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Essential Services Commission

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### **Victorian Default Offer – Staff working paper**

Sumo welcomes the opportunity to respond to the Essential Services Commission's Staff Working Paper 'Victorian Default Offer for domestic and small business electricity customers' dated 21 December 2018.

Sumo is a small, innovative energy retailer primarily offering electricity and gas to small customers in Victoria. Sumo is a stand-alone retailer with no generation assets.

While Sumo supports sensible measures that apply downward pressure on energy prices and encourage and enable consumers to compare offers effectively, it strongly opposes the proposed Victorian Default Offer (**VDO**). A critical role of an energy retailer is to manage energy price volatility on behalf of consumers. However, retailers cannot control all costs – particularly a stand-alone retailer with no upstream generation assets. Retailers need to be able to pass on increases in costs to consumers. A poor regulatory price decision could mean retailers cannot recover all such costs and make an adequate return. Even before a regulatory price decision is made, its very existence will impact the availability of investment funds available to a sub-scale electricity retailer, which relies on such investment to fund its growth.

Attempting to set a VDO that reflects the efficient costs of all retailers is an impossible task. Despite the impossibility of the task, it is critical that the VDO determination is done right. The Commission has been set an extremely challenging task to make this determination in only a few short months. It should be given more time to ensure it undertakes the task comprehensively.

If a VDO must be implemented, it is critical that the price is not set too low. Doing so will push retailers out of the market altogether. The almost unprecedented wholesale electricity pricing event in late January 2019 sends an important warning. These events increase wholesale costs and the prudential capital required by retailers. A VDO that doesn't anticipate such events could have catastrophic impacts on retailers, causing some retailers to exit the market, either in an orderly manner or otherwise.

Appropriate safeguards should be put in place to protect retailers from the impacts of poor VDO decisions.

### **Definition of efficient retailer**

Typically, economic regulators set a price for a monopoly business. Attempting to set a regulated price in a market that is already highly competitive presents additional challenges. In such a market, there are many participants, each with different characteristics – number and type of customers, customer load profile, risk appetite, growth strategy – and the regulated price needs to be able to accommodate all of them.

The Terms of Reference call for the VDO to be based on the efficient cost to run a retail business. In this context, how a notional 'efficient retailer' is defined is critical to determining the methodology for setting each of the cost components; in particular, the wholesale electricity costs, the retail operating

costs, customer acquisition and retention costs, and the retail operating margin. We discuss each of these below.

A healthy, competitive market must encourage new participants to enter the market and grow. New entrant retailers bring pressure on prices and introduce innovation. We agree that the 'efficient retailer' should be stand-alone and not vertically integrated; that it serves domestic and small business customers in Victoria but not large commercial customers or customers in other jurisdictions. We would add that, to enable competition to continue to provide benefits to consumers, the notional retailer should more closely resemble a new entrant retailer than one of the 'Big 3'. In our view, this retailer would have approximately 50,000 Victorian electricity customers and would have a moderate – high growth trajectory. This scale is reasonably achievable for a new entrant retailer over a 3-4 year business plan period.

## **Wholesale electricity costs**

Frontier Economics' proposed methodology for setting wholesale electricity costs has four steps, to which we comment below:

1. What is the likely half-hourly load of retailers' customer?

Frontier proposes to use MRIM data published by AEMO for each Victorian DNSP. As we understand it, the limitation of MRIM data is that it reflects the load shape of all small customers (being those consuming less than 160 MWh pa) in a distribution zone, not the particular load shape of the customer for which a VDO will apply, being residential customers on the one hand, and small business customers consuming less than 40 MWh pa on the other. The load shape of residential customers is very different to that of business customers and is somewhat more difficult (and more costly) to hedge.

Further, each retailer will have a different mix of customers. A retailer that has a customer base dominated by residential customers – like Sumo does – will have a different load shape to the market on average, and would be expected to have a higher wholesale electricity cost as a result.

To better reflect the model retailer described above, the methodology should adopt a load shape that reflects the characteristics of the churning customer, being those who have engaged in the market and switched to a challenger retailer.

The data that is used for this purpose should not reflect the load shape of the most recent year, nor the average of all available years. Retailers must be able to accommodate the worst-case outcome, so the 'worst-case' half-hourly load shape should be selected. To the extent that historical data is used, it should be noted solar PV is increasingly impacting the load shape of residential customers, by reducing the load during times when the sun is shining. Any use of available historical data should be adjusted to reflect the increasing penetration, and impact, of solar PV.

The average of the load shapes across the five distribution zones should be weighted in proportion to the number of customers in each distribution zone.

2. What are the likely half-hourly spot prices that retailers will face?

As above with load shape, retailers need to be able to respond to the worst possible outcome in terms of spot prices. We believe that the 'worst case' spot price outcome should be used in the wholesale cost modelling. To the extent that historical spot prices are used, we note that spot price patterns have been changing year-on-year, following the closure of coal generation, the increasing cost base of gas peaking generation and the penetration of solar

generation (both small and large scale). The pattern of spot prices in the most recent year of data would be expected to more closely resemble the pattern of spot prices in the regulated period than earlier years.

Sumo agrees that the annual level of electricity spot prices should be based on the ASX forward prices for the period, although there is no basis for deducting a contract premium of 5%. This is because the ASX price reflects what the market expects spot prices to be, without premium.

An important factor in assessing the level of the spot prices is the period over which the ASX forward price is assessed. In Sumo's view, the price should be the average ASX forward price over the 12 month period ending 3 months prior to the period in question.

For the first regulated price period – being a period from July to December – the methodology will need to take account of the wholesale cost of electricity over the full calendar year 2019, and not just that of the second half of 2019. Retailers typically set their retail prices for a calendar year, which accounts for much higher wholesale prices in Q1. If the VDO for July – December 2019 is only based on wholesale electricity costs for the July – December 2019, it will materially understate the average costs incurred by retailers.

3. What is the cost of financial hedging contracts available to retailers?

At the outset, it should be noted that the cost of funding working capital makes trading on the ASX an expensive way to hedge electricity costs. A significant proportion of the contract face value must be put forward upfront in cash, and the cost of this capital must be carried for the duration of the contract. The retailer must also fund variation margin calls where the hedge is 'out of the money'. Increasingly, over-the-counter contracts also call for credit support arrangements. This cost must be factored into the cost of financial hedging contracts.

Sumo supports the approach of basing the cost of financial hedging contracts on ASX contract prices over a 12-month period ending 3 months before the period in question, rather than over the most recent 40-day average. This closely resembles the approach adopted by retailers. We don't support a longer period, such as 24 months, although if a longer period is adopted, then the cost of funding the additional working capital must also be included in the cost base.

The ASX costs must be adjusted upwards to account for the funding costs of hedging on the ASX.

In our experience, annual wholesale hedges for smaller retailers are only available at a price that is a 30%-40% premium to the forward price.

4. What kind of hedging position is a prudent retailer likely to adopt?

Sumo supports the approach of building a book of base and peak swaps and caps.

We are very interested to understand better what assumptions Frontier's portfolio optimisation model, STRIKE, takes into account when modelling a prudent hedging position. It must be understood that each retailer's risk appetite will differ. No single hedging approach should be considered superior to any other. Also, each retailer will have a different load profile, and different level of volatility in its load shape. These differences will impact the mix of swaps and caps that would be deemed most appropriate. The appropriate assumptions of the model retailer we discuss above should be adopted.

As above, different retailers will have different levels of volatility in their load shape. Allowances must be made for such volatility, recognising that volatility of shape will result in an over-hedge cost.

#### 5. Determining the volatility allowance

Frontier proposes an allowance for working capital required to avoid default in the case of higher than expected energy purchase costs. Its formula ( $3.5 \times sd \times WACC$ ) appears to address AEMO prudentials (MCL and margin calls). However, it would be insufficient to cover the cost of credit support required by counterparties or the ASX. As discussed above, any calculation of wholesale electricity cost must take account of funding costs for all credit support and prudential requirements. This cost is not typically included in the retail operating cost.

### Retail operating costs

The Staff Working Paper proposes using a benchmarking approach to establishing retail operating costs and customer acquisition and retention costs. While it may be the only one available in the time given, this approach is fraught. The Commission must exercise extreme care to ensure the benchmarks it uses include all relevant cost categories, and to ensure they reflect the costs of the appropriate notional retailer and not the costs of a particular retailer in existence today or the market average.

The task is, in any event, impossible. Retailers all have very different scale and cost structures. A retailer with 1,000 customers cannot possibly be compared to a retailer with 1,000,000 customers.

If the Commission adopts the approach of determining the efficient cost of only one notional retailer then, as above, we consider that the notional retailer should serve only Victorian domestic and small business customers, have around 50,000 customers, and not be vertically integrated. Any benchmarks used should be based on retailers with these characteristics.

A better solution may be to adopt banded benchmarks; that is, to assess the benchmark costs of retailers at different scale: 1 – 20,000 customers, 20,001 – 100,000 customers, 100,001 – 300,000 customers and 300,001+ customers. A different VDO tariff could be determined for retailers that fall within each benchmark.

The Staff Working Paper identifies the work done by the ACCC as part of its retail electricity pricing inquiry as one possible benchmark. The ACCC's analysis was indeed thorough and based on bottom-up analysis. Again, however, the Commission must be cautious in how it applies the cost to serve and customer acquisition and retention costs identified in the ACCC report:

- First, the costs in the ACCC report are based on 2016-17 data and must be adjusted to reflect subsequent changes in costs for Victorian retailers. In fact, there has been a number of additional costs introduced in Victoria since that time, some of which are detailed below.
- Cost to acquire –
  - Whilst the ACCC reports customer acquisition and retention costs in Victoria at \$59 per customer, this number is an average across all retailers, and so is heavily skewed towards the Big 3 retailers. Notably, the ACCC reported that the Big 3 incur much higher CARC per customer acquired or retained than second-tier retailers (\$283 vs \$198), but when that cost is spread across their entire customer base (including the many customers who never engage in the market at all), it is relatively small (\$40 vs \$87).
  - In our view, this benchmark for CARC is the wrong benchmark. The average CARC using the ACCC's methodology is too heavily influenced by the growth rate of the retailer relative to its customer base. On this measure, a large retailer with little or no

growth will have a very small CARC, whereas a small retailer with high growth will have a much larger CARC.

- A better approach would be to amortise the actual average cost of acquiring or retaining an individual customer over the expected tenure of that customer. So, if it costs \$300 on average to acquire and retain a customer, and customers stay with the retailer for three years on average, then the CARC would be \$100 per year. Similarly, if a retailer is able to acquire and retain a customer for \$200, but its customers stay on average only two years before switching away, that retailer will also have a CARC of \$100.
- An increase in competition since 2016-17 – evidenced by higher churn and increasingly aggressive retention and win-back activity – has led to higher costs to acquire and retain, and increased operating costs as a result. Sumo has been advocating for a ban on retention and win-back activity to reduce the significant wasted marketing costs incurred and necessarily passed onto consumers, and this is now Victorian Government policy. Until this policy is implemented, the increasing marketing cost must be reflected in the CARC for the purposes of determining the VDO.
- Cost to serve –
  - The retail operating costs presented in the ACCC report show average costs to serve in Victoria (\$92), and separately break down the cost to serve as between the Big 3 (\$75) and other retailers (\$146). The CTS of a Big 3 retailer reflects their scale across the NEM, and very likely reflects the lower cost of off-shoring call centre and back-office operations. On the basis that the notional efficient retailer should resemble a new entrant retailer, it is important that the benchmark at least reflects the cost to serve of other retailers (excluding the Big 3 and the State retailers) in Victoria. The ACCC report doesn't include this number.
  - New entrant retailers also face higher costs of bad debt, reflecting the average credit profile of the switching market vs those who do not engage in the market, and also reflecting the difficulty retailers face collecting debt from customers who have churned away to another retailer (of which smaller retailers have a higher proportion).
  - The ACCC report noted the additional costs imposed by the separate regulatory regime in Victoria, which it estimated at \$15. It is not clear if this number is reflected in the number the ACCC reported as the average CTS in Victoria. In addition, a number of new regulatory changes have been implemented or are being implemented, including the new payment difficulty framework, the 'best offer' entitlement, the 'clear advice' entitlement and changes to the display of GST-inclusive pricing. These changes have material one-off implementation costs and, at least in the case of the payment difficulty framework, will lead to a material increase in operating costs on a permanent basis.
  - Price increases from increasing wholesale costs – and the political and media reporting of rising prices – drive more and more customers to call their retailer. The increase in call handling also increases operating costs.
  - Costs generally must be adjusted for inflation.

## **Retail operating margin**

The retail operating margin must fund a number of additional costs, including interest on debt finance, tax, depreciation and amortisation.

As with retailer operating costs, the cost of debt will differ markedly across different retailers, depending on their scale and risk profile. Again, if adopting the 'notional retailer' approach, the cost of debt should broadly reflect the cost for a stand-alone, new entrant retailer, not one that is integrated with a generation business that has physical generation assets, or associated business units that may guarantee or de-risk the proposition for an equity or debt investor in the retail business.

Again, as with retailer operating costs, a better solution may be to band the retail operating margins. A separate retail operating margin could be adopted for retailers with less than 100,000 customers vs those with 100,000 customers or more. 100,000 customers is selected as a measure of the number of small customers required by a retailer to achieve sufficient scale.

Extreme caution must be exercised when relying on retail margins determined by other regulators. It is difficult to see how the retail operating margins determined by IPART (being in the range 5.3% to 6.1%), for instance, could fund the costs of debt and equity for a new entrant retailer. The Commission will need to carefully consider the cost of debt and equity in the 'notional retailer'.

## **Other issues**

We comment briefly on a few other issues:

- Sumo considers that the better regulatory period is not the calendar year, but the full financial year July – June. Accordingly, the first regulatory period could cover the period July 2019 – June 2020. This period aligns better with budgeting and reporting periods for most businesses.
- As above, rather than set a single VDO that applies to all retailers, a better solution may be to create a range of VDO outcomes that apply to different categories of retailers. The costs of an efficient smaller retailer would be calculated separately from the costs of an efficient large retailer, and different VDOs would apply to each.
- The Commission proposes only to determine a flat VDO tariff. However, many customers may be on TOU or other tariff structures. Retailers should not be required to offer a flat VDO tariff to customers on different network tariffs. One option is to permit retailers to reassign the network tariff back to a flat tariff.
- The Commission should consider how it deals with material changes in a retailer's costs during the price period. It should reopen the price decision urgently in these circumstances.
- The Commission should consider how it will deal with a poor VDO determination. Appropriate safeguards should be put in place to protect retailers from the impacts of poor VDO decisions. Consideration should be given to compensation for retailers if the price is set so low that the retailer cannot recover its costs.
- The Commission should consider how it monitors the impact of the VDO after it is implemented. What does 'success' look like? For instance, it could monitor the impact of the VDO on market prices, service levels, retailers entering/exiting the market, and product innovation.

Please contact me if you would like to discuss any aspect of this submission.

Yours faithfully

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