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Commissioners
Essential Services Commission
Level 37, 2 Lonsdale Street
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Dear Commissioners

Victorian Default Offer 2021 – Consultation Paper

Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to comment on the Essential Service Commission's (the **Commission**) Consultation Paper – Victorian Default Offer 2021 (the **Consultation Paper**).

Consumer Action considers that there is room to reduce the Victorian Default Offer (**VDO**) from 1 January 2021. There is significant financial stress being inflicted on the Victorian community due to COVID-19. Social restrictions are limiting peoples' ability to work and earn an income. In turn, many peoples' ability to pay for essential services is reduced. It is integral that this be at the forefront of the Commission's thinking in determining the VDO.

As the Consultation Paper notes, the objective of the VDO is to provide a simple, trusted and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the electricity market.[1] As the Commission has previously noted, this has also been described as 'universal access to a fair priced electricity offer'.[2] Consumer Action considers that fairness and community expectations demand that the VDO be set at no more than absolutely necessary to ensure bills remain affordable, particularly for those who are unable to effectively engage in the market.

This submission makes 11 recommendations in response to the Consultation Paper. We think that the focus for the Commission should be:

- Pursuing cuts to the hedging component of wholesale costs. As noted later in this submission, even the Commission's consultant states that the assumptions applied systemically over-estimate wholesale costs. We consider that there is opportunity to revisit the approach taken in the past.
- Ensuring that any costs due to 'shocks' such as COIVID-19 come out of retail margins in preference of being passed on to households. This recognises that it is the role of retailers to manage risk. Existing margins appear quite generous given new retailers are still trying to enter the market and given that there are many offers still sit below VDO prices.
- Making further reductions to the allowance for customer acquisition and retention costs. As the Commission has previously noted, it does not appear that customers in the aggregate are the beneficiaries of increased expenditure on marketing.

[1] Clause 3 of VDO Pricing Oder
[2] Commission, Advice on VDO to apply from 1 July 2019, page 14.

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

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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.

Wholesale costs

Role of retailers in managing wholesale risk

Buying energy on the wholesale market and selling it to households carries inherent risk, since wholesale prices fluctuate on a half hourly (soon to be five minute) basis but retail contracts typically offer prices fixed for a duration of months or years. This in itself is not a problem or a special circumstance for retailers but an inherent feature of their bins model.

Arguably the main service provided by retailers, since electricity at the point of end use is a physically undifferentiated product, is to offer financial risk-management. Retail contracts are used to 'smooth' price fluctuations caused by the changing balance of supply and demand for electricity, using tools—such as derivatives, power purchase agreements (PPAs) and owning of generation assets—which are unviable for individuals and households. Their ability to provide this service forms part of their basis of their 'social licence to operate' and to derive profit from an essential service.

Being exposed to the cost of 'mistakes' or sub-optimal risk management strategies also creates an incentive for retailers to develop better strategies, rather than simply passing costs on to consumers.

In the first instance, any increase in the cost of managing wholesale risk should be borne by retailers, not shifted to individuals or households via the VDO. This is both fair any in line with the principle that risks should be allocated to those best placed to manage them. Submissions from retailers about 'the impact of COVID-19 on their wholesale electricity costs'[3] should be viewed in this light.

RECOMMENDATION 1. Wholesale market risk and the cost of manging it should by default be borne by retailers, not individual or household energy users.

Allowance for unplanned events and economic 'shocks'

By definition, wholesale risk—or any risk—involves events which are not entirely predictable. Showing that an unexpected event has occurred does not in and of itself justify increasing the wholesale cost component of the VDO. Rather, the onus should be on retailers to show why such an increase should apply.

On the fact of it, COVID-19 may seem like exceptional event, creating risk that spot risks and loads will diverge more from forecasts than would generally occur. In light of this, the Commission has asked retailers for submissions on 'changes to volume or patterns of consumption due to COVID-19'.[4] Yet so far, the impact on the balance between supply and demand for electricity—the fundamental driver of wholesale prices—has been limited,[5] with little change in aggregate energy use under lockdown.

In the future, there are likely to be more unexpected disruptions to our communities, the natural environment and the economy—insofar as these systems are distinct, as opposed to interrelated and interdependent. These may include climate-related 'shocks' such as an increase in natural disasters, impacts on infrastructure or generation, and policy responses which could include the influx or removal of particular fuels, technologies and generation capacity.

The Commission should not set a precedent of declaring a 'state of exception' by offering retailers special allowance for COVID-19, in the absence of strong evidence that:

- it has actually caused a material increase in costs; and

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[3] ESC, Consultation Paper—Victorian Default Offer 2021, page 8.
[4] As above.
[5] See http://www.wattclarity.com.au/articles/2020/07/covid4-update/

- any increase is qualitatively and quantitatively different from the inherent risks retailers take on as apart of their role providing risk-management services for consumers.

More broadly, the Commission should not set a precedent that cost and risk from any unplanned economic disruption can simply be passed on via the VDO. The Commission states 'we are aware that COVID-19 will have an effect on the finances of both retailers and their customers'.[6] This will likely be true of any future 'shock' to aggregate production. In the first instance, costs should come out of retailers' profit margins not users of an essential service.

RECOMMENDATION 2. Unexpected events such as COVID-19 should not by themselves lead to a presumption of increasing the wholesale or other allowances for the VDO.

The 'efficient' benchmark contract position

Frontier and the Commission's approach to estimating benchmark contracting costs for an efficient retailer assumes such a retailer will 'cover' their load using ASX-traded financial derivatives:

- purchasing swaps to cover (approximately) aggregate demand;
- purchasing caps, on top of that, to cover (approximately) peak demand;
- in some cases, incurring a small amount of pool exposure at absolute peak demand times.[7]

Frontier itself acknowledges that by focusing on ASX-traded energy derivatives, while excluding other risk-management strategies such as PPAs and vertical integration, this method will systematically overestimate the hedging component of wholesale costs:

"*In practice, it is clear that retailers in the NEM do adopt a mix of hedging strategies, including vertical integration and power purchase agreements…by excluding vertical integration and power purchase agreements from consideration, therefore, regulators will, if anything, tend to overstate the costs that retailers face".*[8]

These inflated costs are then passed on to households via the VDO.

This methodology is especially problematic given most household and small business energy users are still signed with large retailers which own substantial generating assets ('gentailers'). Given the majority of Victorian consumers are still with the 'Big Three' retailers,[9] the approach used to set the hedging component of the VDO will tend to overshoot the actual costs for most of the market.

The Commission should seek methods to incorporate the full range of risk-management strategies available to retailers into their wholesale cost estimates. In absence of these methods, cost estimates based on derivatives-only hedging should be treated as an upper bound for hedging costs, not an 'efficient' estimate.

RECOMMENDATION 3. The Commission should seek to incorporate the full range of risk-management strategies available to retailers into their wholesale cost estimates, as failure to do so will tend to systematically overestimate these costs.

Frontier has presented the following justifications for its 'derivatives only' approach to estimating efficient retailers' costs:

- 'Vertical integration and entering into power purchase agreements can be impractical for retailers with a smaller retail position in a market or with a less certain retail position'.[10]

[6] ESC, above n 1, p 13.
[7] Frontier Economics, Wholesale Electricity Costs for 2020: A report for the Essential Services Commission, page 30
[8] Above, page 6.
[9] ESC, Victorian Energy Market Report 2018-19, page 25.
[10] Frontier, above n 7, page 6.

- 'Prices for exchange-traded financial derivatives are transparent, since they are traded on the ASX. In contrast, the costs of building generation plant or entering into power purchase agreements are less transparent'.[11]

Embedded in the first of these justifications is the assumption an efficient market for residential energy users will contain a significant number of small retailers. This is not necessarily the case. Even outside of hedging, there are theoretical reasons why small retailers may in general face higher costs per customer. Some retailers have a smaller customer base over which to 'smear' fixed costs, resulting in higher average costs per customer. They also have a smaller base over which to 'pool' the risk of bad debt, as well as less access to the full suite of risk-management strategies such as 'gentaling' and PPAs. On top of these theoretical arguments, there is empirical evidence that hedging costs for smaller retailers are, in fact, higher.[12]

This is not to say small retailers cannot participate in a 'good' market structure—only that this participation should be contingent on their being able to offer a fair and efficient cost of service comparable to other retailers.

Without taking a position on what exactly a 'good' energy market structure looks like, pre-determined assumptions about that structure should not undergird the modelling approach to developing cost benchmarks for retailers. Fairness and efficiency are outcomes experienced by the people using (and paying for) electricity, not prescriptions for market structure.

The VDO benchmarks should be drawn from (or at least cross-checked against) these outcomes, i.e. the actual range of wholesale and hedging costs paid by all retailers. Since efficiency, by definition, is about providing a service at lowest cost, 'efficient' benchmarks should in the first instance be located at the bottom of this range.

With respect to transparency, while recognising the difficult task faced by regulators, ease of access to inputs for the benchmarking process should be prioritised over accurately estimating efficient wholesale costs. If anything, such an approach may create an incentive for (especially large) retailers to withhold information, for instance by shifting as much hedging as possible to bilateral PPAs or other commercial-in-confidence agreements. If such strategies are a cheaper way to manage risk than ASX-traded derivatives, these retailers will earn a 'premium' above efficient costs for each of their VDO customers.

RECOMMENDATION 4. The Commission should cross check modelled wholesale costs including hedging against observed data on retailer costs. Where a range exists, efficient costs should be presumed in the first instance to sit at the low end of the range.

RECOMMENDATION 5. The Commission should not seek to promote a particular market structure but should instead base benchmarks on fair and lowest-cost energy for households.

Other potential issues with forecasting methodology

Risk when spot prices diverge from expectations

The Frontier model uses futures market prices to predict spot prices for the wholesale cost component of the VDO:

'In our view, the best available public information about the average level of Victorian spot prices for 2020 is the contract prices published by ASXEnergy. These contract prices – particularly the prices of base swaps – provide the market's view on what will be the average spot price for 2020. Given this, for each simulated year, we assume that the average level of prices is consistent with ASXEnergy futures prices.'[13]

There are multiple reasons why the derivatives market may not accurately predict future wholesale prices.

[11] Frontier, above n 7, page 7.
[12] Finncorn, State of Play: Quantifying the competitive outcomes of retailing in the NEM, available at: https://energyconsumersaustralia.com.au/publications/state-play-quantifying-competitive-outcomes-retailing-nem
[13] Frontier, above n 5, page 17.

Prices on the futures market reflect market expectations, not necessarily trends in the real physical market for electricity. Participation in the trade of ASX energy derivatives requires no underlying position in the physical market. In fact, the volume of derivatives often exceeds the total electricity which is actually being generated—for example in the 2018 calendar year, traded futures represented 237% of power consumption.[14]

This suggests many transactions are purely speculative, and that the futures market is being driven by the beliefs and expectations of participants who have no direct exposure to changes in the underlying supply of, and demand for, electricity. Theoretically an investor who knew there was not likely to be any change in the balance of supply and demand over the next year, but who thought other investors believed prices were about to fall or rise, would have an incentive to buy/ sell energy derivatives based on this prediction. A critical mass of such investors can shift futures prices in ways untethered to the real physical trade in electricity.

This indicates how 'animal spirits' play a role in this (and any) futures market. In the event spot prices are not accurately forecast by the futures market, this discrepancy (positive or negative) will be passed through to consumers through the wholesale cost component of the VDO.

Risk from assuming a fixed correlation between price and load

The Frontier model uses a Monte Carlo method (random sampling from a pool of historical data) to forecast the shape of future energy consumption, that is, the distribution of load throughout the year and the correlation between load and prices. The correlation between load and prices is treated as fixed:

'*For each of these simulated years, load and prices are drawn at the same time (i.e. from the same historical day) so that the correlation between load and prices is maintained.*'[15] (Frontier, 2020, p17)

This is not necessarily the case. Spot prices are determined by the evolving balance between the supply and demand for electricity. Load (or demand) represents only one side of that relationship. As previously discussed, change in the supply of generation—for example due to natural disasters and other climate-related 'shocks' and policy responses—may cause wholesale prices to sharply rise or fall even in the absence of major change to load.

Such an outcome would cause wholesale price benchmarks in the VDO to diverge from actual costs faced by retailers, with the discrepancy (positive or negative) passed on to consumers.

Retail operating costs

Regulatory costs

The Commission has flagged potential allowances in future editions of the VDO (such as 2022) for systems changes within the regulated price due to the introduction of five-minute settlement.[16]

We consider that the full cost of updates to retailers' IT and other systems should not be rolled into the VDO, since retailers need to undertake periodic systems updates even without regulatory change. Moreover, there may be scope to pursue lower costs on grounds that retailers may even gain some efficiencies by installing new systems as in many cases as IT systems need to be updated periodically to remain fit for purpose. For example, in 2014 Origin claimed to have saved $100 million by completing a billing and customer management upgrade one year early[17] while 'glitches' in an EnergyAustralia billing system left over 20,000 bills unpaid.[18]

[14] See https://www.asxenergy.com.au/products/electricity_futures/asx-energy----introduction-to.pdf.
[15] Frontier, above n 5, page 17.
[16] ESC, above n 1, page 10.
[17] See: https://www.itnews.com.au/news/origin-energy-completes-troubled-sap-transformation-392192.
[18] See https://www.news.com.au/finance/money/computer-snags-in-energyaustralia-billing-system-leaves-accounts-unpaid/news-story/599eb0f45a631d7363458388ca0cdea3.

RECOMMENDATION 6. The full cost of systems changes due to five-minute settlement and/or other regulatory changes may not need to be 'rolled into' the VDO, as normal retail operating costs should include periodic systems upgrades and maintenances.

Bad debts

COVID-19 is resulting in financial stress in the community. However, risks associated with bad debt, and the cost of managing it, should be borne by retailers in preference to being passed on households through an increase the allowance for retail operating costs.

In considering this issue, the Commission should acknowledge that retailers receive support from government which limits their exposure to risk from bad debt. This includes direct financial support through measures such as the AER's proposed deferral of network charges paid by retailers for customers affected by the pandemic,[19] and indirect measures such as income support payments to the community including JobSeeker and JobKeeper which are largely spent on essentials such as electricity.

Given this is an evolving situation, it is unclear what the net financial impact of COVID-19 will be for retailers. What is clear is that it is not appropriate for the retail operating cost component of the VDO to be set so as to effectively 'passes on' the cost of bad debt to households, in the absence of evidence that households are better placed to absorb these costs than retailers. In a hierarchy of response, risks should be borne by retailers in preference to households.

RECOMMENDATION 7. The risk of bad debt, and the cost of managing it, should by default be borne by retailers in preference to being passed on households through an increase the allowance for retail operating costs.

Customer acquisition & retention cots

Our previous submissions to the Commission urged reduction in the benchmark for customer acquisition and retention costs (CARC). In this vein, we consider that the Commission must continue to scrutinise whether spending on CARC is modest and efficient.

Rather than solely relying on a benchmarking approach based on cost levels from recent regulatory decisions, and in recognition of the pricing order which allows inclusion of a 'modest' allowance for CARC,[20] we suggest that the Commission 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. Doing so recognises:

- that CARC are inherently inefficient since they represent an 'arms race' of retailers chasing after a fixed pool of essential service consumers, without actually changing the size of the market;
- that increasing CARC simply adds to this 'arms race' since the more retailers spend on attracting customers away from each other, the more they have to spend to retain their existing customers, causing an escalating spiral of cost and inefficiency;
- that CARC have tended to increase over time with deregulation and increased retail competition; and
- that benchmarking allowances for CARC will tend to lock in inefficiencies generated by deregulation and competition.

Should the Commission maintain its benchmarking approach to determining CARC, we note that a recent decision of the ACT Independent Competition & Regulatory Commission excluded a CARC allowance.[21]

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[19] AER, Deferral of network charges rule change, see: https://www.aemc.gov.au/rule-changes/deferral-network-charges.
[20] Clause 12.4(d) of VDO Pricing Order
[21] See: https://www.icrc.act.gov.au/energy/electricity/retail-electricity-prices-2020-24

RECOMMENDATION 8. That customer acquisition & retention costs be reduced in recognition that this expenditure is inefficient.

Retailer operating margin

The Commission's use of benchmarking to set an allowance for retail margins may not result in an efficient allowance that considers how the marketplace has responded to the VDO, and efficiencies that are available in the Victorian market.

The Consultation Paper notes that since the VDO was first applied new retailers continue to emerge and retailers are still providing market offers at prices below the VDO. This suggest that there the margin in the VDO is generous and that there may be room for it to be reduced, particularly recognising the bill affordability challenge associated with the economic effects of COVID-19.

Furthermore, continued use of benchmarking risks becoming circular as it relies on other regulators' historic decision-making, which often relies on prior decisions. Instead, the Commission could consider obtaining updated independent advice regarding efficient retailer operating margins. Recognising the information asymmetry between industry, regulators and consumers, margins should be set at the lower end of any recommended range.

RECOMMENDATION 9. The Commission should conduct independent modelling as to an appropriate benchmark for efficient retail operating margin and set the allowance at the lowest point of any range given.

Calculating VDO tariffs and maximum bill

The Commission's proposed approach to setting VDO tariffs and a maximum bill is appropriate.

However, there must be an ongoing focus on ensuring compliance and understanding the market response. For example, the Commission should use its information gathering powers to require retailers to share prices actually being paid by consumers. This should include customers that have been placed on time-of-use VDO tariffs.

We generally support the Commission's proposed approach to collection of cost data. Ongoing collection of actual costs associated with each element of the VDO cost stack is necessary to inform the setting of the VDO. However, in addition to cost information, the Commission needs to also obtain information about prices actually being paid. It is only with this information that the Commission and the community more broadly able to determine the full impact of the VDO in the marketplace.

RECOMMENDATION 10. The Commission should obtain pricing information from retailers to understand the impact of the VDO in the marketplace.

Length of regulatory period and data collection

On balance, we consider that it would be preferable for the regulatory period for the 2021 VDO to be a period of 6 months from 1 January 2021.

We consider that there are costs and risks with making regulatory determinations too often. These include the direct costs to participants in being involved. We also acknowledge that regulated businesses hold far more information compared to consumer groups or even regulators, and thus have greater power in these processes—if the processes are scheduled too often, regulated businesses can more easily exert their power.

However, with the onset of COVID-19, there is a level of uncertainty relating to costs over the medium term. Furthermore, Victorian network costs are to be determined by April 2021—a further review of the VDO in May 2021 will ensure that these costs are applied, reducing confusion for stakeholders and the community about further changes that might be needed then if a longer regulatory period was applied. As such, on balance, we consider that a further determination in May 2021 for a period of 12 months would be appropriate.

RECOMMENDATION 11. That the regulatory period for the 2021 VDO determination be 6 months from 1 January 2021.

Thank you for the opportunity of providing this submission. Please contact us at **Consumer Action Law Centre** on 03 9670 5088 or at info@consumeraction.org.au if you have any questions about this submission.

Yours Sincerely,
CONSUMER ACTION LAW CENTRE

Gerard Brody | Chief Executive Officer

APPENDIX A - SUMMARY OF RECOMMENDATIONS

RECOMMENDATION 1. Wholesale market risk and the cost of manging it should by default be borne by retailers, not individual or household energy users.

RECOMMENDATION 2. Unexpected events such as COVID-19 should not by themselves lead to a presumption of increasing the wholesale or other allowances for the VDO.

RECOMMENDATION 3. The Commission should seek to incorporate the full range of risk-management strategies available to retailers into their wholesale cost estimates, as failure to do so will tend to systematically overestimate these costs.

RECOMMENDATION 4. The Commission should cross check modelled wholesale costs including hedging against observed data on retailer costs. Where a range exists, efficient costs should be presumed in the first instance to sit at the low end of the range.

RECOMMENDATION 5. The Commission should not seek to promote a particular market structure but should instead base benchmarks on fair and lowest-cost energy for households.

RECOMMENDATION 6. The full cost of systems changes due to five-minute settlement and/or other regulatory changes may not need to be 'rolled into' the VDO, as normal retail operating costs should include periodic systems upgrades and maintenances.

RECOMMENDATION 7. The risk of bad debt, and the cost of managing it, should by default be borne by retailers in preference to being passed on households through an increase the allowance for retail operating costs.

RECOMMENDATION 8. That customer acquisition & retention costs be reduced in recognition that this expenditure is inefficient.

RECOMMENDATION 9. The Commission should conduct independent modelling as to an appropriate benchmark for efficient retail operating margin and set the allowance at the lowest point of any range given.

RECOMMENDATION 10. The Commission should obtain pricing information from retailers to understand the impact of the VDO in the marketplace.

RECOMMENDATION 11. That the regulatory period for the 2021 VDO determination be 6 months from 1 January 2021.