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12 August 2019

Ms Kate Symons
A/Chair and Commissioner
Essential Services Commission
Level 37, 2 Lonsdale St
Melbourne VIC 3000

Submitted electronically: RetailEnergyReview@esc.vic.gov.au

Dear Ms Symons,

Re. Victorian Default Offer to apply from 1 January 2020

Red Energy and Lumo Energy (Red and Lumo) welcome the opportunity to comment on the Essential Services Commission's (the Commission) Issues Paper for the next Victorian Default Offer (VDO) to apply from 1 January 2020.

Red and Lumo support retail competition and offer customers a genuine alternative to incumbent retailers through competitive pricing, a variety of offers and rewards and award-winning customer service. The VDO has the potential to impact the level of retail competition and the range, value and choice of products and offers to customers.

The Commission has to strike the right balance when setting the VDO to avoid setting it too low, resulting in diminished competition, market concentration, a decline in service standards and innovation and more passive consumers (reversing the steady decline in the number of customers on standing offers). Incumbent retailers would be the greatest beneficiary of these outcomes. While the VDO was only recently implemented, we are aware of concerns among consumer representatives that some of these outcomes may be starting to emerge.

Price regulation carries substantial risk and we encourage the Commission to take a conservative and transparent approach to determining the next VDO effective 1 January 2020 to minimise harmful effects of price regulation and ensure Victorian consumers continue to benefit from competition. Looking ahead, the Commission should monitor the nature and extent of any consequences of the VDO, both intended and unintended.

Methodology to estimate retailer costs

Given ongoing price regulation, we support continuation of the cost stack approach, albeit with some caveats. We acknowledge this is a commonly used methodology to set regulated retail prices and will provide consistency across regulatory periods. However, the potential for miscalculation and harmful impacts remains high.

As we have previously argued, it is extremely difficult, if not impossible, to calculate a single estimate of the costs of a hypothetically efficient retailer. It necessarily involves arbitrary assumptions about the size and nature of a retailers' customer base, its operating model, service standards and hedging strategies.

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The Commission should therefore adopt a conservative approach in setting cost components to allow a range of retailers to recover reasonable costs while competing with each other.

Network costs

The Commission's proposal to determine the maximum annual electricity bill amount for domestic and small business standing offer customers on non-flat tariffs (or combination of flat and non-flat tariffs) is of particular concern. This could impact the financial viability of retailers if they face unavoidable network costs they cannot recover from customers.

The paper explains that the Commission is considering capping the maximum amount that standing offer customers with non-flat tariffs will pay; either the amount payable at a single consumption or setting a maximum amount for all consumption levels. Our concern is that such options create unacceptable retail exposure to recovery of network costs.

Victorian networks' pricing and tariff assignment policies are uncertain as they continue to consult on how to comply with cost reflective tariffs obligations under the National Electricity Rules. We expect Victorian networks will seek to assign a greater number of Victorians to cost reflective tariffs in the coming years, without consideration of implications for retailers under the VDO.

Secondly, consumers' consumption patterns vary over time due to weather conditions, the nature of appliances in their premises (and installation of new appliances such as air conditioners or solar panels), and their personal circumstances. Their consumption during peak times can fluctuate from one year to the next, particularly without price signals that discourage consumption during peak periods.

Retailer risks are compounded by consumers' response to the VDO. Even consumers currently on a flexible market retail contract could select the flexible VDO, limiting their exposure to higher prices in peak periods due to a cap on the annual amount they pay. They will probably be assigned to an underlying cost reflective network tariff so the retailer faces costs it cannot recover.

As a more general point, cost reflective network tariffs, such as those incorporating demand charges, are a new and challenging concept for many consumers. We do not anticipate that many consumers will be willing to have exposure to higher prices during peak periods when they can choose a capped VDO to remove the risk.

In order to protect retailers, the Commission could include a premium in the calculation of network costs in its maximum allowable bill to limit retailers' exposure. However, in our view, a simpler and lower risk solution is for the distribution networks to assign on request any VDO consumer to a flat network tariff. The Commission would need to work with the Victorian Government to amend the Advanced Metering Infrastructure Tariff Order to achieve this and we encourage the Commission to initiate the process.

Wholesale costs
We welcome the Commission's commitment to work with stakeholders so we can better understand its approach to estimating wholesale costs and more specifically, the workings of Frontier's STRIKE model. The assumptions in this model - about risk management strategies, for example - are opaque so we welcome the chance to better understand whether they align with actual retailer behaviour and strategies.

Environmental and regulatory costs
The Commission will also need to consider how it will account for environmental certificate and other regulatory costs (including AEMO's ancillary fees and Reliability and Emergency Reserve Trader costs). The Commission will be aware that the relevant determinations for each of these schemes do not align with the VDO determination period and as noted in our previous submissions, the various forecasts of these costs cannot be relied upon. The Commission should liaise with the respective regulatory agencies such as the Clean Energy Regulator and its advisors to get up to date forecasts of renewable energy certificate liabilities for example. To remove uncertainty about retailers' ability to recover these significant costs, the Commission must clearly articulate how it intends to forecast the costs and compensate retailers if it gets these forecasts wrong.

The Commission is also aware of the numerous regulatory initiatives that came into effect in Victoria on 1 July 2019 and other measures on which it is currently consulting. Retailers are also working to implement amendments to the Energy Retail Code to provide assistance to customers affected by family violence. The Commission needs to take account of the additional costs for retailers these measures have created, both the initial costs of implementation and of managing the clear advice entitlement and other changes which are increasing customer handling times.

Customer acquisition and retention costs (CARC)
We acknowledge that the Commission has been instructed to include a modest allowance for CARC in the next VDO. However, in the absence of any headroom allowance, we maintain the view that a reasonable CARC allowance is necessary to maintain competition. As previously noted, we consider competition fosters choice for customers while promoting higher levels of customer service. The more modest the allowance, the more VDO will advantage the incumbent retailers.

A higher CARC allowance than in the current VDO is also required to deliver greatest value from the Victorian Government's initiative of best offer notification on bills. This is intended to encourage all Victorian consumers - including those on standing offers - to consider alternatives to their current arrangements and participate in the market. If the Commission does not allow adequate CARC, competition in the market will reduce, there will likely be fewer retailers and less competitive deals on offer. The benefits for consumers from switching to a best offer will decline.

The Commission suggest that acquisition and retention activity only benefits some consumers. In our view, advertising and brand awareness benefits all consumers, including those on standing offers as it raises awareness of choice and raises standards amongst all retailers as they seek to generate loyalty. The increase in consumers on market offers is evidence of the value of marketing and competition.

Other matters
We understand the Commission is intending to run a separate consultation process for how the VDO will apply to embedded networks later in the year. We recommend that the Commission clarify its views now on which aspects of VDO it intends should apply to all consumers (whether in an embedded network or not).

Finally, we understand the Victorian Government plans to change the start of the next regulatory determination for the Victorian electricity network price determinations from 1 January 2021 to 1 July 2021. This means a VDO determination period will be either 6 or 18 months and there will be further misalignment with other regulatory determinations. The Commission should set out early how the 2021 VDO will apply, particularly in light of the challenges of defining a cost component for environmental schemes and feed-in tariffs discussed earlier. Red and Lumo's preference is for the VDO to apply for the first 6 months of 2021, rather than for 18 months from January 2020 unless additional headroom is provided, reflecting the risk of a longer fixed price determination.

About Red and Lumo

We are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria, New South Wales, Queensland and South Australia and electricity in the ACT to over 1 million customers.

Red and Lumo thank the Commission for the opportunity to respond to its Issues Paper. Should you wish to discuss aspects or have any further enquiries regarding this submission, please call Geoff Hargreaves, Regulatory Manager on [redacted].

Yours sincerely

Ramy Soussou
General Manager Regulatory Affairs & Stakeholder Relations
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