Level 6, 179 Queen Street
Melbourne, VIC 3000

info@consumeraction.org.au
consumeraction.org.au
T 03 9670 5088
F 03 9629 6898

20 October 2020

Submitted via Engage Victoria

Commissioners
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne, VIC 3000

Dear Commissioners

Victorian Default Offer 2021 – Draft Decision

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

We are pleased to see that the Draft Decision will result in average bills falling for households. COVID-19 is inflicting significant financial stress on the Victorian community and the ongoing restrictions mean that we are spending more time at home which is increasing normal energy usage. The lockdown and economic downturn is also limiting peoples' ability to work and earn income meaning that the ability of many in our community to pay for essential services is significantly reduced. These factors are important to bear in mind as the Commission comes to a final decision for the Victorian Default Offer (**VDO**).

The Draft Decision 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.

We support the Commission's scrutiny of the impact of costs associated with the pandemic. Financial impacts of the pandemic on retailers should not necessitate a cost pass-through as the primary function of retailers is to manage risk and this is factored into existing retail margins. We also suggest financial impacts such as bad debt write offs due to COVID-19 may also be covered by retailers' cost savings measures.

We encourage the Commission to scrutinise the methodology used for estimating retail cost benchmarks and ensure this methodology is evolved over time to ensure fair and lowest-cost energy for households. We also provide comment on customer acquisition and retention costs and the proposed regulatory period and variation mechanism.

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

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.

Costs

Role of retailers in managing wholesale risk and unexpected events

The COVID-19 pandemic is impacting retailers and customers alike. We noted in our submission on the Commission's VDO Consultation Paper that the primary service that energy retailers provide, since electricity at the point of end use is a physically undifferentiated product, is to offer financial risk-management. On principle, customers should not bear the costs of wholesale market risk including cost impacts of the pandemic. In the first instance, costs should come out of retailers' profit margins not users of an essential service.

We are pleased to see the Commission scrutinise claims related to impacts of the pandemic on retailer costs and not adjust retail cost benchmarks where information does not substantiate any increase. Moreover, we stand by our previous comments that any increase in the cost of managing 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.

Ensuring retailers are exposed to the cost of 'mistakes' or sub-optimal risk management strategies also provides an incentive for retailers to manage their operations in a prudent way rather than pass losses through to customers.

Unexpected disruptions including climate change related 'shocks' such as an rise in natural disasters like the increasingly severe bushfires we have seen in Australia and elsewhere over the last decade or so, related impacts on infrastructure or generation, and policy responses which could include the influx or removal of particular fuels, technologies and generation capacity will all impact market risk. It is important that the Commission does not set a precedent that cost and risk from any unplanned economic disruption can simply be passed on via the VDO.

Related to this, the Commission has noted that some retailers "have made large savings in costs to serve in recent years, with further savings forecast."[3] These publicly disclosed cost savings are greater than some retailers' forecasts of bad debts due to the pandemic. We encourage the ESC to ensure these are taken into account. There could also be room to further lower retail cost benchmarks based on these "cost to serve" savings.

RECOMMENDATION 1. In its Final Decision, the Commission reiterate the principle that unexpected events such as COVID-19 should not by themselves lead to a presumption of increasing the wholesale or other allowances for the VDO.

Productivity factor

The Commission has suggested there may be merit in applying an annual 'productivity factor' but have not done so in this Draft Decision. We strongly support the application of a productivity factor in future reviews. Any for-

[3] Draft Decision page 4

profit business generally aims to become more efficient over time and it is natural that in a well-functioning marketplace that customers would benefit from such efficiencies. It is also fair.

Introducing a productivity factor would make clear the Commission's intention that retail costs should decrease over time. It would be a perverse policy outcome if retail costs were to increase steadily over time because of inefficiencies on the part of retailers and that these costs were then passed through to end users.

The 'efficient' benchmark contract position

We retain our position that the approach used to estimating benchmark contracting costs for an efficient retailer will systematically overestimate the hedging component of wholesale costs. Focusing on ASX-traded energy derivatives, while excluding other risk-management strategies, fails to account for other ways retailers manage risk including power purchase agreements (PPAs) and vertical integration and results in regulators overstating costs that retailers face.[4]

These inflated costs are then passed on to households via the VDO. While there are significant differences between the approaches of different sized retailers to manage risk, using a methodology that fails to incorporate the full range of risk-management strategies available to retailers is problematic and will tend to overshoot the actual costs for most of the market. Pre-determined assumptions about a particular market structure should not undergird the modelling approach to developing cost benchmarks for retailers.

The VDO should be a fair and trusted price for electricity and we encourage the Commission to evolve the methodology used to estimate these costs so as to make energy more affordable rather than assume or encourage a particular market structure. Cost estimates based on the method relied on in this Draft Decision should be treated as an upper bound for hedging costs and not an 'efficient' estimate.

RECOMMENDATION 2. The Commission should treat the cost estimates relied on in this Draft Decision as an upper bound measure rather than an efficient estimate.

RECOMMENDATION 3. The Commission should evolve the methodology used to estimate benchmark contract costs with an aim to ensure fair and lowest-cost energy for households.

Customer acquisition & retention costs

We have consistently urged the Commission to reduce 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. The Commission should be wary of pinning CARC costs to measures like customer churn and instead explore what may be driving capturing and retaining of customers.

We reiterate our suggestion that the Commission conduct direct research with households to test what consumers value as simply allowing a pass-through of expenditure for CARC does not necessarily indicate a well-functioning competitive market.

In our view the CARC component of the VDO should be reduced to zero to encourage retailers to offer value to customers through other measures such as investing in hardship assistance or making bills more affordable. Charging disengaged electricity consumers so retailers can sponsor football teams, buy Google advertising, or fund third party comparison websites[5] is inefficient and unfair.

RECOMMENDATION 4. That customer acquisition & retention costs be reduced in recognition that this expenditure is inefficient.

[4] Frontier Economics, Wholesale Electricity Costs for 2020: A report for the Essential Services Commission, page 6
[5] https://www.accc.gov.au/media-release/iselect-to-pay-85-million-for-misleading-consumers-comparing-energy-plans

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.

We note that the ACCC has recently published some new data relating to the bills actually paid for by consumers, including in Victoria.[6] The Commission could obtain this data and analyse it to assist with this task.

RECOMMENDATION 5. The Commission should obtain pricing information from retailers to understand the impact of the VDO in the marketplace.

Length of regulatory period and variation mechanism

Our submission on the Commission's Consultation Paper advocated for regulatory period for the 2021 VDO to be a period of 6 months from 1 January 2021 in part because network costs for 2021 are unknown.

Despite this, we support the Commission's proposal for a one-year regulatory period and to instead vary the VDO price determination following the Australian Energy Regulator's (AER) approval of network tariffs. It is important that the Commission does pass through any costs savings that may result from this network determination to the VDO.

Regarding a variation mechanism for potential impacts of the pandemic, we reiterate our position that retailers should not be provided a special allowance for the pandemic unless there is strong evidence that it has caused a material increase in costs and that any driver of an increase is tangibly different from the inherent risks retailers carry in their role providing risk-management services for customers.

RECOMMENDATION 6. The Commission should plan to vary the VDO if the AER network determination results in a reduction in network costs.

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

Yours Sincerely,
CONSUMER ACTION LAW CENTRE

Gerard Brody

Gerard Brody | Chief Executive Officer

[6] https://www.accc.gov.au/publications/inquiry-into-the-national-electricity-market-september-2020-report