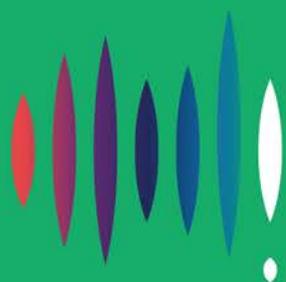
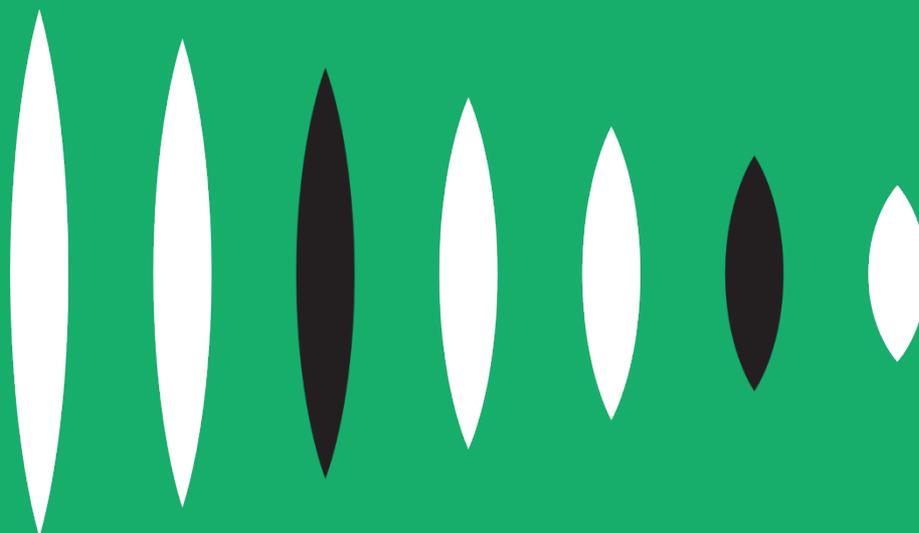


Review of electricity and gas retail markets in Victoria

Submission to the Independent Review Panel
February 2017



**ENERGY
CONSUMERS
AUSTRALIA**

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Version history

VERSION	DATE	COMMENTS
1	1 March 2017	
2	3 March 2017	

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Introduction

Energy Consumers Australia welcomes the opportunity to contribute to the work of the independent panel conducting a review of electricity and gas retail markets in Victoria (the Review).

As Victoria led the way first in moving to full retail contestability and then price deregulation in energy markets almost a decade ago, it is both timely and important that there be a retail market review at this time.

Further, decisions that are made in Victoria in relation to market design and regulatory frameworks will have important consequences for national market participants, and in particular energy retailers.

Energy Consumers Australia is the national voice for residential and small business energy consumers. Established by the Council of Australian Governments in January 2015, our objective is to promote the long-term interests of energy consumers with respect to price, quality, reliability, safety and security of supply.

Related to this objective Energy Consumers Australia has also been tasked with understanding differences in energy markets and the implications across jurisdictions and building the knowledge and capacity of advocates through evidence and research.

Through our Energy Consumer Sentiment Survey (ECSS), Energy Consumers Australia surveys approximately 2,300 residential and small business consumers twice a year about their satisfaction, confidence and activity in relation to their electricity and gas services. We have published two surveys so far, the first in July 2016 from a survey undertaken between 30 March and 14 April 2016, and the second in February 2017, from a survey undertaken between 25 August and 5 September 2016.¹

We have drawn on this survey to provide the Review with evidence of the lived experience of Victorian consumers in energy markets, to add value to the work of the Review.

Energy Consumers Australia has drawn on the work that we commissioned from Finncorn that analysed the business models, profit drivers, cost structures, capital needs and risk management strategies of the retail energy companies using publicly available data (reported to the Australian Stock Exchange).

We also refer in this submission to the analysis that St Vincent de Paul Society undertakes of prices in Victoria through its Tariff Tracker. Energy Consumers Australia funds St Vincent De Paul Society through its Grants Program to undertake this research for other National Electricity Market jurisdictions to provide a national picture of retail price movements annually.

¹ The full reports, as well as state-by-state summaries of the results are available on our website. We also publish the raw data we collect for use by third parties. <http://energyconsumersaustralia.com.au/projects/consumer-sentiment-survey/>

Energy Consumers Australia has more recently funded a number of grants, that are still in progress, that are assessing the information and tools needed to support households in their management of energy expenses in response to increasing prices, including through behavioural insights. This research will provide the basis for assessing the effectiveness of market responses to consumer needs and in particular the circumstances of vulnerable households.

Energy Consumers Australia has structured our submission under the same headings as the Review's Discussion Paper, to facilitate further engagement and discussion with the Review Panel. We have used the evidence and our experience in other markets to help frame the analysis and call out issues worthy of investigation by the Review.

Energy Consumers Australia supports the objective of the Review in eliciting evidence on matters raised in the Discussion Paper. Where we are able to provide evidence to the Review Panel we have done so.

Competition and the long term interests of consumers

Electricity and gas prices are driven by a number of components; the price of the energy, the cost of transmission and distribution networks, retail costs and environmental costs.²

In a competitive market, retailer innovation could reward consumers who can adapt their demand at times when, and in locations where, energy is more expensive. This could have the effect of reducing costs to consumers over time because the need for expensive additional capital investment in centralised generation and network capacity to meet peak demand can be avoided.

Currently the trends in energy costs are in the opposite direction.

There have been increases in network costs and more recently increases in wholesale energy costs.

What is less clear is the evidence of trends in the retail costs component, in the absence of "actual" publicly available data from the retailers on their costs.

² These environmental schemes include the costs due to the Large-scale Renewable Energy Target (LRET). The LRET policy design requires electricity retailers to source a proportion of their electricity from renewable sources. The LRET directly affects retail electricity prices because the costs of large-scale generation certificates (LGC) are recovered through retail prices. According to the Australian Energy Market Commission's 2016 Residential Price Trends report these costs represent around two to four per cent of a typical residential electricity bill.

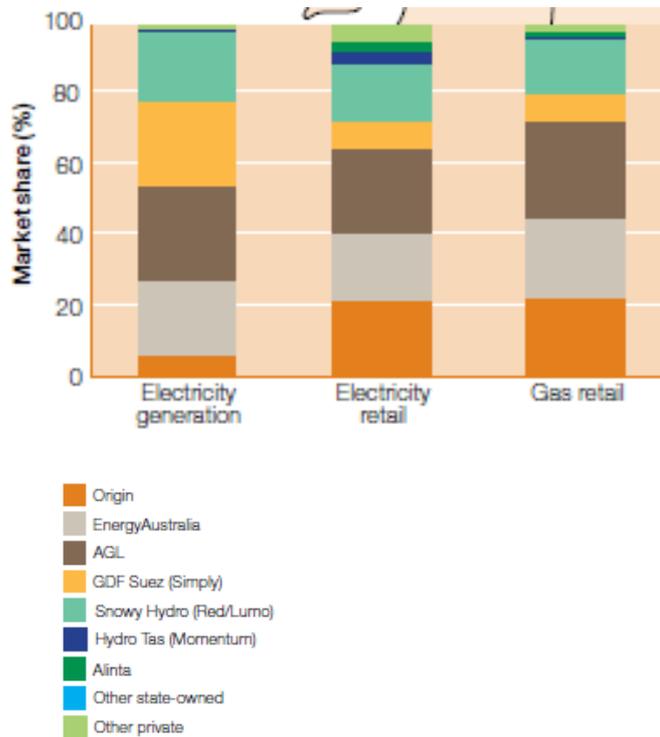
The St Vincent De Paul Society, through its tariff tracker project, has tracked Victorian electricity and gas standing and market offers since 2010, applying a consistent methodology over that time. The available analysis shows that retail cost component is the highest in Victoria, compared with other jurisdictions, and has increased over time.³

Market structure and regulation⁴

Market shares of the “Big 3”

The Australian Energy Regulator (AER) publishes information annually on the extent of vertical integration and market shares in electricity and gas markets.⁵ This is shown below in the chart in Figure 1.

Figure 1: Market shares and vertical integration in Victoria



³ St Vincent De Paul, *The National Energy Market- A hazy retail maze*, p 34

⁴ We have included consideration on the issues in section 6 of the Discussion Paper, *Restraints on competition*, together with the issues raised in this section on *Market structure and regulation*.

⁵ Australian Energy Regulator, *State of the Energy Market 2015*, p128

According to the AER, in 2014 -15 AGL, Origin Energy and Energy Australia had a combined market share of small retail customers of 64% in electricity and 72% in gas.

There is no single dominant retailer, as each of the “Big 3” has between 20-25% market share. Victoria also has significant vertical integration with the 3 major retailers controlling 54% of generation capacity.

There is a question as to whether these concentrated market shares in electricity and gas markets are impacting adversely on the outcomes for consumers in these markets, given that the Big 3 retailers have significant generation businesses.

Retail regulation

This Review in Victoria (and the Independent Review into the Future Security of the National Electricity Market, the Finkel Review) are important opportunities to deliver a greater level of visibility around market structure and pricing in retail markets and the opportunities to improve the future outcomes for consumers.

The Discussion Paper asks the question whether “*there are any features of the market structure or regulation that inhibit the market from delivering outcomes in the best interests of consumers?*”

Energy Consumers Australia considers that this question goes to a key task of the Review, which is to identify whether changes are needed to the market structure and or regulatory framework that will ensure they are fit for purpose over the longer term.

In this context it may be helpful to draw on the parallels between this Review and the two Financial System Inquiries that have taken place since financial market deregulation in the 1980s. In both cases these Inquiries sought to establish whether competition had been effective and delivered outcomes for consumers.

Lessons from reviews of effective competition in financial markets

The first Financial System Inquiry reported in 1997, and was chaired by Stan Wallis, hence is referred to as the Wallis Inquiry. A later Financial System Inquiry reported in 2014, chaired by David Murray (the Murray Inquiry).

The Wallis Inquiry was instigated to analyse the “*forces driving change in the financial system and recommend ways to improve current regulatory arrangements*”.⁶ Under its terms of reference the Wallis Inquiry was required to report on the consequences of financial deregulation that had been initiated by the Australian Financial System Inquiry in 1981 (the Campbell Report).⁷

There is a question as to whether these concentrated market shares in electricity and gas markets are impacting adversely on the outcomes for consumers

⁶ Financial System Inquiry, *Final Report*, p 1 (available from <http://fsi.treasury.gov.au/content/FinalReport.asp>)

⁷ Financial System Inquiry, *Final Report*, p 561

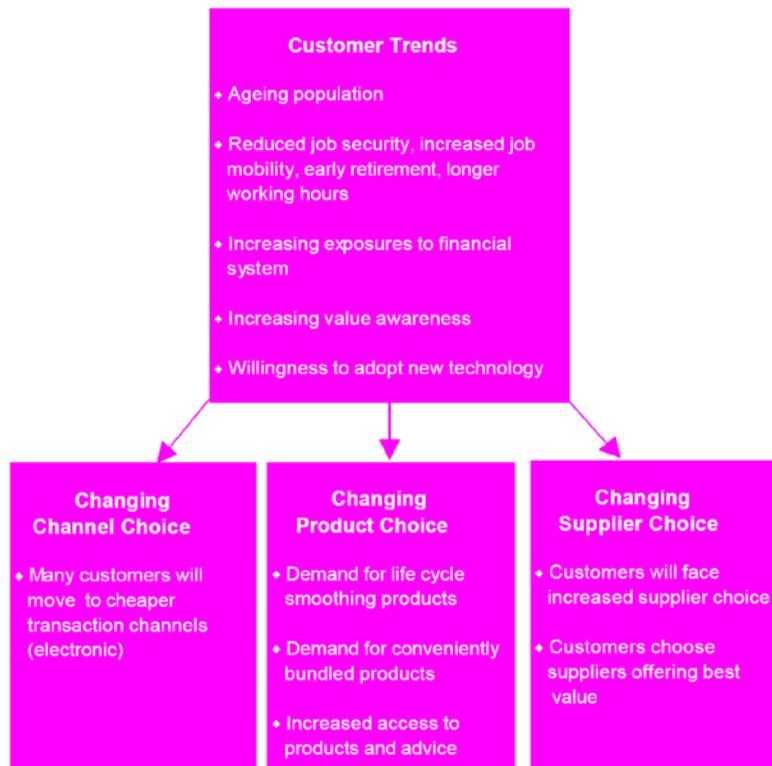
Similarly, the objectives of this Review are to “examine the operation of the Victorian electricity and gas retail markets and provide options that would improve outcomes for consumers.”⁸

The outcomes sought by the Wallis Inquiry were to improve the efficiency of the financial system, for the benefit of consumers, and the national economy.

“There are very large efficiency gains and cost savings which could be released from the existing system through improvement to the regulatory framework and through continuing developments in technology and innovation.

Markets can only deliver these outcomes where competition is allowed to thrive and where consumers have confidence in the integrity and safety of the system.”⁹

Figure 2: Implications for distribution channels, product and supplier choice



The Wallis Inquiry saw its role as developing a blueprint for reform of the regulatory framework that would be resilient in the face of the transformation in the financial system that was already underway.

⁸ Review of electricity and gas retail markets in Victoria, Terms of Reference

⁹ Financial System Inquiry, *Final Report*, p 2

“For the Inquiry, charged with considering the regulatory framework, the need is to ensure that change can be accommodated within responsive and flexible regulatory arrangements, and that regulation encourages innovation and competition so that the most efficient players and processes prevail.”

The Wallis Inquiry summarised the implications of changing customer needs, for the transformation of the financial services market in the graphic reproduced in Figure 2 above.

The outcome of the Wallis Inquiry was changes to the regulatory and system architecture that unleashed greater competition principally between banking and insurance that was dominated by a few large providers, and enabled like products from different institutions to be regulated consistently. These changes provided a necessary impetus to the transformative changes being driven by consumers and the innovation enabled by technological change.

The result of the changes in regulation that stemmed from the Wallis Inquiry was fundamental change in the retail financial market, which saw traditional boundaries between suppliers such as banks, insurers and superannuation funds eroded, product innovation and growth in independent intermediaries whose business model was to empower consumers and to act as their agents.

By way of making this clear, consumers today - unlike consumers at the time of the Wallis Inquiry - no longer rely on tied insurance agents, and bank or credit union managers or branch tellers to manage their financial arrangements as had been the case for decades. Consumers now have access to a range of channels, including online and digital channels, and access financial services from diverse suppliers. A financial services markets was enabled and it was the emergence of this market that empowered customer choice.

The question of the effectiveness of competition in financial markets was again revisited by the Murray Inquiry in 2014. Confidence and trust were two key factors that this Inquiry identified as essential.

“Confidence and trust in the system are essential ingredients in building an efficient, resilient and fair financial system that facilitates economic growth and meets the financial needs of Australians. The Inquiry considers that all financial system participants have roles and responsibilities in engendering that confidence and trust.”¹⁰

Confidence and trust are also key concerns of consumers in the Victorian electricity and gas markets, as the results from the Energy Consumers Australia ECSS show. The results of the ECSS are included later in this submission in the section on Consumer awareness, understanding and engagement.

The Murray Inquiry had this to say about competition:

¹⁰ Financial System Inquiry, *Final Report*, p xv

“Competition and competitive markets are at the heart of the Inquiry’s philosophy for the financial system. The Inquiry sees them as the primary means of supporting the system’s efficiency.

Although the Inquiry considers competition is generally adequate, the high concentration and increasing vertical integration in some parts of the Australian financial system has the potential to limit the benefits of competition in the future and should be proactively monitored over time.

The Inquiry’s approach to encouraging competition is to seek to remove impediments to its development.”¹¹

In a time of dynamic change and transformation it is important, as the Wallis and Murray Inquiries identified, to set a blueprint for a resilient regulatory framework over the longer term. At the same time the Murray Inquiry recognised that a blueprint cannot be implemented as a “set and forget”. There is a need for periodic monitoring.

In particular, the state of competition in the financial system should be reviewed every three years, including assessing changes in barriers to international competition.”

The Murray Inquiry identified a number of key specific changes to improve consumer outcomes in financial markets. The recommendations sought to address the problem of fair treatment for consumers.

“Fundamental to fair treatment is the concept that financial products and services should perform in the way that consumers expect or are led to believe.

The current framework is not sufficient to deliver fair treatment to consumers. The most significant problems relate to shortcomings in disclosure and financial advice, which means some consumers are sold financial products that are not suited to their needs and circumstances. Although the regime should not be expected to prevent all consumer losses, self-regulatory and regulatory changes are needed to strengthen financial firms’ accountability.”

To improve consumer outcomes, the Murray Inquiry made recommendations in three areas.

Improve the design and distribution of financial products through strengthening product issuer and distributor accountability, and through implementing a new temporary product intervention power for the Australian Securities and Investments Commission (ASIC).

¹¹ Financial System Inquiry, *Final Report*, p xvi

Further align the interests of firms and consumers, and improve standards of financial advice, by lifting competency and increasing transparency regarding financial advice.

Empower consumers by encouraging industry to harness technology and develop more innovative and useful forms of disclosure.

Drawing the potential parallels for this Review, a number of the specific recommendations in the submission by the Consumer Action Law Centre similarly look to improve the design and distribution of retail electricity and gas offers, aligning the interests of retail businesses with their consumers, and empowering consumers in Victoria.

For example, Consumer Action has drawn on the use of reference prices in banking (effective interest rates, or unit pricing in groceries) and the use of simple default products in superannuation (and as also applied for low income households with basic banking products at one time) as signaling potential options in electricity and gas markets. Such options could preserve the beneficial effects of competitive markets, while dealing effectively with the information problems which hinder effective choice.

Energy Consumers Australia considers that the challenge facing the Review is to improve the quality and effectiveness of competition in electricity and gas markets in Victoria. There are particular challenges in two sub-markets, regional Victoria, where few or no competitors may be available, and for vulnerable consumers whose needs also must be addressed in a considered way. This is because it is not only the nature of electricity and gas offers that have an impact on the bills of households, but because outcomes for these consumers are affected by many factors, often beyond their control - the quality of their housing and appliances, their ability to change their circumstances through energy efficiency measures or technology, as well as the nature of their employment and certainty of income all impact on their outcomes in this market.

Energy Consumers Australia considers that the challenge facing the Review is to improve the quality and effectiveness of competition in electricity and gas markets in Victoria

Pricing, costs and margins

Pricing

Electricity and gas prices have risen significantly in real terms since 2007.

According to the Finkel Review:

“... household electricity bills increased 61 per cent between 2008-09 and 2012-13, mainly on the back of network investments. This is compared to a 10.4 per cent increase in the consumer price index over the same period.”¹²

¹² Finkel Review, *Preliminary Report*, p 8

The chart in Figure 3 shows the full electricity 'price stack' in Victoria from the AEMC's annual retail price trends reports from 2010 to 2016, and trend to 2019.

Figure 3: Electricity retail price stack, Victoria



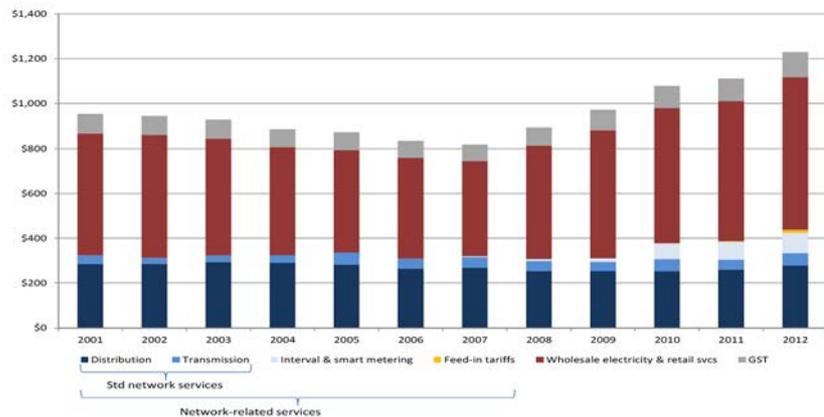
Figure 4 simplifies this chart by grouping network costs together, the environmental costs together and comparing these to the AEMO wholesale electricity price. This chart more clearly shows that the network component in Victoria has driven price increases from 2009 to 2014, and that the combined 'competitive market' elements are expected to drive increases beyond 2016.

Figure 4: AEMC electricity retail components and wholesale prices



A unique feature of the retail price stack in Victoria is the size of the metering costs. In Victoria the costs of the mandatory smart meter roll out to all 2.8 million electricity customers are included in the distribution network component. These costs have been separately identified historically by Oakley Greenwood (OGW) up to 2012 (see chart in Figure 5). We understand that this work is currently being updated.

Figure 5: Retail electricity price stack, Victoria (OGW)



The OGW analysis shows that in 2012 the costs of metering were 8% of the average Victorian residential customer’s bill of \$1,118 (excluding GST).

Impacts on consumers of increases in retail prices

Growth in electricity and gas prices nationally as shown in the chart in Figure 6 (compiled by St Vincent De Paul) has significantly outstripped prices for other utilities.¹³

¹³ See St Vincent de Paul, *Relative Price Index: The CPI and the implications of changing cost pressures on various household groups*, figure 10 http://www.vinnies.org.au/icms_docs/252560_2016_RPI_Full_Report_Aus_Mar-2016_CPI-aligned_FirstRelease.pdf

Figure 6: St Vincent De Paul, Relative Price Index

Utilities prices (Housing)

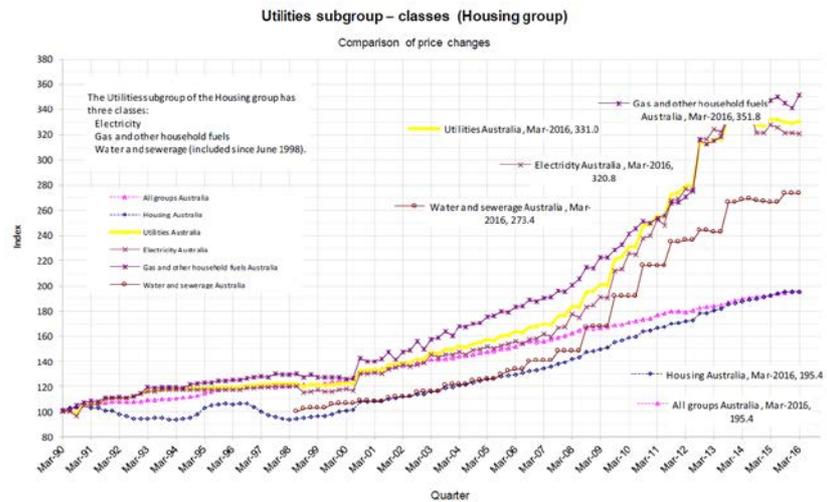


Figure 10: Utilities subgroup price change comparison

As prices have increased, the proportion of household income spent on energy has grown.

The Australian Energy Regulator reports on affordability of electricity and gas for low income households. In the most recent *State of the Energy Market* report, low income households spend between 4% and 6.5% of disposable income on electricity, and between 2.5% and 4.5% on gas.¹⁴ In Victoria, many households use both electricity and gas, and the proportion spent on energy by low income households with dual fuels could be as high as 8.5%.

Given the variation in electricity and gas consumption levels, and the huge dispersion in retail prices, the proportion of income many low-income households are spending on electricity and gas is almost certainly much higher than these AER figures, based on averages, reveal.¹⁵

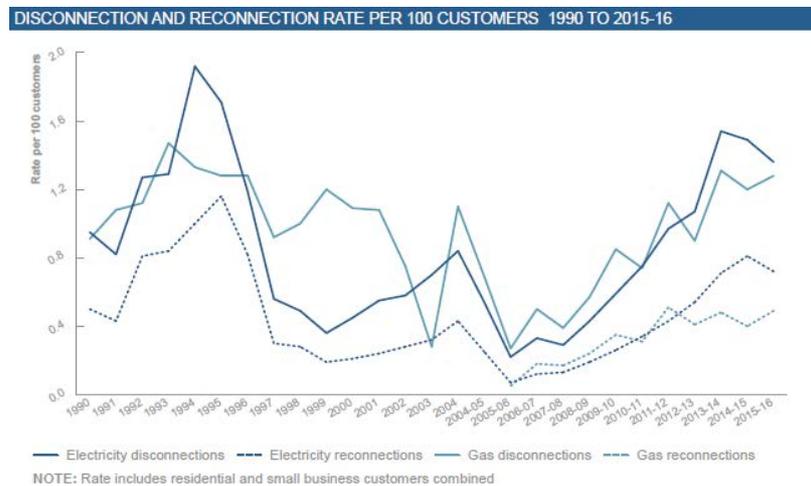
Disconnection rates through this period across the electricity and gas markets nationally have largely tracked prices. The most recent data published by the Essential Services Commission of Victoria (Figure 7) shows disconnections fell in 2014-15 after rising strongly in previous years.¹⁶

Figure 7: Disconnections in Victoria

¹⁴ See Australian Energy Regulator, *State of the Energy Market*, figure 5.8 <https://tinyurl.com/hsvcwu7>

¹⁵ To get a sense of the price spreads in the retail electricity market, see the Australian Energy Regulator’s *State of the Energy Market*, figure 5.7 <https://tinyurl.com/hsvcwu7>

¹⁶ Essential Services Commission of Victoria, *Victorian Energy Market Report 2015-16*, p 37



In addition to the trend increase in disconnections, there is evidence of many households being disconnected repeatedly, which suggests scope for improving current government support mechanisms and energy retailer hardship programs and practices.¹⁷

A key strategic initiative for Energy Consumers Australia is to develop strategies to reduce residential disconnections and the associated costs to industry, through our Keeping People Connected project.

Energy Consumers Australia commissioned KPMG to estimate the costs of existing energy affordability support measures.

The KPMG October 2016 report shows around 160,000 households and 11,000 small businesses disconnected each year. KPMG found costs to government of affordability related schemes are around \$820 million per annum, while ombudsmen schemes are a further \$10 million, and direct cost of disconnections to industry was \$11 million. The KPMG analysis only covers those costs which can be directly quantified and so gives an incomplete picture of the costs to society (such as assistance provided by welfare and emergency relief organisations).¹⁸

¹⁷ St Vincent De Paul, *Households in the Dark*

¹⁸ KPMG, *Estimating costs associated with payment difficulties and disconnections*, October 2016 available at <http://energyconsumersaustralia.com.au/keeping-people-connected/>

A key strategic initiative for Energy Consumers Australia is to develop strategies to reduce residential disconnections and the associated costs to industry

As part of this initiative Energy Consumers Australia canvassed the views of a wide range of stakeholders (advocates, financial counsellors, retailers, regulators and government), and reviewed a range of studies by consumer groups and retailers which have been conducted over recent years. A key conclusion we have reached is that the underlying causes of disconnections have not changed much over the past decade. What has changed is the scale of the issue, with substantial increases in disconnections in most jurisdictions.

From this we understand that the causes and potential solutions addressing disconnections are complex, multi-faceted, and inter-related. Action on any single solution is unlikely to make much difference.

Energy Consumers Australia will be working with stakeholders on a range of measures that together could reduce disconnections for consumers that are unable to afford their energy bills.

Retail cost drivers

As the Preliminary Report of the Finkel Review has observed:

“Competition is intended to yield efficiencies in the operation of energy businesses and enable the introduction of new technologies and services for consumers. However, it is difficult to get full transparency of the drivers of retail prices.”¹⁹

The various components of the drivers of retailer costs could be explored as part of this Review. In particular, these drivers are:

- the (wholesale) cost of electricity;
- hedging costs (retailers use hedge contracts to protect their customers to exposure from volatility in wholesale market prices);
- costs to serve (i.e. billing, customer service, connections, hardship policies, the costs of managing bad debts, the costs of managing financial contracts and the costs of meeting jurisdictional obligations);
- costs to acquire (i.e. marketing and customer acquisition and retention costs); and
- costs of capital including a return on investment.

Analysis undertaken for Energy Consumers Australia by Finncorn suggests that there could be significant differences amongst retailers in their cost structures, due to differences in hedging costs, (unit) costs to serve, (unit) costs to acquire and costs of capital.

These differences in cost structures advantage the Big 3 retailers over their competitors which leads to the question of the effectiveness for consumers of competition among the 25 retailers in Victoria.

These advantages appear to include:

- an ability to efficiently self-hedge against electricity and gas price volatility to a material extent;
- a lower cost to serve per customer based on scale, scope and systems and the quality of the customer base;

¹⁹ Finkel Review, *Preliminary Report*

A key question for the Review is whether these cost advantages of the Big 3 are passed on to consumers in the form of lower electricity and gas prices or whether they take the form of higher margins

- more sophisticated customer information and billing systems, that allow these retailers to differentiate between customers on credit quality, volume and propensity to switch²⁰;
- lower earnings volatility; and
- lower costs of capital (investment grade credit rating).

The ability of Tier 2 and Tier 3 retailers to sustainably deliver the usual outcomes of competition, innovation and price pressure, is a matter for further investigation.

There is some evidence in particular of the cost disadvantage experienced by smaller retailers in the Farrier Swier survey of retailers for the AEMC's 2016 Competition Review, and the potential advantages of scope (access to both electricity and gas markets).²¹ (Other key issues that the smaller retailers raise concerning the effectiveness of competition go to consumer and retailer behavior, such as win back strategies and customer lock-in.)²²

Further the AEMC in its 2016 Retail Competition Review identified that hedge market liquidity ratios are declining in all markets (time series were included in Appendix C). It is difficult for retailers that are not integrated with generation businesses to compete where there are low volumes available to them to hedge with.

Similarly, Energy Consumers Australia is concerned that the market for Large-scale Generation Credits (LGCs) is showing similar restrictions.

In particular, the largest retailers are the only players with sufficient demand to execute power purchase agreements for new renewable generation, and without more generation there will be a shortage of certificates. This shortage not only represents a price increase to consumers, but also a barrier to entry.

A key question for the Review is whether these cost advantages of the Big 3 are passed on to consumers in the form of lower electricity and gas prices or whether they take the form of higher margins.

Retail charge and margins

The Review has a difficult but critical task before it in eliciting the evidence of trends in retail margins.

As the Finkel Review has commented:

“There is very little public information available about retailer operating costs and margins across the industry or how much they contribute to retail prices. For example, the AER's 2015 State of the Energy Market Report aggregates wholesale and retail costs, while

²⁰ Higher switching or churn rates add to costs. Retailers that can reduce churn rates can enjoy a significant cost advantage. For example AGL has a published churn rate of 15.7% p.a. which is below the rest of the market.

²¹ Farrier Swier, *2016 Energy Retailer Survey Report*, p 37-39

²² Farrier Swier, *2016 Energy Retailer Survey Report*, p57

*the AEMC's 2015 Residential Electricity Price Trends report uses a residual method and does not report retail costs separately.*²³

Energy Consumers Australia understands that the AEMC is considering how it might address the issue of the overall performance of retail energy markets, such as profit outcomes, in its 2017 Retail Competition Review.²⁴

One approach that this Review might take could be to obtain time series data of the total revenue for the electricity and gas retailers in Victoria. Retailers may be willing to “pool” this data on a confidential basis, whereas they would not be willing to share data on their individual company margins.

Analysis could then be done to subtract the cost of wholesale energy at spot prices, the cost of network charges and the cost of environmental programs, to derive a gross retail margin.

Energy Consumers Australia recognises that there could be some difficulty in isolating the retail and wholesale components of the price stack.

While in theory retailers pay the spot price for all the electricity and gas their customers use for each half-hour period, various contracts in the hedging market share the risk of this price volatility between wholesalers and retailers. How much of this cost of hedging—insurance—is properly allocated to wholesale and how much to retail is an unresolved question.

However, given that the alternative to hedging is that consumers would be fully exposed to the market price, there is a case to consider it entirely a retail cost rather than grouping it with the wholesale costs.

Care would need to be taken interpreting this gross margin, so that it is clear that is not conflated with profit across the sector. The gross margin will have a number of components including retailers’ operating costs, retailers’ hedging costs, the retailers’ return of capital (depreciation), the return for capital as well as any ‘economic profit’.

Energy Consumers Australia is of the view that the long term interests of consumers are served by competition between innovative retail energy businesses that are able sustain consistently high profits over time because they continue to deliver new products and services ahead of their competitors.

Costs associated with retail competition

The Review is concerned with the quantifying the effectiveness or quality of competition in electricity and gas markets in Victoria. Traditionally this has been done with a focus on supply side metrics.

²³ Finkel Review, *Preliminary Report*

²⁴ The terms of reference for the AEMC’s Retail Competition Reviews were set by the Council of Australian Governments Energy Council in 2014.

One approach that this Review might take could be to obtain time series data of the total revenue for the electricity and gas retailers in Victoria

In earlier submissions to the AEMC on retail competition reviews Energy Consumers Australia suggested the use of a composite index

In earlier submissions to the AEMC on retail competition reviews Energy Consumers Australia suggested the use of a composite index that includes both supply and demand side indicators as a means to provide a more useful measure of the effectiveness of competition.²⁵

More recently we have considered the approach to a composite index put forward by the European Agency for the Cooperation of Energy Regulators (ACER).²⁶

This promotes the use of a composite index using a number of measures grouped in the structure-conduct-performance framework used in competition analysis. To the top level indicators used in the ACER approach we would add indicators of confidence, engagement and satisfaction.

AEMC approach to the 2017 Retail Competition Review

The Australian Energy Markets Commission (the AEMC) has announced in its Information Sheet for its 2017 review of retail competitiveness that it is adopting a different approach to previous years.

Given that most jurisdictions where competition has been found to have been effective have removed price regulation, the 2017 review will focus on how competition is evolving.

The AEMC has also revised the indicators that will be used that apply the structure-conduct-performance paradigm used in other competitiveness reviews, including those undertaken by the Australian Competition and Consumer Commission (ACCC).

The graphic in Figure 8 is the AEMC's representation of the indicators it will report on.

Figure 8: AEMC Retail competitiveness indicators

²⁵ Energy Consumers Australia submission to the AEMC 2016 Retail Competition Review

²⁶ IPA Advisory, Ranking the Competitiveness of Retail Electricity and Gas Markets: A proposed methodology, September 2015
http://www.acer.europa.eu/en/electricity/market%20monitoring/documents_public/ipa%20final%20report.pdf



Costs of competition

Energy Consumers Australia recognises that it may be difficult for this Review to quantify the benefits to consumers that have resulted from competition, after allowing for changes in costs, in the absence of historic data being available. Clearly there are additional retail costs in markets such as Victoria with high switching rates, which may or may not be matched or exceeded by the savings on retail bills.

However, even were the data available, it is likely that the dynamic changes that have taken place in Victoria’s electricity and gas markets since the initial competition reforms could make it difficult to isolate cause and effect.

One aspect of costs that is often cited as a barrier to entry is the differences in regulatory frameworks between Victoria, and the National Energy Customer Framework (NECF) that applies in other jurisdictions.

In this context we note that many if not all jurisdictions have specific features that apply only in their jurisdiction. This adds to costs passed onto consumers overall, and could act as a barrier to new entrants from adjacent markets or international competitors because of multiple licensing and regulatory frameworks that apply.

As a matter of principle, Energy Consumers Australia takes the view that costs to consumers overall would be lower if there was a single, nationally consistent regime that governed the consumer protections in the energy market for all the approximately 10 million small (residential and small business) customers in the National Electricity Market (many of whom are also dual fuel customers).

Price differentiation and dispersion

Ron Ben-David, the Essential Services Commissioner of Victoria has drawn attention to the fact that we do not have data or evidence of the prices being actually paid by consumers. Nor do consumers necessarily know what they are being charged, or their contract terms, other receiving a bill.

In referring to the various price trends reports prepared by regulators, Ron Ben David has said that:

“...all we are reporting is the increase in the price of new contracts over the past 12 months. It would be safe to assume that very few customers enter new contracts every 12 months. Therefore, we cannot say with any certainty that the price movements we are reporting bear any resemblance to those experienced by customers.”²⁷

Ben-David goes on to say that prices that are being paid by the majority of customers are “are completely invisible to the regulator, competitors and other customers.”

It is clear to Ben-David that “it can become very difficult for customers to confirm the status of their contracts against the original offer into which they entered; as well as the broader market of offers.”

Similar concerns have been raised by the Queensland Consumers Association in their submission to this Review.

Energy Consumers Australia is concerned that this is the case even before other barriers to customers engaging effectively with the retail market are taken into account. These barriers for some consumers include

- an inability to pay on time with any certainty;
- poor credit history and access to direct debit arrangements;
- general literacy and numeracy skills in the community that are not sufficient to deal with complex terms and conditions in retail contracts or the fine print; and
- language and other cultural barriers.

Some estimates have been made by regulators of the proportion of customers on higher priced standing offers, versus market offers, as an indication of the effectiveness of competition. However, generally this data underestimates the proportion of those consumers that may be paying the equivalent of standing offer rates, because their contract is still in force but their benefit or discount period has expired.

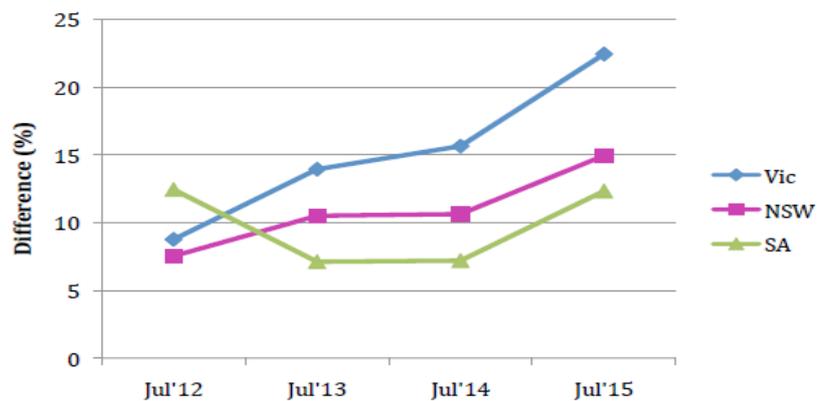
The available data shows the increasing price dispersion between consumers on standing offers and consumers on market offers in Victoria.

While we agree with the view expressed in the Discussion paper that “some level of price dispersion is likely to be an important feature of well-functioning, competitive retail electricity and gas markets” it is concerning that the price dispersion in Victoria has increased significantly.

²⁷ Ron Ben David, *Shock Therapy*
21

According to the The St Vincent De Paul Society tariff tracking project price dispersion in Victoria increased from below 10% to above 20% between 2012 and 2015 as shown in the chart reproduced in Figure 9.²⁸

Figure 9: Price dispersion, comparison



One view is that price dispersion may not be a cause for concern if only relatively high income households are on the higher priced standing offers, for whom the energy bill is not a major expenditure. In this case the dispersion is effectively a cross-subsidy from people who are less price sensitive to those who aren't.

However, if a significant proportion of those households on standing offers or on standing offer rates are low income households then it is a significant concern. For example, AGL published a report in 2015 that shows that 26,000 customers were on AGL's standing offer.²⁹

At the very least retailers should be ensuring that no consumers in payment difficulties or on hardship plans should be on higher priced standing offers or rates. Given that many of these consumers are on energy concessions, it is an inefficient transfer of limited government funds for energy concessions to retailers for these consumers to paying higher prices than necessary.

Energy Consumers Australia considers that there is merit in the concept of a low cost *default* option for all consumers, that addresses the needs of low income households as well as simplify the terms and conditions for consumers that do not wish to engage with their electricity and gas pricing arrangements. The challenge is to create a default option that is both "low frills" and low cost.

Fixed charges

Energy Consumers Australia's concern with the increase in the fixed charge component of the retail electricity and gas offer is because of the absence of innovation that would give consumers more options as to the structure of their electricity and gas charges.

In Energy Consumers Australia considers that there is merit in the concept of a low cost default option for all consumers

²⁸ St Vincent de Paul Society and Alvis Consulting 2015 Figure 15

²⁹ AGL Applied Economic and Policy Research Working Paper 49

What appears to be absent are other alternatives that might also reflect consumer preferences

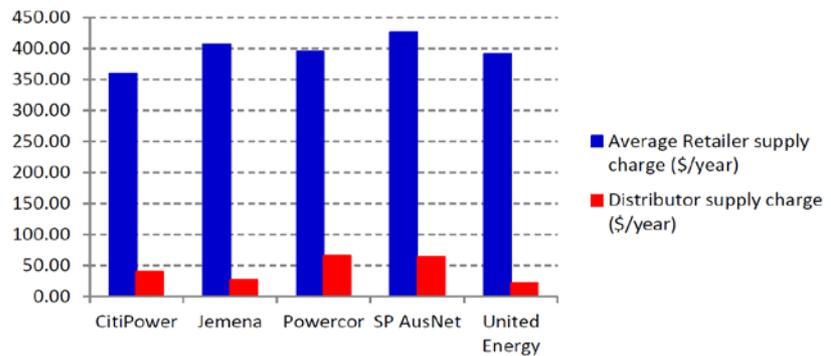
The advent of the “all you can eat” predictable plan, which is fixed for twelve months, highlights that some customers may prefer bill certainty. It is the ultimate in a fixed charge, albeit one where the level can be adjusted, as mobile plans are after a contract period.

In Victoria, where consumers use both electricity and gas, consumers that consider a predictable plan can weigh up the value of knowing what their payments will be in advance, against the potential uncertainty of more volatile bills. As the plan can be adjusted after twelve months, consumers have an opportunity to course correct, although not adjust their payments based on usage as they can under “bill smoothing” arrangements that are also offered by a number of retailers.

What appears to be absent are other alternatives that might also reflect consumer preferences. The higher the fixed charge, in any retail charging structure, the less opportunity there is for consumers to benefit from adjusting how much energy they use. This is regressive for low income households but is also inefficient as consumers are not using energy consistent with the value they attach to that energy.

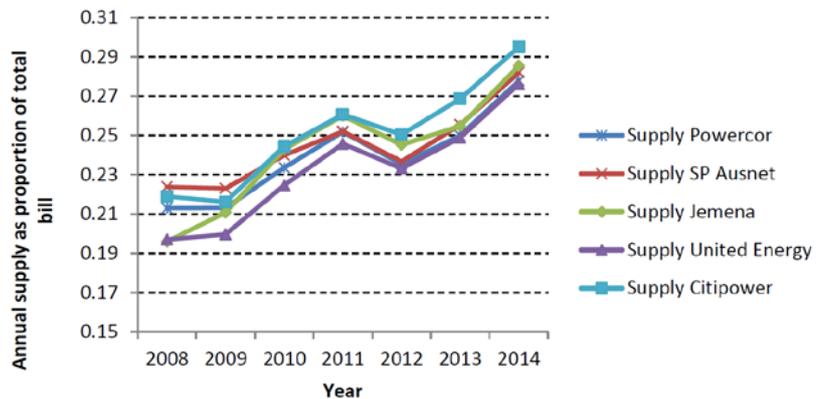
Ben-David has documented that there is little correlation between the network charge, which in effect is largely fixed in nature when recovering sunk costs, and the fixed component of the retail charge for electricity in Victoria. This is shown in the chart reproduced in Figure 10.

Figure 10: Comparison of network and retail supply charge



Ben-David has also shown that the fixed charge in the retail bill has been increasing over time, as shown in the chart reproduced in Figure 11.

Figure 11: Annual supply charges 2008-2014 (% of total)



As Ben-David has argued there could be an expectation in a competitive retail energy market that consumers could be offered a retail charge that was totally variable, or that the fixed charge was limited to the amount of the network charge.

Flexible pricing in Victoria, was introduced in July 2013, but the policy intent of better outcomes for consumers has not been achieved in the market. As the Auditor-General’s Report found in 2015, less than 1% (0.27% in 2014) of Victorian consumers have taken up the regulated time-of-use pricing option. While there was an extensive information and education campaign in Victoria, the earlier disaffection with roll-out of smart meters, the strictly regulated nature of the underlying network tariff (that did not take into account consumers shifting from highly beneficial controlled load tariffs) and changing price levels that left consumers worse off were all contributing factors to a poor outcome.

This is clearly unfinished business. As the Auditor General stated:

“Achieving these benefits relies heavily on the majority of consumers changing behaviour, including by finding a better electricity deal and changing consumption patterns.

In this respect, a key role for government is in providing consumers with a better understanding of the benefits that smart meters can provide and encouraging the required behaviour change. Yet despite improvements to consumer education since our 2009 audit, market research conducted in early 2014 found that two-thirds of Victorians do not understand what the benefits provided through smart meters are, and many are still unaware of their ability to help minimise energy bills.”³⁰

³⁰ Victorian Auditor General, *Realising the Benefits of Smart Meters*, September 2015, p.viii

From Energy Consumers Australia's perspective, the Review is an opportunity to understand the factors that may have led to this outcome, using the insights from behavioral economics.

Behavioural economics is a method of analysis that applies psychological insights into human behaviour to explain economic decision-making. The value of using behavioural insights is explained in a report by the Citizens Advice Bureau in the UK, undertaken by Behavioural Insights Team.

“Consumers today have to make a bewildering array of decisions on everything from energy suppliers to insurance products. We often turn to rules of thumb to make these judgements such as shop around for the best price. It is no surprise that in some instances businesses take advantage of these rules. Fees get hidden until the last minute, refunds are a hassle to claim, and our natural inertia is reinforced by intentionally clunky or time-consuming processes. As a result we make decisions we later regret.

Behavioural economics helps us to think systematically about these problems... Once we know the rules of thumb people use, and the way these rules tend to err, we can design consumer protections that are both less intrusive and more effective.”³¹

More needs to be done to ensure that consumers understand and are informed about their retail contracts

Currently there is research being undertaken by CitySmart and the Queensland University of Technology (QUT) under Energy Consumers Australia's Grants Program to understand consumer decision making in the context of time varying pricing. The research report will be available by mid-year but CitySmart and QUT may be able to share the findings of the qualitative and quantitative research with the Review in the coming months.

Work by RMIT and UNSW are also looking at technologies and tools to understand energy management and pricing.

More needs to be done to ensure that consumers understand and are informed about their retail contracts. Ben-David has identified a range of contract types that may make it difficult for consumers themselves, as well as other consumers, to know what price they are paying for electricity and gas.

Product and service innovation

In the previous section of this submission Energy Consumers Australia commented on the need for innovation in retail energy pricing structures, in relation to fixed charging and time varying pricing.

Retail pricing structures which do not vary by time or location provide a hedge to consumers against volatility in wholesale markets, or in the future against the cost of network services at times or in locations where the network is at capacity. Innovation in retail pricing would allow consumers that have flexibility in their energy use to be charged more “cost-reflectively” that is to pay less for using energy at peak times, and to save on their energy bills.

³¹ Citizens Advice Bureau, *Applying behavioural insights to regulated markets*, p 3
25

In their submission the Queensland Consumers Association has identified 6 possible actions to ensure consumers are better informed. Other options that Energy Consumers Australia considers may have merit include:

- market offers should be specified as a base price or structure, not discounts, and they should be enduring. Retailers could be able to withdraw a market offer on six months' notice, but otherwise consumers would stay on the price structure till they elected to change; and
- to enable consumers to actively manage their energy plans with their retailer, retailers could be required to periodically (possibly annually) provide the customer with a comparison of the total amount they paid over the previous twelve months with the amount they would have paid under either all alternative plans of the provider, or simply the best alternative plan.

In the absence of cost-reflective retail pricing, innovation is emerging in enabling consumers to directly benefit from managing their demand on the network at peak times. Programs from network businesses such as PeakSmart in Queensland being offered by EnergyQueensland and SummerSaver offered by United Energy on the Mornington Peninsula are leading the way. Both are using technology and digital engagement, as well as non-traditional channels to market (for example appliance retailers) to engage with their customers.

New entrants such as Greensync, Reposit Power, PowerLedger and Powershop are all piloting demand management with consumers.

The Review has sought comment on non-price innovation.

In this context, Energy Consumers Australia considers the fundamentals of the sale of energy supplied from central generation assets, and the sales to consumers of technology (in the form of solar and battery storage) to be the same. The product being sold is largely a "commodity" that is energy in the form of electricity or gas to meet people's need for power in their homes or businesses.

To a certain extent there has been "innovation" in the nature of credit arrangements, so that consumers now have access to bill smoothing, or upfront financing arrangements for solar panel purchases (and leasing) rather than simply paying in arrears.

Options to pay weekly, fortnightly or monthly in arrears (or in advance) are emerging, but do not appear to be widespread amongst customers. Discounts or late payment fees can simply be understood as rewards or penalties for customers with better or worse credit performance. Disconnections and hardship programs can be seen as means of denying or limiting credit.

Where innovation appears to be lacking is in the development of energy service market intermediaries, that give customers the means to actively manage and control their energy bills if they choose.

Where innovation appears to be lacking is in the development of energy service market intermediaries

Intermediaries have an important role to play in connecting how people use energy, within their home or business environment and providing advice such as home energy management and choice of appliances. Consumers and small businesses who rent may lack choices that are available to consumers who own their premises, and may require specific initiatives for addressing these constraints. There are vulnerable consumers also in rental housing, where the quality of appliances and housing add considerably to energy usage and costs.

Innovation is needed not only in products and advice, but in the nature of information and tools that are available to support consumers in making decisions that achieve better outcomes. In the ECSS consumers are telling us that they are confident in their abilities to make choices, but that there is not enough easily understood information available and tools to enable them to make effective decisions.

One of the barriers to innovation appears to be the ability of retail competitors to offer tailored or bespoke offers, based on the customer's own data.

While smart meters make this data available to both the network and the retailer, it is not easily accessible by the customer. Portals developed by a number of network businesses currently make this data available, but an ability to transfer easily to a comparison website or to an alternative supplier is not always possible.

It could be logical for this functionality or platform to be developed by the network businesses, as Energy Consumers Australia understands that they have the full history back to the installation of the smart meter whereas retailers only have the history that the customer has with them. However, such a proposal is not without cost and would need to be approved by the AER. The development of such a platform could be done as a shared infrastructure project, in consultation with consumers and advocates.

Consumer awareness, understanding and engagement

Energy Consumer Sentiment Survey

The Energy Consumer Sentiment Survey is a long term project for Energy Consumers Australia. It is designed to provide information on household and small business consumer sentiment with a focus on three key areas of satisfaction, confidence and activity. As the survey is undertaken every six months, it will track changes in sentiment over time and detect trends which can inform energy market and policy development in the long term interests of consumers.

In this submission we report the results for the second survey of 413 households in Victoria. The data is publicly available for both the first and second survey (a combined sample size of over 800).

One of the barriers to innovation appears to be the ability of retail competitors to offer tailored or bespoke offers, based on the customer's own data

Overall satisfaction and satisfaction with level of competition

Victorian household consumers are telling us that overall they are satisfied with energy services.³² Households report relatively high levels of satisfaction with energy services with 69% rating services 7 out of 10 or higher (a positive rating), the second highest nationally behind the Australian Capital Territory (70 per cent). Less than 3% were dissatisfied with their energy services.

In Victoria more than half of households are positive about the level of competition in the energy market (56%), shown in the chart in Figure 12. This is the highest proportion nationally. Victorian households also reported the lowest level of dissatisfaction with competition in the energy market (8%).

Figure 12: Satisfaction with competition



What is perhaps surprising is that almost a decade after competition reforms were introduced into the Victorian market, that the proportion positively rating their satisfaction with competition is not higher. A significant proportion (36%) are neutral, which may be consumers that are disengaged.

What is also evident from the results for satisfaction with competition nationally is that dissatisfaction is the highest in jurisdictions where price regulation remains in place (noting that currently we cannot separate the South East Queensland results from the rest of the state).

Satisfaction with value for money

To understand more about consumer satisfaction in Victoria, we asked a series of questions about value for money, customer service and billing, reliability and faults management for electricity and gas separately

Household consumers in Victoria are more satisfied with the levels of reliability and fault management than they are with the value for money of their electricity and gas services. This is shown in Figures 13 and 14.

³² It is not possible with the sample size to report the responses for small business by jurisdiction.

Figure 13: Satisfaction with their electricity service

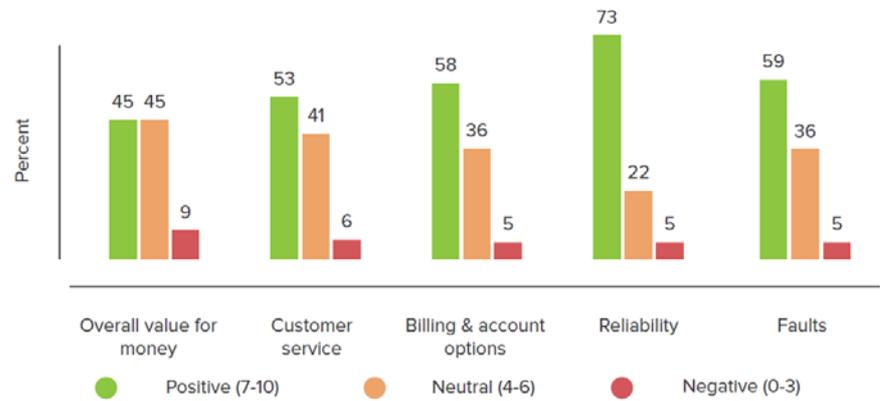
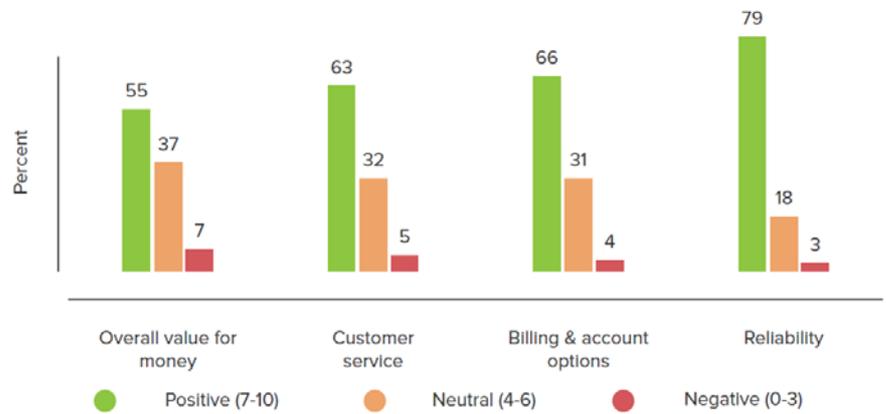
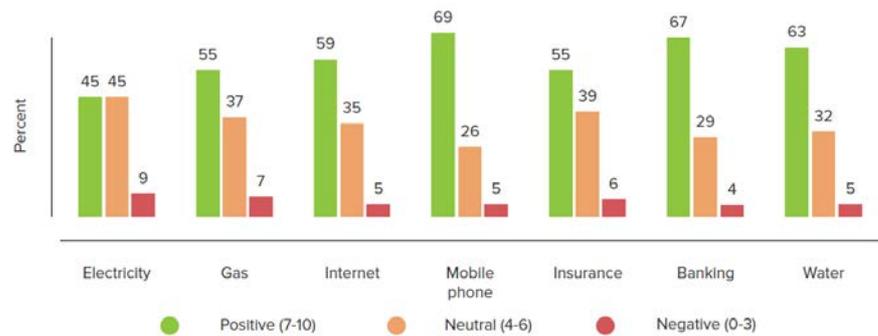


Figure 14: Satisfaction with their gas service



In the survey we asked household consumers how they rated their satisfaction with the value for money across a range of “utility” services. The value for money of electricity and gas services.

The results are shown in the chart in Figure 14.

Figure 14: Comparisons of value for money

Victorian consumers rank the value for money of their mobile phone service, banking, water and internet services ahead of electricity and gas. This was similar in other jurisdictions.

In a recent presentation for Energy Consumers Australia Foresighting Forum 2017, Malcolm Alder from Orchestrate provided some thoughts on the attributes of good value for money and bad value for money.³³ These appear to go some way to explaining how consumers may rank bank and mobile phone services ahead of electricity and gas.

Attributes of good value for money were *“simplicity, intuitive, works first time, saves time, cool and unobtrusive upsell.”*

Attributes of bad value for money were *“doesn’t work, time consuming, frustrating, untrained, not empowered, don’t care.”*

Switching

In the ECSS we asked consumers whether they had switched energy providers or plans in the last 3 years. Victorian households are the most likely of all states and territories to say they have considered switching energy providers in the past three years (60 per cent), with 27% deciding to switch – the highest switching rate nationally.

However, those that switched were no more likely to be satisfied with the value for money than those that didn’t switch.

The main reasons identified for considering switching are dissatisfaction with value for money of the current deal (42%), or that the consumer found a better deal (28%).

For those who did not consider switching, many are satisfied with the deal they are currently on (34%). There is also a significant proportion who felt the barriers are too high (28%). Only 6% per cent of Victorian households stated that the reason they didn’t switch is because there are no other alternatives, or that it made no difference.

³³ Malcolm Alder’s presentation is available on the Energy Consumers Australia’s website.

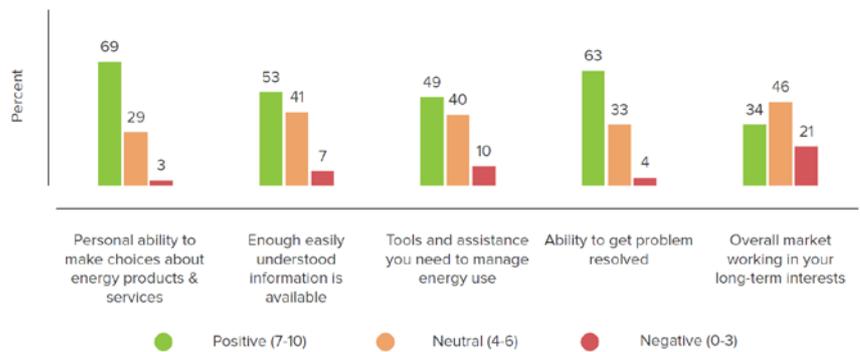
When we asked Victorian households whether they had never switched (in a separate question), 36% said they had never switched. While this is the lowest rate nationally, it suggests that a significant proportion of switching is being undertaken by the same consumers. It may also reflect the lack of regional competition in gas, and to a lesser extent electricity, but until we correlate these answers by postcode it is not clear.

Confidence

Consumers tell us that they are confident in their own abilities to choose the energy products and services that are right for them.

Victorian households are the most confident nationally in their ability to make choices about energy products and services compared with households in other states and territories. Consumers are less confident that enough easily understood information and tools are available to assist them make good decisions.

Figure 16: Confidence and trust



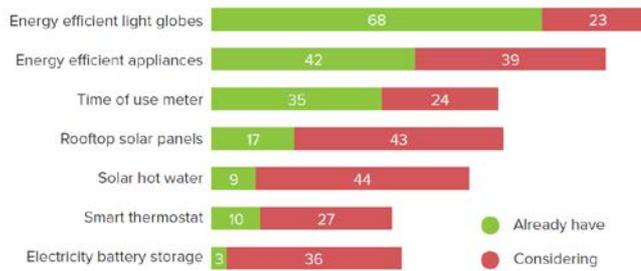
Households in Victoria are not confident that the market is working in their interests (only 34% of households) – they lack trust in government, regulators and industry to act in their interests. The proportion of households that are confident that the energy market would provide better value in the future was 19%.

At the same time 48% of households in Victoria are confident that reliability will improve in the next 5 years and 46% of households are confident that technological advances will enable them to manage energy costs in the future.

Investment intentions in technology

In the ECSS survey we asked consumers about their past uptake of technology and their future intentions.

Figure 17: Technology uptake and intentions



The most surprising result is that only 35% of consumers responded that they had a time of use meter, when “smart meters” or advanced meter infrastructure has been rolled out to all 2.8 million electricity consumers. There is no common terminology that is used with consumers to describe digital meters nationally, but we are considering how to ask this question in future surveys.

From separate research Energy Consumers Australia undertook with UMR on 1800 consumers (nationally) with solar panels we know that the principal reasons for investing in solar panels and in future considering batteries were to manage costs, independence from the grid and other financial reasons (fed in tariffs and grants). Environment was ranked 5 out of the top 5 reasons.³⁴

Power Shift program

The Review may be interested in the Power Shift program that Energy Consumers Australia is undertaken over the next three years, which will include addressing the potential barriers to engagement in electricity and gas markets, in particular for low income consumers.

The foundation of the Power Shift program is the Low Income Energy Efficiency Program (LIEEP) through which the Commonwealth Government provided funding of over \$56 million (between 2012-2016) for 20 pilots of innovative approaches to improve the energy efficiency of low-income households. The consortiums managing the pilots contributed a further \$15 million to the projects.

Energy Consumers Australia has received a Commonwealth grant of \$2million to undertake Power Shift – to research the findings and data from the LIEEP projects, and undertake complementary research, in order to:

- improve our evidence-based understanding of what really works in supporting vulnerable consumers to manage their energy bills (the research outcome); and

³⁴ This research, including an overview report from KMPG, is available from the Energy Consumers Australia website

- identify opportunities for market-led solutions and other initiatives to support consumers to manage their energy bills (the empowering consumers outcome).

The pilots trialed a variety of energy efficiency initiatives and communications strategies aimed at changing energy consumers' decision making behaviour (i.e. changing consumption to decrease energy costs, or increase thermal comfort). The pilots were asked to identify barriers to energy efficiency, and capture how the initiative would aim to overcome that.

The barriers identified were not restricted to consumers' behaviour in relation to energy efficiency.

The barriers identified included:

- lack of information
- time constraints
- trust – identifying a trusted source of information
- limits to behaviour change
- low motivation
- limited energy / technology literacy

Each of the above barriers have often been cited as constraints to consumers flexibly managing demand and controlling energy costs (demand side participation) in the National Electricity Market.

Energy Consumers Australia is able to share with Review the outcomes of the LIEEP pilots, making available the full reports which include findings and key insights but also potentially making available the researchers that were part of the project consortiums. In our view the LIEEP pilots provide a rich evidence base from which to identify measures of assistance and engagement that address those barriers to consumer engagement in the energy market.

Energy Consumers Australia is currently undertaking a foundational research project which will synthesise the learnings from the LIEEP pilots, to encourage a dialogue with decision-makers to identify how best to address these barriers. The first research findings will be made public from June 2017.

Concluding comments

The task before the Independent Review Panel is an important one; of examining the operation of the Victorian electricity and gas retail markets in 2017 and providing options that could improve outcomes for consumers.

For more than a decade there have been significant reforms undertaken in Victoria's electricity and gas markets, that have led the way nationally.

The case can be made that reforms – the privatisation of electricity and gas network and retail businesses, retail contestability and the removal of price regulation – have all contributed to a more efficient, lower cost market for consumers.

Despite this, Victorian consumers are telling us that they are not satisfied with the value for money of their electricity and gas services when compared with other services such as mobile phones and banking. Levels of confidence and trust in the market are also low.

This Review provides an opportunity to restore confidence and trust and to improve consumer outcomes, by improving the quality and effectiveness of competition in this market. It is also an opportunity to address market design and set a blueprint for the regulatory framework that supports innovation and is resilient in the context of the transformation currently underway in energy markets. In our view, this should include working towards greater national consistency in consumer protection frameworks to minimise regulatory burdens and to facilitate new entry by players from adjacent markets or international businesses that have scale in their own markets.

Energy Consumers Australia looks forward to further dialogue with the Review Panel on this critical task. If you would like to discuss this submission further, please do not hesitate to contact Lynne Gallagher, Director of Research at lynne.gallagher@energyconsumersaustralia.com.au.

