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Essential Services Commission
Level 8, 570 Bourke Street
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Dear Commissioners,

Victorian Default Offer 2023-24: Consultation Paper

Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to comment on the Essential Services Commission's (**ESC**) Consultation Paper on the review of the Victorian Default Offer (**VDO**) for 2023-24.

On balance, we consider that the VDO has been, and continues to be, successful in its objective to provide, "…a simple, trusted and reasonably priced electricity option,"[1] for people who are unable or unwilling to engage in the electricity market. Given the increase in wholesale energy prices over the past year, and broader cost-of-living pressures currently impacting the community, it is critically important the VDO continues to deliver against this objective in the coming regulatory period. While acknowledging that elevated wholesale electricity prices will see an increase in the 2023-24 VDO, we consider that community expectations demand that the VDO be set at no more than necessary to ensure bills remain affordable, particularly in a period when more Victorians will likely struggle to afford the cost of their electricity use.

Related to this, we note reports that electricity futures prices have fallen since the Federal Government's recent intervention into the energy market.[2] We would expect to see this downward pressure on wholesale prices flow through to household bills and to be reflected in the 2023-24 VDO. When making its decision on the 2023-24 VDO, we urge the ESC to give precedence to the impact of any price rise on Victorians, particularly people on low incomes or in vulnerable circumstances, rather than the viability of particular energy retailers.

The issues raised in the consultation paper present an opportunity to minimise any increases in the coming regulatory period. With respect to the Australian Energy Market Operator's (**AEMO**) June 2022 intervention into the wholesale market, we are of the view that there should not be a direct pass through of associated costs to consumers. We consider that the ESC must have regard to how any costs incurred can be more fairly shared between retailers and consumers, including through assessment of retailer's capacity to absorb at least some of these costs. We also recommend that any further costs associated with AEMO's intervention into the wholesale market which are currently unknown should be accounted for in the 2024-25 VDO, rather than through a variation to the 2023-24 VDO.

[1] Essential Services Commission (2022), Victorian Default Offer 2022-23: Draft decision , p.2
[2] The Age, "Futures market signals energy intervention will lower household bills", accessed January 6 2023

Regarding the question on the benchmark for retail operating costs, we recommend that the ESC use cost data collected from Victorian energy retailers to estimate changes in costs to apply to the benchmark currently in use. This would be both accurate and simple to understand. Furthermore, we would recommend that when reviewing the benchmark that the ESC use a cost towards the lower end of any range obtained as this would better represent an 'efficient' cost of service than the average cost. We also repeat our long-held position that the ESC follows up on its suggestion from 2019[3] to undertake analysis to ascertain if there is merit in applying an annual productivity factor to the VDO as a way incentivise retailers to pursue increased efficiency over time. In relation to the benchmark on customer acquisition and retention costs (**CARC**), we recommend that the ESC seek actual cost data from retailers to understand changes to expenditure on CARC in the Victorian market.

Finally, we support the ESC's proposal to publish future consultation papers only when significant changes to the methodology used to calculate the VDO are being considered, and to instead proceed directly to a draft decision where there are no significant changes proposed. However, as part of this change, we recommend that the ESC lengthen the period between draft and final decisions to give stakeholders sufficient time to consider in depth the implications of the draft decision. We also suggest that in addition to inviting submissions that the ESC commit to holding an annual public forum between draft and final decisions, so that stakeholders can raise any matters of concern in relation to the draft decision with ESC staff directly and transparently.

More detailed comments in response to the questions posed in the consultation paper are provided below.

About us

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.

[3] Essential Services Commission (2019), *Victorian Default Offer to apply from 1 July 2019: Draft advice*, p.49

Response to items for consultation

Wholesale costs methodology

In previous submissions, we have argued that the ESC should incorporate the full range of risk-management strategies available to retailers into its wholesale cost estimates to ensure these represent an efficient cost. The consultation paper proposes that ESC's previous approach of using ASX futures provides a reasonable proxy for hedging positions that retailers take, and notes that ASX futures are more transparent that alternative approaches (like over-the-counter contracts and vertical integration). While we continue to think that the ESC should consider how it can garner different evidence about efficient wholesale costs, we are supportive of ESC retaining the ASX futures methodology for 2023-24. We note the concerns raised by the Australian Competition and Consumer Commission about retailers shifting away from ASX futures over the course of 2022.[4] We expect, however, this to change over the course of 2023-24, given the steps that have been taken to improve liquidity in these markets[5] and the recent Federal Government interventions which have indicated a reduction in Victorian forecast prices of 29 percent.[6]

RECOMMENDATION 1. Retain the use of trade-weighted futures contract prices to estimate wholesale prices for the 2023-24 VDO.

Market intervention costs

We are not in support of the position advanced by the ESC in the consultation paper that compensation costs associated with AEMO's June 2022 intervention into the wholesale market should be entirely included in the 2023-24 VDO.

Instead, we are of the view that there should not be a direct pass through of costs associated with AEMO's intervention. We take this view for several reasons, chiefly that we consider it unfair for consumers to be expected to fully wear the cost of issues in the wholesale energy market, given that these issues were not of their making. While this intervention was extraordinary, we consider that retailers (or at least prudent retailers) should have had risk management procedures in place to buffer the impact of some of these costs. One of the key roles of energy retailers is to manage the risk of price volatility in the wholesale market on behalf of their customers. Where retailers have failed to do so, they should also be expected to wear some of these costs. We recommend that the ESC use its information gathering powers to collect information from retailers about risk management strategies that may have allowed them to absorb costs incurred. The insights gained from this exercise should then be used to arrive at a fairer sharing of costs associated with AEMO's market intervention, as opposed to a direct pass-through of costs to consumers. Given the objective that the VDO represents a reasonably priced electricity option, we ask the ESC to consider what a 'reasonable' sharing of costs would look like. We would suggest that asking consumers to cover the entirety of the compensation costs associated with AEMO's intervention is not a reasonable outcome.

Further to this point, we suggest the ESC should apply a broader lens in considering the allocation of costs than simply looking at this event in isolation. While recognising the point in the consultation paper that, "There is no mechanism for retailers to claim compensation from the market operator for lost hedging revenue that would have offset the higher wholesale costs,"[7] we suggest that the ESC consider where aspects of previous VDO decisions may have favoured retailers and would allow them to absorb costs associated with AEMO's intervention, even in the absence of the ability to claim direct compensation for costs incurred. As one example, we have previously raised that the retailer margin in the VDO cost stack has been set at a level we consider to be generous, given that it sits at the top end of the range identified through comparison of retailer margins in other

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[4] Australian Competition and Consumer Commission (2022), *Inquiry into the National Electricity Market: November 2022 Report*, p.48.
[5] Australian Financial Review, 'ASX sought RBA help to revive electricity market', 19 December 2022
[6] Australian Financial Review, 'Electricity prices will come down – just not yet', 20 January 2023.
[7] Essential Services Commission (2022), Victorian Default Offer 2023-24: Consultation Paper, p.12

jurisdictions.[8] Where retailers have benefitted from previous decisions in this way, they will have capacity to also bear some of the costs associated with recent events, rather than costs being passed through to consumers in their entirety.

RECOMMENDATION 2. The ESC uses its information gathering powers to collect information on retailers' capacity to absorb costs associated with AEMO's market intervention and share costs accordingly between retailers and consumers.

In addition to the consideration of fairness in how costs are shared between retailers and customers, the ESC should also consider fairness with respect to how costs are distributed between customers. Adding costs associated with the market intervention on to the daily supply charge (fixed costs) portion of a person's bill will negatively impact households with lower consumption. Conversely, if costs are added only onto the usage charge (variable costs) portion of the bill this will have an impact on higher-consumption households. Households may have high levels of non-discretionary consumption due to circumstances outside of their control, for instance because they are a large family or are living in a house with poor energy efficiency. Adding costs only to the variable cost portion of the bill would unfairly penalise these households through no fault of their own. If after assessing the cost to retailers of AEMO's market intervention, there are found to be additional costs to be incurred by consumers, we recommend that the ESC consider equity of outcomes between consumers as to how these costs are apportioned to bills.

RECOMMENDATION 3. The ESC considers equity of outcomes in how any costs to consumers associated with AEMO's market invention are applied to bills.

Finally, purely from a practical point of view we note that the quantum of costs incurred as a result of AEMO's market intervention are not yet clear. As the consultation paper notes, the second tranche of directions and suspension pricing compensation payments are scheduled to be settled only in January 2023, while there is still no published timeline of when costs associated with administered pricing compensation will be settled.[9] We consider it preferable to account for these costs in the 2024-25 VDO once the exact amounts are known, rather than through a variation to the 2023-24 VDO. Delaying accounting for these costs until the 2024-25 regulatory period would allow time for the exact costs to be settled, and it would also permit for costs associated with AEMO's market intervention to be smoothed over time. Many people in the community are currently struggling to cover their day-to-day expenses amid high inflation and cost-of-living pressures. These people have limited, if any, ability to absorb further price rises at this time. Accounting for remaining costs in the 2024-25 VDO would give these people some breathing room until cost-of-living pressures hopefully begin to ease, rather than passing through a further price rise in FY2023-24. It is our view that retailers should be expected to manage the impact of any additional costs until the commencement of the FY2024-25 regulatory period.

RECOMMENDATION 4. Any currently unknown costs should be accounted for in the 2024-25 VDO, rather than through a variation to the 2023-24 VDO.

Retail operating costs

We suggest that the ESC should use its information gathering powers to collect actual cost data from Victorian electricity retailers to ascertain what changes are required to the current benchmark. Comparing retailer's actual costs to the benchmark currently in use is an important step to validate that it remains applicable. Given that the benchmark represents a moment in time—in this case being arrived at in 2017—as time passes there is an increased risk that changes in the market render the current benchmark less accurate (if not entirely invalidated by a fundamental change to market conditions).

[8] See our submission to the 2022-23 VDO draft decision, available at: https://consumeraction.org.au/victorian-default-offer-electricity-tariffs-2022-23/
[9] Essential Services Commission (2022), Victorian Default Offer 2023-24: Consultation Paper, p.12

Where prices are found to diverge from the benchmark currently in use it would suggest that the benchmark no longer serves as a useful proxy for the cost of retail operations in Victoria. In line with the principles outlined in the consultation paper that will be used to set a benchmark, this approach would be both the most accurate, and simple for people to understand. We acknowledge that collecting this detailed data is time and resource intensive for both the ESC and retailers but consider that this work is necessary to understand if the current benchmark is still valid.

We note recent statements both from the ESC and the Australian Competition and Consumer Commission (**ACCC**) that suggest retail operating costs are declining. The ESC's Final Decision on the 2022-23 VDO states, "The average of the median value for retail operating costs reported by retailers in each year (in response to our formal information requests issued under the ESC Act) from 2017-18 to 2020-21 is $140, below the benchmark adopted in our final decision. The median value for 2020-21 was lower than this four-year average."[10] Similarly, in its November 2022 report as part of the ongoing Inquiry into the National Electricity Market the ACCC notes, "…continued reductions in National Electricity Market-wide retail costs per residential customer. Retail costs in 2021–22 were lower than all previous years with available data, except 2007–08."[11] This data underscores the importance of the ESC collecting actual cost data from retailers to ascertain if the current benchmark needs to be adjusted downwards to account for decreasing retail operating costs.

This collection of data should also be used to investigate whether recent regulatory reforms have reduced the cost of operations in Victoria, and whether the allowance of $10 per customer for new regulatory obligations and Victorian specific costs is still justifiable. The ESC previously noted in advice to Victorian Government ahead of the initial VDO that the default offer, along with other recent reforms, had the potential to decrease operating costs through lower levels of accumulated debt and avoided costs related to bad debt and debt collection.[12] If the ESC is collecting data on retail operating costs we recommend they also capture information to understand if these reforms have indeed resulted in reduced costs.

RECOMMENDATION 5. The ESC collects actual cost data from retailers to identify what changes are required to the current benchmark for retail operating costs.

RECOMMENDATION 6. The ESC review cost data to identify any cost savings from recent reforms and adjust the benchmark accordingly.

While reviewing cost data and updating the benchmark, we also urge the ESC to use a figure towards the lower end of the range of costs observed. Consumer advocates, including Consumer Action, have previously raised that the use of benchmarking risks arriving at a VDO that does not represent an efficient price.[13] This is because Victorian retail costs are likely to include existing inefficiencies in retailer operations. To counter this, we recommend that the ESC choose a figure towards the lower end of the range of operating costs observed in market. While acknowledging the different in operating costs between Tier 1 and non-Tier 1 retailers, we consider it still to be important for the ESC to set a benchmark figure below the midpoint of any range of operating costs to better reflect an 'efficient' measure of retail operating costs.

RECOMMENDATION 7. In updating the retail operating cost benchmark the ESC use a figure towards the lower end of the range of costs observed.

Finally, the ESC suggested in its 2019 Draft Advice ahead of the initial VDO that analysis to identify the merits of applying a productivity factor to retailers' operating costs, "…will be a major focus of our future work."[14] We were supportive of this suggestion at the time it was made, and we are unclear whether work on it has not been

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[10] Essential Services Commission (2022), Victorian Default Offer 2022-23: Draft decision , p.25
[11] Australian Competition and Consumer Commission (2022), Inquiry into the National Electricity Market: November 2022 Report, p.74
[12] Essential Services Commission (2019), Victorian Default Offer to apply from 1 July 2019: Advice to Victorian Government, p.55
[13] VCOSS et al (2019), A simple, efficient and accessible energy deal: Response to draft Orders in Council on the Victorian Default Offer, p.8
[14] Essential Services Commission (2019), Victorian Default Offer to apply from 1 July 2019: Draft advice, p.49

undertaken as yet. Given that both the ESC and ACCC have acknowledged trends in falling retail costs over recent years, we recommend that the ESC follow through on their earlier suggestion and undertake analysis to identify if a productivity factor should be applied to future estimates of retailers' operating costs when calculating the VDO. We are of the view that a productivity factor serves as an important signal to business to improve efficiency over time. Including a productivity factor in future VDO decisions makes this expectation explicit for retailers and ensures that customers benefit from continued downward pressure on retail operating costs.

RECOMMENDATION 8. The ESC undertake analysis to explore the merits of introducing a productivity factor to retailer's operating costs.

We also note that the ESC is seeking stakeholder views on the cost impact of the consumer data right (**CDR**) on retailers. We are opposed to any additional pass-through associated with the CDR. Notwithstanding the ESC's initial analysis which found the ongoing costs of complying with the CDR for the first tranche of retailers were very low, we simply note that the CDR is premised on promoting a more efficient and competitive marketplace, thus reducing pressure on costs. It would be perverse if the VDO were increased because of a reform designed to promote competition and efficiency.

RECOMMENDATION 9. The ESC should not include any additional pass-through relating to the consumer data right.

Customer acquisition costs

We have long been of the view that CARC should not be included in the VDO, for the simple fact that people unable or unwilling to engage in the electricity market derive no benefit from retailer's spending to acquire them as customers. Although we still hold this view, we acknowledge that the pricing order requires the ESC to include a modest allowance for CARC when making their price determination.

Given that the VDO determination is required to include an allowance for 'modest' spend on CARC, we consider it important that the ESC check costs against retailer data to identify any required changes to the benchmark. As for retail operating costs and margin, we note that expenditure on CARC appears to be declining over recent years. ACCC analysis of expenditure on CARC per customer among the 'big-3' retailers show a decline from $50 in 2018-19 to $37 in 2021-22.[15] We note that this latter figure is less than the CARC benchmark currently in use for the purposes of calculating the VDO.

We recommend that as a first step the ESC collect cost data from retailers to understand if the trend of decreasing spend on CARC across the National Electricity Market (**NEM**) is also occurring in Victoria. If a similar trend is observed locally, this would suggest there is a case for the ESC to revisit the CARC benchmark currently in use and revise it accordingly.

RECOMMENDATION 10. The ESC collects cost data from retailers to understand if recent decreases in expenditure on CARC across the NEM are also reflected in Victoria and adjust the benchmark accordingly where decreases are observed.

Retail operating margin

We are pleased to see that the ESC will review the retail operating margin as part of this review but are concerned that the ESC has already expressed an initial view to maintain the margin at 5.7%. We consider it important that the ESC approach a review of the margin without a proposed figure already in mind, and instead be guided by the insights gained from that review to arrive at an updated figure in a Draft Decision.

We have previously noted concern that the retail margin in the VDO is generous, given that it falls towards the top of the range when compared to other jurisdictions. In line with this view, we point to the ACCC's most recent report

[15] Australian Competition and Consumer Commission (2022), Inquiry into the National Electricity Market: November 2022 Report, p.76

from their Inquiry into the National Energy Market. The report notes that retail margins are at near record lows, stating that, "…the average retail margin across the National Electricity Market had dropped to $35 per residential customer in 2021–22, a decrease of 33% in real terms from the previous financial year. This decline continues the general downward trend in retail margins from their peak in 2016–17."[16] We urge the ESC to consider these findings when undertaking the review of retail operating margins and explore what scope there is to decrease the retail operating margin included in the VDO as a result.

As part of a review of retail operating margins we recommend the ESC consider obtaining independent advice as to what an efficient margin should be. We also recommend that an updated margin is set at the lower end of any recommended range, making clear that electricity retailer's primary focus must be on delivering value to customers, as opposed to compensating investors.

RECOMMENDATION 11. As part of a review of retail operating margin, the ESC obtains independent advice on what an efficient retail margin should be.

RECOMMENDATION 12. Any updated retail operating margin is set at the lower end of the recommended range.

Consultation papers

We are supportive of the ESC publishing consultation papers only when major changes to the VDO methodology are proposed. We appreciate that by proceeding directly to a draft decision this will lower the regulatory burden on stakeholders involved in VDO reviews, particularly given that prices are reviewed annually. However, although the consultation paper notes feedback has been received from stakeholders that, "…the pricing methodology is well established,"[17] we do not consider that this should mean that the methodology is settled. As this consultation paper highlights it is critical that the pricing methodology is regularly interrogated to ensure that it delivers a fair and reasonably priced VDO.

To this end, we recommend that if the ESC does not publish consultation papers in future years, that an earlier draft decision is delivered so that stakeholders have ample time to consider the implications of the decision (including aspects of the decision they may deem significant or matters that have been omitted in the decision but would benefit from consideration) and respond appropriately.

RECOMMENDATION 13. In future years when a consultation paper is not published, the ESC releases an earlier draft decision so that stakeholders have time to review the decision and respond.

In addition, we recommend that the ESC commit to holding a public forum between the draft and final decisions as regular practice during each VDO review. We note that the ESC typically does this already but consider that it would be of value to formalise this approach as part of the annual price review process. While submissions are a valuable means to provide feedback (and form an easily accessible historical record of stakeholder input across various VDO reviews through being uploaded to the ESC's website) there are further benefits to be gained from a public forum (whether online or in-person) where various stakeholders can engage directly in public dialogue with ESC staff and one another.

RECOMMENDATION 14. The ESC formally commits to holding a public forum as part of the annual price review between the draft and final decisions.

[16] Ibid, p.74
[17] Essential Services Commission (2022), Victorian Default Offer 2023-24: Consultation Paper, p.21

Thank you again for the opportunity to respond to the consultation paper. Should you wish to discuss any of the issues raised in our submission, please contact Luke Lovell, Senior Policy Officer at luke@consumeraction.org.au or on 03 9670 5088 for more information or to arrange a meeting.

Yours sincerely,

CONSUMER ACTION LAW CENTRE

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