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Mr Paul Smith
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Dear Mr Smith

AEMC 2014 RETAIL COMPETITION REVIEW – DSDBI SUBMISSION

The Victorian Department of State Development and Business Innovation (DSDBI) as the portfolio agency responsible for energy market development in Victoria, is pleased to make this submission in response to the Australian Energy Market Commission's (AEMC) consultation on its 2014 Retail Competition Review.

Approach to the retail competition review

The AEMC 2014 Retail Competition Review will play an important role in contributing to public understanding of the current state of retail competition across the National Energy Market (NEM) and within each participating NEM state and territory. This review will be the first annual NEM retail competition review and should set the benchmark for future reviews.

As the first Australian jurisdiction to move to full price deregulation in 2009, Victoria has, by many measures, a strongly competitive retail energy market. Currently, there are a number of active retailers, consistently high levels of customer switching, a diverse range of energy offers and increasing levels of product and service innovation.

The Victorian Government supports a fully competitive retail energy market as the primary means of ensuring consumers benefit from affordable energy prices and quality service.

In this context, the Government has recently undertaken a number of initiatives to strengthen consumer engagement and further promote competition in Victoria. These include:

- the launch of the *Switch On* website with a wealth of information and tools to assist consumers understand their consumption habits and energy needs;
- the introduction of optional flexible pricing for those consumers who do not use energy during peak hours or are capable of shifting their energy use in response to price signals;
- the launch of the *My Power Planner* (MPP) price comparator tool that allows consumers to compare offers and realise savings by switching their retail plan or provider;
- the launch of the *Energy Information Fund* grant program as a means of educating and empowering customers that may not be reached by mainstream information campaigns. This

initiative is specifically targeted at older Victorians, consumers living in rural areas, and non-English speaking consumers to enable them to make informed decisions about their energy purchasing decisions.

These measures will improve transparency in relation to retail pricing and products and reduce information asymmetries within the sector and between retailers and consumers. They will also allow DSDBI to understand, evaluate and, where appropriate, respond to changes in market dynamics.

While these measures should help to further drive competition in Victoria, DSDBI notes that in a report released in 2013 the Victorian Essential Services Commission (ESC) identified the existence of seemingly elevated retail margins for Tier 1 retailers in Victoria.¹ In addition, the AEMC in its 2013 Review of Residential Electricity Price Trends found that the competitive wholesale and retail component of representative market offers was higher in Victoria than Queensland, New South Wales and South Australia.²

The issues raised in these reports requires careful investigation to determine the nature and level of these margins and whether the presence of these margins suggests that there are actions the Government could take to further drive competition in Victoria.

DSDBI requests the AEMC, in conducting this 2014 review, to develop a robust methodology that would:

- test the accuracy of current findings on retail margins, including whether or not these exist, to what extent, and their potential causes;
- determine whether there is any correlation between margins and the broader state of retail competition;
- serve as a useful tool to observe future retail market trends; and
- inform future policy responses as appropriate.

A cohort of Victorian consumers remains on standing or default offers and has not yet taken advantage of the large number of competitively priced market offers that are currently available in the market. The exposure of this cohort to higher prices and to potentially higher margins is an important issue for this review.

There is often a preference for numerical competition indicators (such as market shares or rates of switching) that can be easily observed or measured, and that lend themselves to comparisons over time. However, understanding more complex aspects of the market such as the existence of inactive customer segments or retailers' pricing decisions requires a more in-depth analysis of retail price offerings or other forms of targeted research. The experience in Victoria suggests that undertaking such additional targeted research is critical to understanding the state of retail competition.

DSDBI will consider carefully the results of the AEMC's analysis to inform whether additional policy initiatives are necessary to further drive competition in Victoria for the benefit of all customers.

Key questions for consideration relating to the Victorian electricity retail market

DSDBI's over-riding objective is to ensure that Victorian consumers are well served by their energy retailers. To this end, DSDBI supports the role of competition as a means of delivering efficiently priced energy services and products of an acceptable quality to Victorian consumers.

A review of high-level indicators suggests that competition in the Victorian electricity retail sector is strong. There has been significant new entry and the market shares of incumbent retailers have

¹ Essential Services Commission, Progress of Electricity Retail Competition in Victoria, Research Paper, May 2013

² Australian Energy Market Commission, Residential Electricity Price Trends Report, 13 December 2013

declined. As of 2012-13, there were 17 active electricity retailers and the combined market share of new entrants in electricity retail was more than 30 per cent of residential customers.³

Further, customer switching rates in Victoria are high. The ESC estimates the rate of customer switching between different retailers at around 29 per cent for electricity customers.⁴ In addition, customers have access to a diverse range of retail offers. Based on a preliminary analysis of MPP data, DSDBI estimates that an individual customer is currently eligible for around 120 electricity offers. The introduction of smart meters further enables new flexible (time of use) pricing offers, as well as the development of value added services such as demand monitoring through web portals and in-home display devices.

Whilst the factors outlined above provide a signal that competition in Victoria is strong, the ESC has reported in 2013 that there are indications that retail margins in Victoria exceed those in other jurisdictions. Further, the ESC has found that the electricity bills of some Victorian customers have increased in recent years.

The following questions for the AEMC review should progress understanding on the key drivers for price increases in Victoria.

Are there elevated retail electricity prices and margins in Victoria?

The presence of a number of active competitors in the Victorian retail market would be expected to limit the ability of any one retailer to sustain price or profit margin increases above underlying costs. Given that standing offers have been deregulated in Victoria, far less information is available about retailers' cost structures than in other NEM jurisdictions. Detailed tariff analyses therefore invariably pose methodological issues and require more assumptions to be made about the composition of costs and other factors.

This highlights the need to develop a robust methodology to (a) test the accuracy of the findings in public reports on retail margins and (b) have an accurate and widely accepted basis for measuring trends in margins over time. Such a methodology should focus on observable prices and costs in order to estimate differences in margins across supply areas, tariff types and retailers. Given data limitations, assumptions would need to be made about costs and other factors that are internal to retailers, such as retail operating costs and wholesale hedging costs.

DSDBI considers that a process where the assumptions underlying the analysis are disclosed for public debate, and are generally agreed, would assist in advancing the understanding of competitive trends in Victoria's energy sector, including the nature and level of any sustained retail margins.

Specifically, the review should attempt to test the potential causes for retail margins in Victoria including whether:

- Tier 1 retailers may be exposed to higher internal business costs relative to Tier 2 retailers that are not outwardly apparent; or
- retailers operating across the NEM use Victorian customers to cross-subsidise revenue shortfalls arising from formal price regulation in place in other NEM jurisdictions such as New South Wales and Queensland.

DSDBI would look to the AEMC to test these and other possible factors specific to Victoria that might better explain the incidence and extent of retail margins.

Does price dispersion in Victoria indicate effective competition?

The removal of price regulation in Victoria has encouraged significant tariff and product innovation in Victorian retail markets. This has resulted in 'price dispersion' – that is, the variation in prices of

³ ESC 2013, n.1

⁴ Essential Service Commission, Energy retailers comparative performance report—pricing 2012-13, October 2013

different tariffs. Recent analyses of published Victorian electricity tariffs suggest customer bills could vary widely even if similar demand or consumption profiles are assumed. For instance:

- a report from the St Vincent de Paul Society and Alviss Consulting stated that the price spread between the lowest and the highest electricity market offers ranged from \$300 to \$440 per year. Households with typical consumption profiles can save up to \$600 to \$800 per year if they switch from the highest standing offer to the lowest market offer.⁵
- DSDBI's preliminary analysis of price recommendations on the MPP price comparator similarly found the median savings from switching to be \$390 in annual bill savings and potentially equate to around 24 per cent of the typical electricity bill.

The review should consider the level of gains customers can make from switching and related to this, whether there is sufficient pressure on Tier 1 retailers to reduce their prices particularly in respect of those customers who remain on standing offers and do not switch.

How effective is customer switching?

Recent research on behalf of the ESC identified lower tariffs and the availability of discounts as the key reasons why respondents switched between retail offers.⁶ Other potential reasons cited by respondents include poor service from their existing retailer, a desire to purchase renewable energy, or to take advantage of particular appliance offers such as solar panels. These reasons should be tested further as part of the AEMC review.

DSDBI notes other findings on the reasons for, and potential barriers to, switching that should be tested as part of the review:

- whether the impetus to switch arises from customers being contacted directly by retailers
- whether a significant share of customers find the process of comparing energy offers difficult.

Specifically where customers on standing offer contracts are concerned – estimated by the ESC at around 22 per cent⁷ – a survey undertaken by Wallis on behalf of the ESC highlights two main reasons why these customers do not switch:

- loyalty to the customer's existing retailer (43 per cent); and
- a view that switching is not worth the effort (30 per cent).⁸

Others may not consider switching because of time or opportunity cost-type considerations, or because they are not price responsive.

In DSDBI's view, these findings should be tested particularly if the existence of an inactive customer segment allows incumbent retailers to target and price discriminate among certain groups of customers.

How competitive is retailer pricing?

The empirical evidence in relation to electricity suggests that Tier 2 retailers actively compete on price. A report by SKM MMA concluded that gross retail margins realised by Tier 2 retailers were generally lower than those charged by Tier 1 retailers.⁹ DSDBI's preliminary analysis of customer - tariff matching on the Victorian Government's MPP price comparator, indicates:

- the 'best tariff' shown to users who could save by switching is from a Tier 2 retailer in 99 per cent of cases;

⁵ St Vincent de Paul Society and Alviss Consulting Pty Ltd, Victorian Energy Prices, January 2014

⁶ Wallis, Victorians' Experience of the Electricity Market, 2013 – Final Report, August 2013

⁷ Essential Services Commission, Victorian Residential Electricity Retail Market Research: Discussion Paper, October 2013

⁸ Wallis, n.7

⁹ SKM MMA, Analysis of Electricity Retail Prices and Retail Margins 2006 - 2012 Report for Essential Services Commission, May 2013

- when the analysis is broadened to consider the ‘top 10’ tariffs shown to website users, 96 per cent of offers are from Tier 2 retailers.

Has retail competition improved levels of service?

The ESC compiles data on various performance indicators to assess service levels by Victorian retailers. The ESC’s most recent assessment is that:

- call centre performance of electricity retailers has remained relatively unchanged; and
- electricity complaints to retailers increased in 2012-13 (with the majority of complaints for relating to billing issues, customer transfers, and marketing practices).¹⁰

The most recent statistics on the number of complaints referred to the Energy and Water Ombudsman Victoria (EWOV) show a rising trend from 6 complaints per 1,000 customers in 2007-08 to almost 16 in 2011-12.¹¹ However, the ESC notes that complaints referred for full investigation by the EWOV have decreased in recent years, reflecting an increased focus by many retailers on improved customer service.¹² Other significant issues observed in Victorian energy retail markets relate to a significant increase in the number of delayed bills being sent to customers, as well as numbers of wrongful disconnections.

DSDBI considers that these findings should also be raised and tested as part of the AEMC review.

Summary

The available empirical evidence raises important questions about the extent to which Tier 1 retailers are able to realise elevated margins in Victoria and the extent to which certain customers, including those who remain on standing offers are able to fully realise the benefits of competition. These questions require careful analysis to verify the nature and level of any retail margins and whether there are additional policy initiatives that should be undertaken in Victoria to further drive the benefits of competition.

Should you have any questions regarding this submission, please contact Andrée Wheeler, Director Strategic Policy, by email Andree.Wheeler@dsdbi.vic.gov.au or Mayuran Sivapragasam, Principal Policy Analyst, by email Mayuran.Sivapragasam@dsdbi.vic.gov.au.

Yours sincerely



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¹⁰ Essential Services Commission, Energy retailers comparative performance report — customer service 2012-13, Melbourne, Revised January 2014

¹¹ Energy and Water Ombudsman Victoria, Annual Report 2013

¹² ESC, n.11