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Essential Services Commission
www.engage.vic.gov.au

Lodged by email: VDO@esc.vic.gov.au

RE: Victorian Default Offer 2023-24 Consultation paper

Powershop is an innovative retailer committed to providing products and services to benefit consumers. Powershop also recognises the benefits to customers in transitioning to a more distributed and renewable-based energy system. Powershop has introduced several significant, innovative and customer-centric initiatives into the retail energy market, including the first mobile app that allows customers to monitor their usage, a peer-to-peer solar trading trial and a successful customer-led demand response program.

Powershop thanks the Essential Services Commission of Victoria (the “**ESC**”) for the opportunity to provide a submission in response to their Victorian Default Offer 2023-24 Consultation paper (the “**Paper**”).

Statement

Powershop acknowledges the issues raised by the Paper and shares the concerns raised in relation to the significant energy market events of 2022 that materially impacted customers and retailers alike. It is pleasing to note that the ESC understands the key issues which have arisen and need to be considered for the Victorian Default Offer (the “**VDO**”). Market intervention costs, retailer costs including those incurred by the introduction of Consumer Data Rights (the “**CDR**”) framework and customer acquisition costs all require genuine review by the ESC to ensure they achieve not just the VDO’s objective¹, but also uphold the ESC’s objective in relation to promoting the development of full retail competition².

The submission that follows focuses on several important positions in response to the paper:

- The methodology underpinning the calculation of the wholesale electricity cost and that it is not reflective of the risks retailers currently face in the market.
- Supporting a continuation of the CPI indexation in the development of the retail operating cost element of the VDO.
- Recognising the parallels that can be drawn between current market conditions in Victoria and the recent experience of the UK retail energy market.
- Passing through any known market intervention costs to 2023-24 VDO and passing through any future costs as they are incurred, subject to a materiality threshold and consultation.
- The ESC continuing to consult transparently in any future VDO price determinations.

¹ https://www.esc.vic.gov.au/sites/default/files/documents/Victorian%20Default%20Offer%202022-23%20-%20Final%20decision_0.pdf Page 44

² Section 10 (b) of the Electricity Industry Act 2000

Wholesale Costs

Powershop is concerned that the ESC will continue to use trade weighted futures contract prices. Powershop believes this is likely to underestimate true wholesale costs and not capture the full risk retailers must carry during these uncertain, volatile times. The Australian Competition and Consumer Commission (the “ACCC”), in a report³ released in November 2022 speaks to the need for greater support for retailers to manage their wholesale risks. We consider the ACCC report provides pertinent analysis around the recent wholesale events and impact to the retailers operating in a more complex and volatile market, and we urge the ESC to reflect on the ACCC’s findings when determining wholesale costs within the VDO. In particular, we consider the following findings are relevant to the VDO in the ACCC report:

Competition in financial and retail markets

In relation to competition in both the financial and retail markets, the report notes that

“To maintain and promote competition during periods of temporary price volatility, it is essential that market participants can appropriately manage financial risks. Our analysis indicates that retailers are finding it increasingly difficult to manage their exposure to prices in a volatile spot market. This, in turn, increases the likelihood of retailer failure, declining competition, and higher bills for consumers.”⁴

While external factors and the energy transition are providing a challenging environment, Powershop consider that the VDO must continue to meet the objective of promoting competition in Victoria, for the benefit of Victorian consumers. It will be critical that the VDO supports a competitive retail market, with sufficient incentives to deliver the required investment needed for the energy transition, and to allow retailers to operate efficiently, protecting the market and ultimately consumers from the instability of retailer failure.

Managing risk

With respect to managing market risk in the current challenging environment, the report notes that

“The expectation in financial markets that relatively high and volatile spot prices will persist. has led to steep increases in contract prices. High contract prices have increased the credit support or ‘margins’ required from market participants, impacting retailers, generators and the brokers and clearing participants that facilitate trades. Some clearing participants have responded by reducing their exposure to electricity contracts on the Australian Securities Exchange (ASX); for instance, by closing out existing positions or not taking on new clients.

The result is that a number of smaller retailers have lost access to exchange-traded contracts in 2022. This means that they must rely on over-the-counter (OTC) hedging contracts to manage their risk and are more likely to be exposed to high and volatile wholesale electricity spot prices, threatening their financial viability. Further, our analysis reveals that prices in the OTC market were notably higher than on the ASX from quarter 2 2022 onwards, putting retailers without ASX access at a disadvantage”⁵.

³ ACCC, Inquiry into the National Electricity Market, November 2022 report

⁴ ACCC, Inquiry into the National Electricity Market, Page 1

⁵ ACCC, Inquiry into the National Electricity Market, Page 2

Powershop consider that the risk profile for retailers is unquestionably increasing with greater exposures to rising and volatile wholesale markets and credit support requirements increasing. This has resulted in some retailers losing access to exchange traded contracts, which further decreases liquidity in the market. Consequently, retailers are more reliant on OTC contracts to manage risk and thus more exposed to spot and financial viability risks, contrary to the views held by the Paper.

Powershop notes the suggestion of allowing the ESC to request OTC contracts. While this would help to re-create a more reflective wholesale cost, Powershop would expect this process to be fully transparent and the process consulted upon, as the increased frequency of compulsory information requests in the last year carries with it a cost to retailers, especially smaller retailers.

Furthermore, in the spirit of transparency, Powershop propose that the ESC publish the period or date range that has been used for the most recent 12 months of trade-weighted futures contract prices. This would provide stakeholders with confidence in and understanding of the data that underpins the calculation of wholesale energy costs.

Retail competition

It is important that the VDO is not set at a level that only allows large incumbent retailers to operate. Competition is essential to support consumers and their purchasing interests and competition has increased over the last decade. New entrants have won gradual market share but more importantly, presented an improved value proposition through product innovations and services. .

Powershop notes that the ACCC in the report have also highlighted that retailers currently have a limited ability to pass through increased costs in the short term, creating further pressure on smaller retailers and the overall financial viability of the market. The report includes that

“High and volatile wholesale electricity spot prices, coupled with high contract prices, reduced access to hedging contracts, impending compensation payments and retail price caps are impacting the financial viability of retailers. While retail prices have increased, retailers have limited ability to pass through increased costs in the short term, increasing their liquidity risk”⁶.

Since May 2022, the NEM has lost 6 retailers, who have exited through the RoLR process. Alarmingly, some retailers encouraged customers to switch to another retailer around the same time, whilst other retailers elected to withdraw market offers, creating a movement back towards incumbent retailers. This activity has had the concerning effect of reducing competition and highlighting the challenges that retailers face in passing through relevant costs to consumers, especially in the short term.

Powershop wish to draw the ESC’s attention to events in the UK. There are some concerning parallels to the failure of price regulation and contagion failure of retailers and suppliers being experienced in the UK market.

In our submission to the Australian Energy Regulator (the “AER”) for the upcoming 2023-24 Default Market Offer (the “DMO”)⁷we supported the AER’s assertion, consistent with the ACCC that financial viability of retailers is vital to ensure energy costs do not significantly increase further.

⁶ ACCC, Inquiry into the National Electricity Market, Page 3

⁷ <https://www.aer.gov.au/system/files/Powershop%20-%20AER%20DMO%205%20Issues%20Paper%20-%2030%20November%202022.pdf>

Similar to the recent events in the NEM, during 2021-2022, the wholesale price retailers paid for gas and electricity in the UK increased to unprecedented levels. However, in the UK, this led to the failure of 29 energy suppliers. Those failed retailers, except for Bulb Energy (1.6 million customers) were managed through the equivalent RoLR scheme.

“Ofgem’s current best estimate of the cost of the 28 suppliers that have exited the market is £2.7 billion, which equates to around £94 per customer⁸”

The cost of failure is being borne by consumers and taxpayers, a situation stakeholders should seek to avoid in Victoria, seemingly only achievable through the appropriate setting of prices and an understanding of the risk retailers are currently facing.

Regulated retail prices should reflect risk management cost

The ACCC report reflects on regulated pricing and the impact it has on retailers operating in the market in their management of price risk

“Regulated retail pricing affects the ability of retailers to recover their costs and remain financially viable. It is important that regulated pricing reflects the actual costs of operating in the market, including the costs of managing price risk”⁹.

The report advises that risk management costs have increased, with a shift to over-the-counter contracts and increased credit support requirements. Powershop supports the views held by the ACCC that this increase should be reflected in regulated retail electricity prices. The ESC should strongly consider these findings in the current and future VDO determinations, ensuring that regulated prices reflect a prudent retailer’s hedging costs.

Linked to the above issues is the rising interest rate environment driving up costs of funding for retailers, especially for those retailers not vertically integrated. This is a concern that applies to the industry broadly and puts further pressure on margins.

In summary, the ACCC report highlights that the financial viability of retailers is under pressure. Consequently, the ability to pass through all relevant costs and to make a reasonable retail margin in a high-risk environment needs to be considered. The consequences of not providing these opportunities is that the market may experience continued and multiple failures, of which consumers ultimately bear the cost.

Given the reluctance to disclose the precise calculations that underpin the wholesale cost methodology to industry and based upon the evidence provided by the ACCC, Powershop believes the ESC should include a greater risk premium for retailers in the development of the wholesale electricity cost element of the VDO. An increased risk premium is reflective of the market currently and reflects a prudent retailer’s actions given the environment retailers have faced over the last 12 months and will continue to face. so that retailers can manage increased volumes to deal with these volatile market movements.

⁸ <https://committees.parliament.uk/publications/31575/documents/177114/default/> page 5

⁹ ACCC, Inquiry into the National Electricity Market, Page 4

Market Intervention Costs

Powershop supports the position taken by the ESC to include the relevant compensation costs in the VDO, allowing Powershop and other retailers to recover efficient costs. Powershop also acknowledges that only some of these costs will be known when the ESC makes its final decision in late May 2023. It is reasonable to only expect that known costs are passed through at the point the VDO final determination is published. Any additional costs that become known and impact Victorian electricity retailers, Powershop believes can be accounted for as a pass through in the 2024–25 VDO price determination.

The above position is subject to the materiality of any future compensation costs being assessed, and whether a change to the VDO out of the normal regulatory period is required. Powershop would encourage the ESC to consult with industry in determining whether a particular cost is material.

Retail Operating Costs

Powershop supports a continuation of the Consumer Price Index (“CPI”) indexation with respect to Retail Operating Costs. Powershop questions the logic behind the Paper’s preference to switch from a CPI indexation to a lower alternative (e.g., a wage index or a benchmark from another regulator) in order to apply Retail Operating Costs (“ROC”) to the VDO. The Paper states that

“During previous Victorian Default Offer reviews, the consumer price index has been used as a proxy for increases in retail operating costs. In a low-inflation environment this transparent assumption is reasonable. However, given the large increase in the consumer price index, and smaller increases in wages (which make up the largest share of retail operating costs), it may no longer be as reasonable”¹⁰.

Powershop believes that continuing to apply CPI will at least continue to assist retailers to recover their ROC. Retailers are just as exposed to various and numerous economic pressures as are customers in the foreseeable future. Cost-of-living, interest rate rises and the Australian Taxation Office’s post pandemic increase in debt collection will flow through the economy impacting both residential and small business customers.

Other economic pressures are exposed in ROC, including but not limited to higher bad debt provisions and subsequent write-offs. The expectation is that a prudent retailer will also need to increase their resources to manage and mitigate increased activities required for revenue collection, hardship programs and customer call centre activities. Not applying CPI moving forward ignores these additional factors that underpin a retailer’s ROC. Considering these compounding impacts to the retail customer base coupled with the need for an efficient, simple and stable benchmark method, the application of the CPI remains the most appropriate mechanism in the development of the ROC element of the VDO.

More than ever, and beyond CDR, increasing costs for retailers in managing new regulations, increased privacy & security requirements, increased support for customers and focus on improved services/innovation should be respected and catered for in the VDO.

¹⁰ Essential Services Commission Victoria, Victorian Default Offer 2023-24 Consultation Paper, Page 14

Consumer Data Right Costs

Powershop will provide the estimated costs of complying with the CDR requirements confidentially to the ESC, closer to May 2023 or as they become known during implementation. The ESC should also note that CDR will impose an ongoing cost that will need to be accounted for in future VDO determinations.

Consultation papers

The ESC has published a consultation paper to begin each VDO review. Powershop understand that the ESC has proposed a new approach, which includes only publishing a consultation paper for VDO reviews if material changes are being considered in the setting of prices. In such a dynamic, volatile market, going through an unprecedented transition, Powershop does not support the proposed change to the consultation process for the VDO.

The current VDO Order in Council explicitly states

“The Commission may decide the nature and extent of stakeholder consultation it will undertake when making a VDO price determination or a decision to vary a VDO price determination”¹¹.

The 5 principles that the ESC Stakeholder Engagement Framework are built around can be summarised by transparency, accountability, considered, planned, inclusive, clear, accessible and simplistic understanding. The proposal to only consult on material changes, in our view, does not meet these principles. Powershop consider that at this time, the ESC should engage more regularly with industry and other stakeholders. It is important that in a volatile, transitioning energy market, all relevant information and costs are captured and understood in determining the VDO price. Furthermore, retailers are in a unique position to provide the ESC with data and market information that may be relevant to the determination of the VDO. Consultations often provide the most suitable avenue for this information to be provided to the ESC.

Conclusion

Powershop acknowledges the ESC are required to determine a regulated price in the current environment of rising cost challenges that were never foreseen when the initial VDO methodology was developed. Powershop believe that in establishing the next VDO, it will be important for the ESC to recognise how Victorian electricity retailers are now more materially impacted by extreme external factors, than previous VDO determinations. These concerns are contemplated in commentary within the ACCC report, and the AER and shared in similar market conditions extant in the UK. Powershop encourage the ESC to continue to consult closely with retailers and other regulators in its consideration of how a prudent retailer would manage the risks associated with the current environment.

¹¹ https://www.esc.vic.gov.au/sites/default/files/documents/Victorian%20Default%20Offer%202022-23%20-%20Final%20decision_0.pdf



Powershop would welcome further engagement with the ESC on the points highlighted through this submission. If you would like to discuss, please contact Alan Love at alan.love@powershop.com.au.

Yours sincerely,

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