



VCOSS response

Developing a reference price methodology for Victoria's energy market

April 2018

VCOSS welcomes this opportunity to comment on the development of a 'reference price' by the Essential Services Commission ('ESC'). This forms part of the ESC's implementation of recommendations of the Independent Review of Electricity and Gas Retail Markets in Victoria ('the Review').

Depending on its purpose and design, a reference price could be a useful guide to the reasonableness of Victorian energy pricing, and whether the energy market is operating in consumers' long-term interests, particularly low-income and vulnerable consumers.

The ESC has been asked to develop a methodology that enables publication of a reference price from 1 July 2018. The reference price will be an 'efficient' price that helps the ESC assess the competitiveness and efficiency of the Victorian energy retail market. We understand the initial reference price will be an interim measure and subject to further development.

However, how the reference price will be ultimately used is unclear to VCOSS at this stage. In order to refine the reference price over time, VCOSS recommends the Victorian Government should engage with community organisations, consumers and industry and determine the optimal purpose and form of the reference price, and the most appropriate methodology to produce it.

Summary

VCOSS believes that developing a reference price may be a useful intervention in the energy market. However, a reference price may serve different purposes, and the appropriate method should reflect the intended purpose. Any methodology should maximise the benefits for consumers, especially those on low-incomes, experiencing high energy bills, or not engaged in the energy market. In this submission, we explain:

- some of the methods used by other jurisdictions, noting that they align with an explicit purpose for the price determination
- the need to ensure 'representative' retailer costs reflect efficient, quality services and a diversity of household circumstances, include access to solar generation
- if the reference price is publicised, care is needed in ensuring people have enough information to interpret it, and are not misled into accepting higher prices than necessary.

Matching the pricing methodology to its purpose

The ESC's preferred methodology for the reference price involves a cost-based approach that estimates the costs a retailer would incur in providing its services. The ESC proposes to use a benchmark approach for estimating retail operating costs and a retail margin, based on decisions made by other Australian regulators. Over the longer-term, the ESC has indicated it will also employ a bottom-up approach to estimating retail operating costs, using information provided by retailers.

As the purpose of the reference price is unclear, it is difficult to comment on the preferable methodology. Pricing methodologies will differ, depending on whether the reference price is intended to signal:

- a price 'cap', which seeks to prevent excessive pricing in the market
- a no-frills, low-cost price that acts as a frontier price for the market
- a price that sits at a different level to those above, such as a 'fair and reasonable' benchmark price.

The terms of reference do not discuss the purpose of the reference price. They state that in monitoring and reporting on the competitiveness and efficiency of the Victorian energy retail market, the ESC is to:

develop and apply a methodology for determining an efficient price in the energy retail market – a 'reference BSO [Basic Service Offer] price'.

The reference price is to have the same features as the Basic Service Offer described by the Review and be based on the efficient costs to run a retail business, include an allowance for a maximum retail profit margin, and exclude customer acquisition and retention costs ('CARC') and headroom.

Our understanding is that other jurisdictions have been able to establish pricing methodologies because government has made clear the purpose of the pricing.

For example, in the Australian Capital Territory, the Independent Competition and Regulatory Commission ('ICRC') determines a maximum average percentage change that ActewAGL Retail ('AAR') can apply to its regulated tariffs, or standing offers. The retail costs component is determined by estimating the costs that would be incurred by an efficient incumbent retailer in the same position as AAR. The resulting price direction by the ICRC is a weighted average price cap.¹

Prior to deregulation, the Independent Pricing and Regulatory Tribunal New South Wales ('IPART') set a regulated retail price for electricity customers. The regulated price was unlikely to be the lowest price in the market, but the price for customers who had not taken up a competitive, unregulated market offer. Prices were set at a level that reflected efficient retail costs and included a competition allowance that was intended to provide an incentive for retailers to enter the market and for customers to engage in the market. IPART also used a weighted average price cap approach, meaning the regulated incumbent retailers could set

¹ Independent Competition and Regulatory Commission, *Final report: Standing offer prices for the supply of electricity to small customers from 1 July 2017*, Report 6 of 2017, June 2017, ix, 7-8.

their own prices provided the average change in prices was no more than the percentage determined by IPART.²

The ESC intends to use benchmark data from other Australian regulators like the ICRC to help develop the retail component of the reference price. However, this data may not be entirely applicable if it was designed to produce a form of pricing, such as a price cap, that ostensibly has a different purpose to the Victorian reference price.

Developing and using the reference price

We request the ESC takes the following factors into account in developing the initial reference price.

Ensure any ‘representative retailer’ is efficient

We understand the ESC will develop a ‘representative retailer’ to determine the retail component of the reference price. The number of Victorian retailers and their varying market shares and profiles makes the development of a Victorian reference price more challenging than in other jurisdictions.

The scale and business model of the representative retailer will be important to the final reference price. The representative retailer should not reflect any inefficiencies of incumbent retailers with ‘sticky’ customers, meaning those customers who rarely seek better deals, and often pay higher prices. Equally, it should be able to operate at a reasonable scale to a high standard, and not rely on heavily segmenting ‘risky’ customers, including low-income customers.

Ensure service costs include customer protections

The calculation of costs to serve in the retail costs component should include the costs of providing the full suite of customer protections under the Energy Retail Code, including a sufficient allowance for compliance with the new payment difficulty framework, high-quality hardship programs, and training that enables call centre staff to assist vulnerable people in financial stress.

Ensure prices reflect household diversity

Several reference prices may be needed for a range of representative households. Low-income households have varying levels of energy consumption, ranging from households that are self-rationing in order to afford energy bills, to large households with high energy needs.

The retail costs component will be influenced by whether a household has solar panels or not. The retail costs borne by consumers appear to be much higher for non-solar households than solar households. Since January 2017, the apparent retail costs have proportionately increased the most for non-solar market offer customers.³ The ESC may need to develop separate reference prices for solar and non-solar households, and determine whether non-solar households are exposed to any unique retail costs.

² Independent Pricing and Regulatory Tribunal New South Wales, *Review of regulated retail prices and charges for electricity from 1 July 2013 to 30 June 2016*, 6-10.

³ St Vincent de Paul Society and Alviss Consulting, *Victorian Energy Prices January 2018*, 71-73.

Reference price should not mislead people into accepting high prices

Assuming the reference price is publicised to some degree, there is a risk the reference price could inadvertently lead people to accept higher prices than necessary if there is confusion about what kind of price signal the reference price is sending—is it a ‘fair and reasonable’ benchmark price, a price approximating a cap, or something else? For example, if it ends up approximating a price cap, people will need to be encouraged to seek deals below the reference price.

There is also a risk of people accepting relatively high prices if the cost-based approach preferred by the ESC produces a higher price than an index-based approach.

An index-based approach draws on observed prices in the market. Under this approach, the ESC could examine a sample of market offers and adopt criterion for establishing a ‘reasonable’ price as a starting point, such as the median of the best available offers of all retailers. The ESC decided against an index-based approach on the basis that:

an index-based approach requires a starting point from which to index. In a competitive market that is operating effectively, the starting price could be based on a sample of observable market offers. Given the findings of the review panel it does not appear possible to establish ... a competitive retail price that is representative of all consumers for the purpose of establishing a starting point. As a result, this approach to establishing a starting point is not viable.⁴

A cost-based reference price may be higher than an index-based price, depending on what is taken to be the representative retailer, representative households, and whether previous benchmarks used by other Australian regulators are appropriate. We therefore request the ESC and the Victorian Government carefully consider how they apply the reference price in their analysis and publicise it to Victorians.

⁴ Essential Services Commission, *Developing a reference price methodology for Victoria’s energy market*, consultation paper, 20 March 2018, 26.