

17 April 2018

Mr James Clinch
A/Senior Regulatory Manager, Energy
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

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

Dear Mr Clinch,

Developing a reference price methodology for Victoria's energy market

Simply Energy welcomes the opportunity to provide feedback on the Essential Services Commission's (ESCV) consultation paper on Developing a Reference Price Methodology for Victoria's Energy Market.

Simply Energy is a leading second-tier energy retailer with over 660,000 customer accounts across Victoria, New South Wales, South Australia and Queensland. As a growing retailer, Simply Energy supports open market competition and is committed to ensuring affordable energy services continue to be provided to end-use consumers.

Simply Energy understands that the Victorian Government considers that there are benefits in setting a reference price, such as for the purposes of better understanding the effectiveness of pricing and competition in the Victorian energy market.

In saying this, Simply Energy would like to emphasise that a reference price will always be an estimate – and as such imperfect – and should not be seen as providing the basis for regulated prices that seek to perfectly substitute for market driven outcomes.

Simply Energy, therefore, encourages the ESCV to qualify and provide appropriate disclaimers around the reasonable uses and application of the reference price.

In exploring this matter in further detail, Simply Energy's submission considers:

- the issues with price regulation;
- the ESCV's proposed methodology for setting a reference price; and
- the reference price's potential uses and application.

Issues with price regulation

Open markets are dynamic and as they evolve, competitive tension generally leads to a cost equilibrium. While there will always be those who wish to pay lower prices for a service or commodity, the self-correcting nature of a market means that prices tend to be reflective of how much the average consumer is willing to pay.

It is accepted that in the Victorian energy market competitive tension has led to considerable price dispersion and a range of product offerings. However, this is not necessarily a bad outcome, as the differentiation in prices and service offerings reflects an evolving market that is attempting to cater for differing consumer choices.

Regulated prices, on the other hand, are generally used as a proxy to competitive market outcomes where competitive tension does not exist or is ineffective. In order to function effectively, regulated prices need to be set at a level that allows businesses to recover the efficient costs of service delivery, while ensuring customers are not paying too much. This is a difficult balance to achieve and the effect of getting the price wrong can impede future competition and innovation, to the long-term detriment of consumers.

In recognition of this challenge, Simply Energy encourages the ESCV to qualify and point out the limitations in its reference price methodology to ensure policymakers are aware of the limits to the reference price's reasonable uses and application.

The ESCV's proposed methodology

Simply Energy considers that the ESCV's cost based approach to setting a reference price is broadly consistent with the methodology used by other regulators in setting regulated retail energy prices. Due to information asymmetries, the lack of wholesale contractual transparency and time-constraints in publishing a reference price, it would be unreasonable to expect the ESCV to develop a robust model by 1 July 2018. Simply Energy therefore considers that policymakers need to be made aware that the reference price methodology will need to be refined over a period of time to ensure it is robust and credible.

Wholesale prices and environmental scheme costs

In terms of wholesale electricity prices, Simply Energy agrees that the major cost drivers include financial hedging and an allowance for higher than expected energy costs. Retailers also bear the costs of compliance with environmental scheme requirements. These cost drivers will inevitably evolve in line with the composition of the generation mix and any market concentration across the National Electricity Market, particularly with the Australian Government's focus on emissions and the implementation of the National Energy Guarantee (NEG).

The effects of these changes are, however, difficult to predict, meaning that the most indicative forward price expectations can only be derived from futures contracts and load shape expectations. There will of course be a degree of uncertainty to these estimates, as all are to some extent based on historical data, which may not be a good guide to the future.

In view of this, the ESCV will need to review the wholesale and environmental scheme components of its cost stack at least once a year to ensure they reflect prevailing market conditions. If there is a substantial change in the market, which makes historical datasets poor guides to the future, then the ESCV may need to resort to a forward-looking long-run marginal cost (LRMC) approach. This may become more relevant if the NEG is introduced. In fact, a LRMC approach may more effectively align with the contractual basis of the NEG, which is aimed at ensuring there is sufficient generation to meet future demand.

Similarly there will be a high degree of estimation with respect to the wholesale gas price component. As wholesale gas transactions are primarily executed pursuant to confidential bi-lateral contracts, rather than through an open market, it is difficult to infer wholesale gas prices from public transactions data. Without going down the path of estimating gas production costs with a rate of return commensurate to economic conditions and the state of financial markets, the most transparent way to calculate wholesale gas costs is through a liquefied natural gas netback price.

The netback price assumes that there is a correlation between international and domestic gas prices. This may not be perfect in every instance, but it is accepted that gas producers will look to liquefy their natural gas and export the commodity, if domestic buyers are unwilling to buy gas at comparable rates based on a netback calculation. This, in turn, makes a netback calculation a reasonable approximation for wholesale gas prices.

Network costs

Simply Energy agrees that this component of the retail cost stack should be calculated on a cost pass-through basis. However, Simply Energy would like to point out that network charges vary depending on service area and nature of the customer's connection to the grid. For example, some electricity consumers may be connected for commercial purposes, while some residential consumers may have distributed generation installed meaning they are subject to different network tariffs.

In light of this, Simply Energy does not consider that the ESCV can simply adopt a 'one-size-fits-all' network cost approach to setting a reference price. If the ESCV does so, appropriate qualifications will need to be made around the assumptions that underpin the calculation.

Retail operating costs and margins

Simply Energy understands that in the current time constraints, a benchmarking approach is the only feasible way of calculating retail operating costs and margins. Having said that, benchmarking is a high-level approach giving indicative results only. There can be jurisdictional as well as organisational efficiency factors that can influence the actual operating costs incurred by a business.

In view of this, Simply Energy only supports benchmarking as an interim approach. A more effective approach would be to undertake a bottom-up analysis of major retailers operating in Victoria and then use benchmarking as a reference to ensure the inferred operating costs and margins are reasonable.

Use and application of the reference price

Although the consultation paper's primary focus is on the methodology used to set the reference price, Simply Energy urges the ESCV to think carefully about how the price may be used by policymakers and consumers.

While Simply Energy understands that the reference pricing is intended as a helpful tool in monitoring retail energy prices, Simply Energy does not believe that a reference price should be used as a basis for imposing retail price re-regulation in Victoria. Using the reference price as the basis for setting a basic service offer would be a fundamental step backwards for the Victorian energy market.

The difficulties in setting a regulated price for energy means that the reference price will be set too high and could end up costing consumers more than they would otherwise pay in an open market. Alternatively, the price will be set below cost-reflective levels, leading to smaller retailers exiting the market.

At an extreme this could lead to a small group of large vertically integrated retailers having greater ability to influence unregulated wholesale energy prices. Given that wholesale costs (along with network costs) make up a substantial component of the retail cost stack, a failure to take into account such effects while focusing on costs to acquire and retain customers could have significantly adverse implications for consumers, particularly in the longer term.

For this reason, Simply Energy is of the view that the ESCV needs to highlight the potential consequences of not including acquisition and retention costs within its reference price cost stack. Direct marketing, such as telemarketing and comparator sites, are the main channels for smaller retailers to acquire market share. These channels help make consumers aware of their options, helping to bring more efficient and innovative products into the market.

There is ultimately little point offering a basic service offer based on a reference price to all customers. This will only compound inefficient energy usage by those who have the means to pay and will delay attempts to reduce average network charges by providing widespread incentives that encourage consumers to use energy more efficiently. Indeed, customers with the capacity to pay and actively search for better offers should be encouraged to do so, rather than being provided with a regulated basic service offer.

If the goal of price re-regulation is to increase protections for vulnerable customers, then measures targeted at this group could be developed.

Concluding Remarks

The ESCV’s proposed methodology is consistent with regulated pricing practices undertaken across other jurisdictions in the past. For this reason, Simply Energy accepts that despite not being a perfect reflection of market driven pricing, an appropriately developed reference price may achieve some of the benefits sought, such as for the purposes of better understanding the effectiveness of pricing and competition in the Victorian energy market.

That said, Simply Energy does not believe that a reference price should be used as the basis for a regulated basic service offer. This is particularly the case with a reference price that excludes some of the costs incurred by the businesses that are to be regulated. To this end, it is important to keep in mind that not allowing retailers to recover all their costs will threaten their financial viability and lead to a direct reduction of competition in the market. This will, in turn, be detrimental to the long-term interests of the Victorian energy market and consumers more broadly.

In view of this, Simply Energy welcomes further discussion in relation to this submission and the ESCV’s proposed methodology for setting a reference price. To arrange a discussion or if you have any questions please contact Anthony O’Connell, Senior Regulatory and Compliance Officer, on [redacted].

Yours sincerely

[redacted signature]

James Barton
General Manager, Regulation
Simply Energy