting process, the ESC changed the benchmarks used to determine efficient retail operating price. This saw a \$29 on average increase of the overall VDO price.⁷ The ESC gave some indication of the information provided by retailers that caused this change to their view of the ACCC REPI appropriateness as a benchmark. These included 'central managed expenses such as IT and insurance' and 'shared costs'.⁸ When re-examining appropriate benchmarking, the ESC must check that these central costs, shared costs or any other costs presented by retailers are not double counted or inefficient. It is also essential to provide more transparent and detailed information on any reason as to why benchmark pricing varies from the ACCC REPI findings.

The ESC also indicated that public reporting suggested that retail operating costs could be as efficient as \$69 per customer for some retailers during the previous VDO price setting process.⁹ This indicates the need for the ESC to prioritise research that would allow a bottom up approach to retail operating costs, as opposed to a benchmark approach, as soon as possible. A bottom up approach has the potential to deliver significant savings to Victorian households accessing their essential electricity services.

RECOMMENDATION 8. The ESC ensures that retailer information provided to the ESC that varies retail operating cost benchmarks is not the result of double counting or inefficiencies.

Have any major changes occurred to retail operating costs since May 2019 when we submitted our final advice to Government? If so, what is the nature and magnitude of these changes?

The ESC has previously noted that the VDO and other reforms 'have the potential to lower retailer's operating costs'.¹⁰ We agree that the VDO and other changes around bills and marketing may lower retailer's costs. The ESC should further investigate whether reforms have increased efficiencies for retail businesses and adjust the benchmark accordingly if it is the case.

RECOMMENDATION 9. The ESC should further investigate whether retail operating costs have lowered following the VDO and other reforms.

The ESC also noted there was a financial buffer for managing the transition to the VDO. This buffer was contained in the \$134 average allocated for operating costs that was recommended for the VDO price to apply from 1 July 2019.¹¹ Such a buffer should not be carried forward as it represents inefficiencies that are not in the interests of consumers. The ESC also stated that there was \$10 per customer charge added to retail operating costs for additional costs for new regulatory obligations and Victorian specific costs.¹² The ESC must calculate how much of this benchmarked price was allocated to transition costs or new regulatory obligations and remove these now that these transitions have occurred.

RECOMMENDATION 10. The ESC must remove the financial buffer that was in place to assist with the transition to the VDO.

⁷ ESC, 2019. *Victorian Default Offer to apply from 1 July 2019; Advice to Victorian Government*, p.6.

⁸ Ibid, p.59

⁹ Ibid, p. 54

¹⁰ Ibid, p.65.

¹¹ Ibid, p.65

¹² Ibid

The Payment Difficulty Framework has been in place for 8 months. In implementing the requirements to offer timely and tailored assistance to people who are in \$55 or more in debt,¹³ retailers are likely to be seeing a reduction in the amount of bad debt that their customers accumulate.

Retailers often indicate that bad debts make up a significant proportion of their retail operating costs. Debt age and the prevention of debts building to levels that are unmanageable for households should be reducing due to the Payment Difficulty Framework's universal entitlement to timely and tailored assistance.

RECOMMENDATION 11. The ESC reduces the retail operating costs allowed for servicing bad debt in an efficient business.

Customer acquisition and retention costs

Customer Acquisition and Retention Costs are not in the interests of households

Customer acquisition and retention costs (**CARC**) are not efficient or in the interests of households, especially disengaged households who are not looking to switch energy retailers. They are a 'zero sum game' that must be constrained to stop retailers passing on unnecessary costs.

We accept that the ESC is not able to exclude these costs from the VDO price methodology. However, the ESC can ensure that these costs are kept modest.

Are there any new sources of data that we should consider to estimate a modest allowance for customer acquisition and retention costs?

Unless a productivity increase can be proven as the result of increased spending on CARC, then costs input into the VDO to recover CARC should only reduce. The ESC has indicated in the issues paper that it will seek more information from retailers. We call for the ESC to further scrutinise whether spending on CARC is modest and efficient. The ESC should also consider conducting direct research with households to test what consumers value, and use this to determine whether any spending identified as being CARC is modest.

RECOMMENDATION 12. That customer acquisition and retention costs only reduce from the previous VDO price.

Retail operating margin

Are there other issues we should consider in determining retail operating margin? How could we resolve these issues in determining VDO tariffs for the first regulatory period (1 January 2020 to 31 December 2020)?

As stated in recommendation 3 of this submission;

Wherever there is variation in the data, giving rise to a range of reasonable estimates for any given cost stack component, the ESC should tend in the first instance towards the low end of the range. The burden of proof should sit with retailers to provide information demonstrating why a higher figure should be used.

Modelling by Frontier in relation to retail margins in the last VDO price setting process gave a 4.4 – 7.4 per cent range, yet the ESC chose a benchmark approach to setting the margin and this landed at 5.7 per cent. In the 2020 process the ESC should recommission bottom-up modelling of the efficient retail margin from an independent source and in its draft determination set the proposed margin at the low end of any range given.

¹³ ESC, 2017. *Energy Compliance and Enforcement Policy: Guidance note – payment difficulty and disconnection.*

RECOMMENDATION 13. The ESC must request bottom up modelling for setting an efficient retail margin and propose setting the margin at the low end of any range given.

Variation of a VDO price determination

In what circumstances should the commission consider, and on what basis should the commission decide on, a proposed variation to a VDO price determination?

The commission should consider variation of a price determination wherever the average amounts charged to customers are significant. This is particularly important where charges could result in cases of bill shock, where 'true up' is delayed for price increases, or where people unnecessarily face payment difficulty when a price reduction is delayed. The ESC could consider the \$55 trigger for entitlement to tailored assistance in the Payment Difficulty Framework as a proxy for what is a significant amount to warrant beginning a process to vary a determination.

We agree with the ESC's assessment that price determinations should be varied where there are uncertain or unforeseen circumstances, or where material errors have been made. However, whether unintended consequences should trigger varying a price determination should be subject to consultation on a case by case basis. This is because unintended consequences may be associated with a decision that delivers a more important and impactful objective that should be prioritised above resolving smaller and less significant impacts of any unintended consequences.

RECOMMENDATION 14. The ESC should vary a price determination when not doing so would have a significant impact on Victorian households.

What process should the commission adopt in varying a VDO price determination?

The ESC should consult with stakeholders according to their Stakeholder Engagement Framework. Any decisions relating to increases of prices should include considerations as to how to best manage any resulting payment difficulty for households. Any decisions that result in a price drop or a credit to 'true up' cost should be reflected in household's billing immediately to minimise harm.

RECOMMENDATION 15. The process for varying VDO price determination should prioritise reducing any harm that may result for households.

Are there any other issues we should consider regarding the basis for the VDO compliant maximum annual bill?

We support the ESC proposal to cap all non-flat tariff VDO prices to the VDO flat tariff pricing that would be paid equivalent. If alternative tariff structures cause households to pay more than the efficient flat tariff price, then the tariff design is not in their interests. The proposed approach to the compliant maximum bill therefore offers simple and appropriate protections that ensure all have access to a fair price for their electricity.

How might any overpayment by customers subject to the VDO compliant maximum annual bill amount be dealt with?

Energy retailers should be able to easily calculate whether their tariffs are compliant with the approach proposed by calculating two billing amounts corresponding to different VDO tariff structures. This process is not unlike the tasks retailers would have to undertake for the 'best offer notification' requirements, where they must compare the price that results from their customer's tariff to other tariffs they have that may deliver a better outcome.

Wherever it is clear that the flat VDO would result in a lower price, a 'true up' cost should be reflected as a credit in household's billing, before it is issued. This will prevent any harm that may be caused by overcharging before it

occurs. The retailer should also be required to report this event to the ESC, including details of what the difference in prices were, and how many of the retailer's customers were affected. The ESC should also audit businesses to ensure that the maximum bill amount requirements are properly administered.

RECOMMENDATION 16. The ESC should cap the amount all households on the VDO pay to the flat tariff VDO rates. Any potential overcharging should be calculated in advance and be credited on billing.

Embedded Networks

What are the key issues associated with setting prices applying to embedded networks?

Monopoly scenarios

Customers in these networks are likely to be in monopoly situations where they have no access to competitive lower prices because of the cost or practical barriers associated with exiting an embedded network at their property. Recent estimates indicate that 117,000 residential customers are connected to exempt networks that have registered in Victoria alone.¹⁴

Like all households, people in this situation should have access to a fair price for their electricity. Their protections should be equivalent to their peers in the competitive market or greater. That is to say that they should have access to the VDO price or a better price. The Department of Environment Water Land and Planning has previously reviewed the General Exemption Order and made a policy decision to task the ESC with 'formulating a new price cap benchmark based on commercial market data'.¹⁵ The VDO is equivalent to this policy intention because it is set using an equivalent methodology.

Efficiencies

Embedded networks should produce cost efficiencies beyond traditional retailers, especially where a number of 'child' meters feeding off a 'parent' meter split the network costs associated with the parent meter. Embedded network operators should also be using the combined business of all their customers to 'bulk negotiate' for lower prices on behalf of their customers and have no CARC costs. Households in embedded networks should pay no more than those in the competitive market, and the price cap should reflect the VDO or lower pricing given these theoretical efficiencies.

Less consumer protections that are harder to enforce

The flow on consequences of unfair pricing in embedded networks can be more severe than the consequences of unfair pricing for households with access to the competitive market. This is because embedded network operators are:

- Not required to comply with all of the consumer protections in Victoria's energy retail code;
- Not always required to register their existence with the regulator, so there is little oversight of their operation;
- Not subject to a comprehensive enforcement and compliance regime with appropriate penalties; and

¹⁴ AEMC, 2019. *Updating the regulatory frameworks for embedded networks review final report*, p. ii

¹⁵ Department of Environment, Land, Water and Planning, 2017. *Review of the Victorian Electricity Licence Exemptions Framework Final Position Paper*, p. 19

- Often in another position of power relative to a household (like being a landlord) which means households are even less likely to dispute an unfair practice.

When paying higher prices, households are more at risk of finding themselves in a situation where they would need consumer protections like access to support for serious payment difficulty, or in need of disputing their arrangements. It is therefore essential that households in embedded networks are protected from issues arising in the first place by setting their price cap at VDO rates to actively protect their right to a fair and efficient price equivalent to other households.

How do you consider those key issues do or do not affect the approach that should be applied to embedded networks?

All of the above issues point to the need for the ESC to set the regulated cap in embedded networks to the local distribution network's VDO price or lower.

RECOMMENDATION 17. Set the price cap for embedded networks at rates lower or equal to the local VDO price.

APPENDIX A - SUMMARY OF RECOMMENDATIONS

RECOMMENDATION 1. The ESC must focus on delivering an efficient price when setting the VDO.

RECOMMENDATION 2. The ESC clearly outlines the estimated pricing for the VDO and what could change when more information is released at the draft determination stage

RECOMMENDATION 3. Where there is variation in the data, giving rise to a range of reasonable estimates for any given cost stack component, the ESC should tend in the first instance towards the low end of the range. The burden of proof should sit with retailers to provide information demonstrating why a higher figure should be used.

RECOMMENDATION 4. The ESC recommend that the Victorian Government improve disengaged consumers' access to VDO protections and oblige all retailers to offer the VDO to all Victorian households who request it.

RECOMMENDATION 5. Refunds are provided to households in scenarios where modelling means households are burdened by unnecessary costs.

RECOMMENDATION 6. The ESC considers options for managing the risk of excessive wholesale transfer costs.

RECOMMENDATION 7. The ESC must present more detailed information about the Feed In Tariff and Premium Feed In Tariff's costs for Victorian households on the VDO.

RECOMMENDATION 8. The ESC ensures that retailer information provided to the ESC that varies retail operating cost benchmarks is not the result of double counting or inefficiencies.

RECOMMENDATION 9. The ESC should further investigate whether retail operating costs have lowered following the VDO and other reforms.

RECOMMENDATION 10. The ESC must remove the financial buffer that was in place to assist with the transition to the VDO.

RECOMMENDATION 11. The ESC reduces the retail operating costs allowed for servicing bad debt in an efficient business.

RECOMMENDATION 12. That customer acquisition and retention costs only reduce from the previous VDO price.

RECOMMENDATION 13. The ESC must request bottom up modelling for setting an efficient retail margin and propose setting the margin at the low end of any range given.

RECOMMENDATION 14. The ESC should vary a price determination when not doing so would have a significant impact on Victorian households.

RECOMMENDATION 15. The process for varying VDO price determination should prioritise reducing any harm that may result for households.

RECOMMENDATION 16. The ESC should cap the amount all households on the VDO pay to the flat tariff VDO rates. Any potential overcharging should be calculated in advance and be credited on billing.

RECOMMENDATION 17. Set the price cap for embedded networks at rates lower or equal to the local VDO price.

Please contact Jake Lilley at **Consumer Action Law Centre** on [REDACTED] or at [REDACTED] if you have any questions about this submission.

Yours Sincerely,

CONSUMER ACTION LAW CENTRE

A handwritten signature in black ink that reads "Gerard Brody". The signature is written in a cursive, flowing style.

Gerard Brody | Chief Executive Officer

