EnergyAustralia
LIGHT THE WAY

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EnergyAustralia Pty Ltd
ABN 99 086 014 968

Level 19
Two Melbourne Quarter
697 Collins Street
Docklands Victoria 3008

Phone +61 3 8628 1000
Facsimile +61 3 8628 1050

enq@energyaustralia.com.au
energyaustralia.com.au

Clare Thomas
Review of the Victorian Default Offer Order in Council
Energy Sector Reform

Lodged electronically: VDOOrder.Review@delwp.vic.gov.au

Dear Ms Thomas,

Review of VDO Order in Council – Consultation Paper - PUBLIC VERSION

EnergyAustralia is one of Australia's largest energy companies with around 2.4 million electricity and gas accounts in NSW, Victoria, Queensland, South Australia, and the Australian Capital Territory. EnergyAustralia owns, contracts, and operates a diversified energy generation portfolio that includes coal, gas, battery storage, demand response, solar, and wind assets. Combined, these assets comprise 4,500MW of generation capacity.

We welcome the opportunity to provide this submission to the Department's review of the Victorian Default Offer Order in Council (VDO Order). The review is not seeking views on the substantive policy merits of the VDO, so we focus on specific issues around the level of the VDO and the VDO pricing methodology.

The key points in our submission are:

- The VDO is set too low today and below median Retailer costs of supply, meaning over half of Retailers are not recovering their costs of supplying Standing Offer customers. This undermines the long-term financial viability of the industry.

- The VDO must cover the realistic costs of supply. Looking forward, the VDO must cover the cost of the clean energy transition (the direct and indirect costs faced by Retailers in emissions reductions activities). The VDO Order should be changed to require the Essential Services Commission (ESC) to *have regard to* actual costs.

- The VDO Order should also have a specific reference to depreciation and amortisation (D&A) as a cost that must be considered. D&A is not sufficiently provided for in the VDO today.

- It would be unreasonable to make changes to the pricing methodology which would reduce the VDO any further, in any part of the VDO's cost stack. Any changes to methodology must be strongly backed by evidence.

- The VDO should also not be set too low (below realistic costs) because of its role as the Reference Price. Lower percentage savings between the VDO and Market Offers have broader market impacts and dampen customer engagement/churn.

- The terms "Modest costs of customer acquisition" in the VDO Order, results in a Cost of Acquisition and Retention Cost (CARC) that is too low. The modest cost approach was justified on the basis that increasing CARC spend was not increasing customer churn. However, customer churn dropped around the time the VDO started. Since then CARC has likely helped to slowly restore churn closer to historic levels of 25%. However, it has not yet reached 25%. Until churn levels stabilise, we recommend keeping the same level of CARC and not reducing it.

- It is also too early to assess the impact of the Energy Fairness Plan bans on CARC. The Department needs to see data for FY 2022 and 2023 which suggests actual CARC has reduced (which we doubt). Even if actual CARC were to reduce and this was seen as a reason to reduce the VDO's CARC, the terms "modest costs of customer acquisition" are broad enough to allow the ESC to reduce CARC. They do not need to change.

- The VDO order should be changed to clarify it does not apply to unmetered supply (UMS) sites as this coverage is likely to be unintended.

If you have any questions in relation to this submission, please contact me (Selena.liu@energyaustralia.com.au or 03 9060 0761).

Yours sincerely,

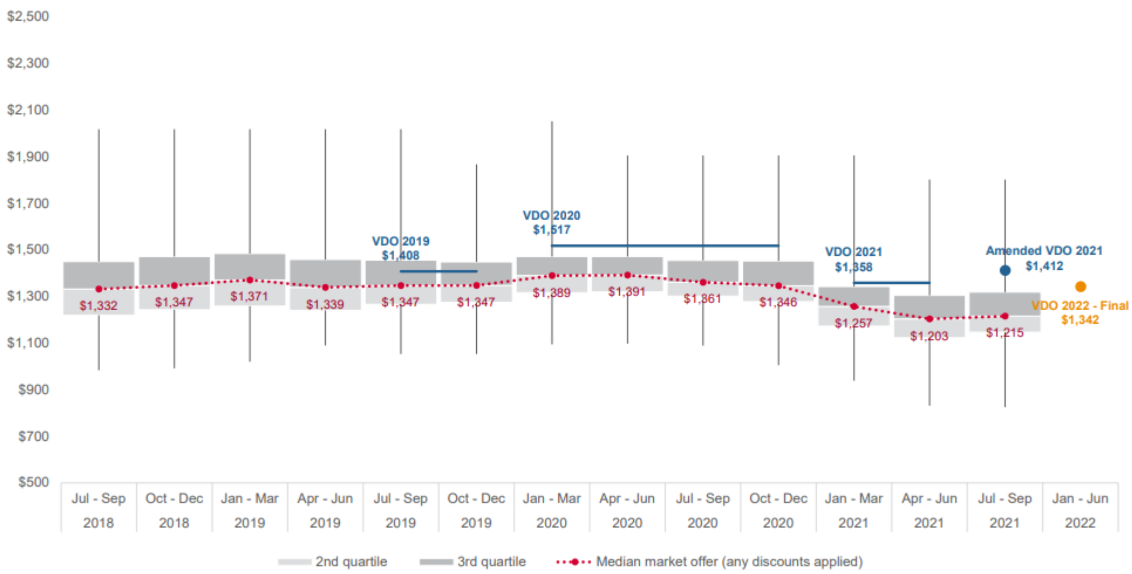
Selena Liu
Regulatory Affairs Lead

1. We question whether the VDO allows recovery of Retailers' realistic costs

There is a real question as to whether the VDO allows for Retailers to recover their costs of supplying electricity to Standing Offer customers. It would be unreasonable to make changes to the pricing methodology which would reduce the VDO any further, in any part of the VDO's cost stack.

The Essential Services Commission of Victoria (ESC) has sometimes compared the VDO to Market Offers available in market (acquisition offers) to validate that the VDO allows for recovery of efficient costs. For example, in the 2022 Draft VDO decision:

Figure 4: Annual residential Victorian Default Offer bill compared to market offer bills (4,000 kWh/year)



From this comparison, the ESC concludes the VDO allows Retailers to recover at least their efficient costs, as "most Market Offers are below the average VDO bill". However, this assumption is misplaced. The Market Offers in the graph are acquisition offers for new customers only which are lower priced and can be priced below cost. They do not represent the pricing that a Retailer's entire customer base is on, with many customers on plans that are no longer available in market.

Instead of comparing the VDO to acquisition Market Offers, a more meaningful comparison is to compare the VDO to Retailers' actual total cost data, which the ESC has sometimes done.

In November 2020, the ESC compared the 2021 VDO with Retailer's actual costs of supply and found that the VDO was 11% below the median cost. This means that for over half of Retailers, the 2021 VDO would have under-recovered their costs.

Clause 12(8) provides that the VDO does not have to be *based on* the actual costs of *a Retailer*. The ESC often refers to this clause when the VDO departs from actual costs reported by Retailers. However, clause 12(8) does not mean that actual costs across *all Retailers* can be completely disregarded. **We recommend that clause 12(8) be removed, and that actual costs be made a matter which the ESC must have regard to**. Actual cost data across the industry provides important information on efficient costs in a competitive market, which is a valuable data point in making the VDO.

Further, if over half of Retailers cannot recover their costs it infers that the VDO is not supporting the long-term financial viability of the industry (another matter the ESC must have regard to).[1] This under-recovery should not be minimised due to Standing Offers only making up a small proportion of customers. Rather any under-recovery should be assessed in proportion to the customers the VDO applies to.

Below we set out EnergyAustralia's costs per residential customer compared to the VDO.

[Confidential:

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In the figures above, EnergyAustralia's figure uses the 5.7% EBTIDA retail margin used by the ESC in the VDO, for a consistent comparison. However, this EBITDA is insufficient to cover EnergyAustralia's depreciation and amortisation (D&A) [Confidential:]. If this was fully included our costs would be even higher. We expand on this issue in our recent submission to the VDO FY 2023.[2]

This D&A issue results in a material under-recovery for EnergyAustralia and other Retailers which have high capital costs (and D&A). **We submit that the VDO Order should explicitly require that depreciation and amortisation be a matter that the ESC must have regard to under Clause 12(4).**

We also wish to make a point around transparency. The ESC is yet to publish a more recent comparison of the VDO against actual costs since November 2020, but it stated that the Draft FY 2023 VDO falls within the range of Retailers' total costs. Although we expect that the VDO will still be below the median cost of supply. **We ask that the VDO Order require the ESC to publish a comparison of the VDO against actual cost data (including actual retail margins and not just the VDO's 5.7% margin).**

[1] Clause 12(1) specifies that the ESC must have regard to its objectives under the Essential Services Commission Act (ESC) and the Electricity Industry Act. Section 8(1) of the ESC Act states that the objective of the ESC is to promote the long-term interests of Victorian consumers. Section 8A of the Act lists a number of matters the ESC must have regard to, 'to the extent that they are relevant in any particular case', which includes the financial viability of the industry.

[2] EnergyAustralia.PDF (esc.vic.gov.au)

Our last point relates to the politicisation of electricity price regulation. Energy prices are often key issues in elections. Stakeholders on both sides have strong views. We would have serious concerns if costs of supply increase e.g. network costs, and there is pressure to make changes to the VDO pricing methodology in other parts of the cost stack (e.g. retail costs), to offset those cost increases and keep the VDO low. We urge the Department to take a balanced, evidence-based approach to the VDO, which balances energy affordability and the industry's long-term financial viability (by ensuring recovery of realistic costs).

2. Role of the VDO in the clean energy transition, and role as Reference Price

In the broader context of the clean energy transition, a VDO that does not provide for realistic Retailer costs, will hinder the ability for Retailers to quickly adapt and innovate to changing environments. Due to climate change policy and competitive pressures, and separate to changes in generation mix, Retailers will increasingly need to ensure that electricity plans offered to customers support decarbonisation. These new de-carbonised retail products often apply across Standing Offer and Market Offer customers.[3] A price regulatory framework that impedes these changes, will lead to a transition that is ultimately more costly than necessary for consumers. The UK is a current example of how stringent price regulation, a lack of investment in a smooth transition, and resulting significant increases to regulatory tariffs causes unnecessary costs and pain for customers.

As the Reference Price, the VDO places downward pressure on Market Offer pricing. In the broader market, only a small proportion of Market Offers are above the VDO. [Confidential:

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Retailers are pressured to price Market Offers below the VDO so that customers will engage in the market, which in turn drives greater competition.

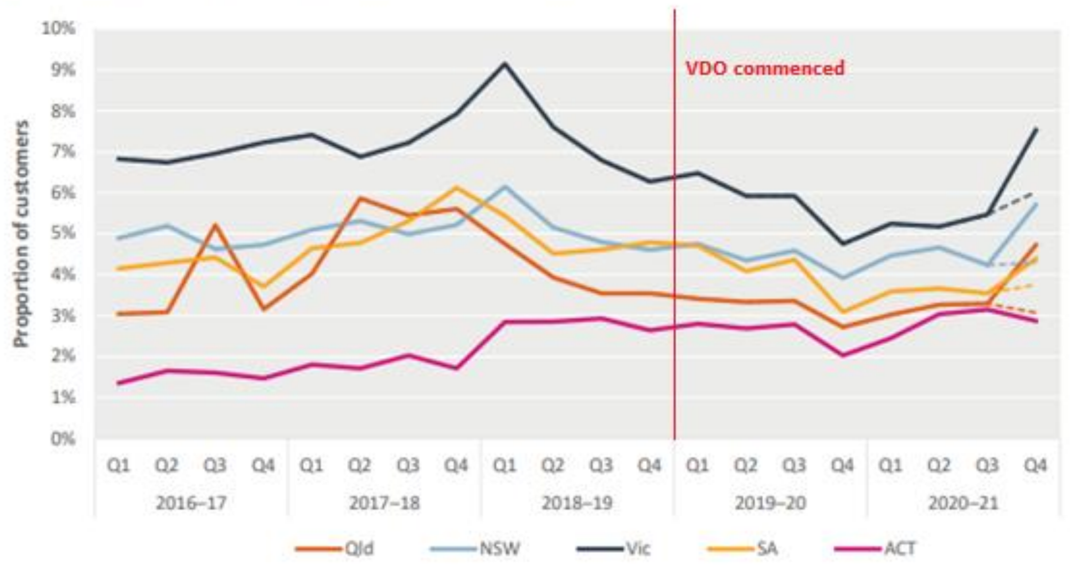
In addition, as the Reference Price, the VDO theoretically enables easier comparisons of Market Offers, which could provide the transparency that drives the intense price competition that exists today.

However, to be effective as the Reference Price, the VDO must be set at the right level. If the VDO is set too low and does not reflect realistic costs, then Market Offers will have lower percentage savings compared to the VDO, then they otherwise should. Lower percentage saving comparisons have the effect of dampening customer engagement and churn.

This is shown by comparing customer churn after the Default Market Offer (DMO) and VDO were introduced. While customer churn dropped in all relevant states, it dropped further in Victoria where the VDO is set lower than the DMO (and percentage savings are smaller). See below where the Victorian line is steeper:

[3] For example, EnergyAustralia's solar feed-in tariffs and carbon offset program are available to Standing Offer customers and we are providing or trialling other plans, products and pricing that facilitate the further decarbonisation of the electricity and gas usage for our customers (our scope 3 emissions).

Figure 1.19: Electricity switching rate between retailers



Source: Australian Energy Regulator[4]

Note: The peak in 2018 in NSW and Victoria was due to Government Energy Switch programs, including Victoria's $50 Power Saving Bonus (as reported by the AEMC)

The exception is in SA, where churn dropped in a similar way to Victoria. This is explained due to retail margins in South Australia being very thin, historically. This meant that when the DMO was introduced, and price dispersion decreased even further, customer engagement also dropped in response to low price dispersion. We discuss churn more below as it relates to Cost of Acquisition and Retention.

The Department should monitor the current DMO experience. For the first time, mainstream Market Offers will likely be priced above the final DMO in NSW and Qld, which will likely result in Customers disengaging and churn reducing significantly over time. This has happened because of proposed changes which will lower the DMO compared to the status quo, and because of recent very high wholesale costs that the DMO will not fully pass through.

3. Cost of Acquisition and Retention

The Department seeks feedback on clause 12(4)(d) of the VDO Order, which requires the ESC to have regard to "the modest costs of customer acquisition and retention" when considering efficient costs of supply.

The Department seeks views on how marketing and CARC costs have changed since the introduction of the VDO, and the recent Energy Fairness Plan bans.[5]

We discuss the issues relevant to CARC in detail below. In summary:

- Standing Offer customers benefit from CARC and CARC should continue to be fully reflected in the VDO.
- "Modest costs of customer acquisition" actually results in a CARC that is too low, compared to actual costs. The modest cost approach was justified because increasing CARC spend was

[4] Annual Retail Markets Report 2020-21.pdf (aer.gov.au)

[5] The Energy Fairness Plan banned door to door sales, outbound calls, and win backs and saves (Energy Fairness Plan bans)

not showing increases in customer churn. However, customer churn levels dropped after the VDO, and have not yet fully returned to historic levels. We therefore recommend keeping the same level of CARC and not reducing it.

- It is also too early to assess the impact of the Energy Fairness Plan bans on CARC as they only commenced on 1 January 2022.
- Even if there is a reduction, the current terms in the VDO Order - modest cost - are broad enough to allow the ESC to reduce CARC if actual costs reduce.

3.1 Standing Offer customers benefit from CARC and it should be fully reflected in the VDO

Some stakeholders maintain that CARC does not benefit Standing Offer customers and should not be funded by them via the VDO. This position is misconceived.

Firstly, Standing Offer customers directly benefit from CARC, where acquisition and retention activities result in Standing Offer customers switching to Market Offers. Looking at overall figures, the percentage of customers on Standing Offers has decreased year on year. From 12% in 2017, 7% in 2018 and 2020, and 6% in 2021.[6] This suggests that acquisition and retention activities still play a meaningful role in engaging Standing Offer customers.

Moreover, these overall figures downplay the full extent of the benefit, because the Standing Offer customer population is not fixed. A subset of Standing Offer customers is switching out and others are switching in to replace them. The overall figures do not reflect this subset. This subset is likely to be made up of those customers that have engaged in the market once before, but have defaulted to a Standing Offer because their Market Offer has lapsed or they have moved premises. As this subset of customers have engaged in the market before, acquisition (and retention) activities will likely stimulate their engagement again.

Secondly, acquisition and retention activities drive churn and the associated benefits. Customer churn is a well-accepted "indicator of competitive rivalry".[7] Victoria's retail electricity market has the highest churn, the greatest level of competition and the lowest market concentration (namely, five large Retailers instead of three). This translates into lower retail costs and retail margin, as the ACCC stated in 2021:

> "There has been a multi-year trend of gradual reductions in retail costs and margins… The number of active retail brands has increased, and there are signs of decreasing market concentration with smaller retailers growing their customer bases. This allows increasing economies of scale for these retailers and puts downward pressure on both retail costs and margins."[8]

Further and importantly, these lower retail operating costs are fed back to benchmark the retail operating costs used in the VDO, which is another tangible benefit for Standing Offer customers.

In view of the benefits that CARC spend provides to Standing Offer customers, it is appropriate for CARC to be fully reflected in the VDO.

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[6] State of the Energy Market | Australian Energy Regulator (aer.gov.au) Each State of the Energy Market Report reports on the percentage of customers on Market Contracts vs Standing Contracts.

[7] 2020 Retail energy competition review - Final report (aemc.gov.au)

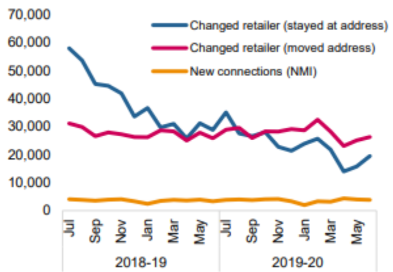
[8] Inquiry into the National Electricity Market - November 2021 report - Copy.pdf (accc.gov.au) , p 7. The ACCC also noted the role of the VDO and DMO in reducing retail margin (but retail margins still continue to fall outside of that), and also that door knocking would have been suspended during lockdown (lowering cost).

3.2 Customer churn dropped after July 2019 and continues to be in a state of flux

Customer churn clearly dropped from peak levels in mid-2018 to a 21-month period of low customer churn (around 20%). This period started when the VDO and other reforms were introduced.

Multiple regulatory reports noted this drop. The Australian Energy Market Commission (AEMC) reported that there had been a five per cent decrease in switching in 2019 across the NEM.[9] The following figures and graphs also show the market change.

Figure 19 - Completed transfers in 2019–20, by customers switching between retailers



Data source: *AEMO retail transfer statistical data*

Figure 17 - Customer transfers by financial year

Financial year	Total customer transfers	Change (%)
2017–18	824,256	-
2018–19	834,703	+1%
2019–20	659,653	-21%

Data source: *AEMO retail transfer statistical data*

Source: Essential Services Commission of Victoria [10]

We recognise multiple factors would have impacted churn in opposite ways, but whatever the reasons churn reduced overall. These factors are:

- The introduction of the VDO and Reference pricing might have dampened churn.
- The pandemic might have also slowed churn, however customer churn already started dropping in Q4 2019 before the full extent of the pandemic was known.
- Three other reforms would have actually stimulated churn:
    - Reform which made it faster for customers to switch Retailer and limited 'save' activity.
    - Best offer on bill messaging.
    - Advance customer warning of changes to prices and benefits.

The Department should check CARC spend for the two years after the VDO was introduced (in cost data submitted to the ESC). We expect that Retailers either maintained consistent spending or may have increased spending in response to the reforms.

[Confidential:

[9] 2020 Retail energy competition review - Final report (aemc.gov.au) , p 83
[10] RPT - Victorian Energy Market Report 2019-20-FINAL_1.pdf

The above discussion highlights that regulatory reform, customer churn and potentially acquisition and retention activities (which all have cross impacts), continue to be in a state of flux. In this uncertain context, it would be difficult for the Department to make decisions about changing the level of CARC.

3.3 "Modest costs of customer acquisition" results in a CARC that is too low, it should actually be increased

The terms "modest costs of customer acquisition" already sets a level of CARC in the VDO which is too low. The ESC has interpreted "modest" as well below realistic CARC costs in Victoria. i.e. The first VDO's CARC of $38 was significantly below the ACCC's estimate of actual costs of $61.[11]

[Confidential:
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Retailers cannot avoid this under-recovery by simply reducing acquisition and retention activities, because strong customer churn rates in Victoria will mean losses in customer numbers if activities are reduced. This would have flow on negative effects i.e. smaller customer base over which to spread costs. Frontier acknowledged this relationship:

> "The relationship between CARC and switching rates is complex: more customer acquisition activity (and, therefore, cost) is likely to result in higher switching rates, *but higher switching rates are also likely to require retailers to engage in more acquisition and retention activity in order to maintain (or grow) their customer base".*[12]

The ESC's interpretation of modest CARC is contained in 2019 decisions on the first VDO. The ESC chose to use the NEM-wide average for 2013-14 CARC from the ACCC inquiry final report. The decision to adopt old 2013-14 data was because it pre-dated and therefore limited the impact of the 'arms race' observed in later years; where Retailers spent increasing amounts on CARC with no corresponding increase in customer churn, in pursuit of a zero-sum game.[13] i.e. customer churn remained consistent at 25%.

However, as above, customer churn has been in a state of flux. Since July 2019 when churn dropped, acquisition and retention activities likely helped to restore churn closer to historic levels. That is, recently it has not been a zero-sum game.

[Confidential:

[11] excluding inflation.
[12] RPT - Frontier Economics - Final Report - Operating costs and margin 20190419 (2) (5).PDF p 5
[13] Victorian Default Offer to apply from 1 July 2019_0 (12).pdf , p 75

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In view of customer churn improving but still being below the historic level of 25%, and until it stabilises, we recommend keeping the same level of CARC and not reducing it, regardless of any effect of the energy fairness plan bans).

3.4 It is too early to assess the impact of the Energy Fairness Plan bans on CARC spend

We strongly advise against DELWP adjusting the level of CARC in the VDO Order without clear evidence that Retailer CARC costs have reduced. As the bans commenced 1 January 2022, the ESC will only be able to assess the impact in 2023 when it has 18 months of data.

Even if CARC were to reduce, the terms "modest costs of customer acquisition" are broad enough to allow the ESC to retain its approach and lower CARC. i.e. they do not need to change. The ESC often assesses step changes in costs in response to changes in regulation, under its ordinary VDO determination process e.g. cost increases for five-minute settlement etc. It would be inconsistent, if the Department were to change the VDO Order to essentially direct the ESC to take a certain position on CARC.

We doubt that CARC spend will reduce following the Energy Fairness Plan bans, because:

a) The bans only apply to residential customers. The ban does not affect small business customers who have higher CARC [Confidential:]. CARC under the VDO should not change for small business customers.

b) The bans only apply to a narrow set of CARC activities.

   - The ban on win back and saves, only bans activity within the prohibited period of 6 months after the customer transfer. Customer retention activity outside this period still continues.

   - EnergyAustralia has not engaged in door-to-door sales for 9 years now and so this ban has no effect on EnergyAustralia's customer acquisition costs. Tier 1 and many other Retailers are in the same position.

- Outside of the banned activities, Retailers have a very broad range of CARC activities that are captured under CARC. [Confidential:

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c) Where the ban does discontinue some activities, Retailers will likely invest [ ] in other acquisition channels to offset any reduction in sales volumes/increases in churn. The AER noted that this has happened historically, when Tier 1 Retailers moved away from door-to-door selling to expand their digital acquisition channels e.g. via price comparison websites.[14]

4. VDO Order should be changed to clarify that it does not apply to Unmetered supply sites

The VDO Order technically applies to unmetered supply (UMS) sites, when this might not be intended. This issue is broader than the VDO Order and relevant to other retail regulations which also apply to UMS customers unintentionally. We raise this issue in this review because DELWP should consider changing the definition in the relevant Order to fix the issue for the VDO Order and other retail regulation.

Specifically, section 5 of the VDO Order defines Prescribed Customer as a domestic or small business customer. For the main clauses in the Order which specify what the VDO applies to[15], the definition

[14] State of the energy market 2021 (aer.gov.au) , p 255
[15] VDO Order, clauses 6 and 7

of domestic and small business customers links back to another Order made in 2008 (the 2008 Order). The 2008 Order defines a person as a 'relevant customer' for a given supply point if either:

- the person purchases electricity principally for personal, household or domestic use at the supply point; or
- the person's aggregate consumption of electricity taken from the supply point has not been, or, in the case of a new supply point, is not likely to be, more than 40 megawatt hours in any year[16]

This definition defines the customers which retail regulations in Victoria apply to. This includes the VDO Order, the *Electricity Industry Act,* the *Energy Retail Code of Practice,* among other regulation.

UMS sites fall into the second dot point above. They are not domestic customers, but they consume 40 MWh or less a year.

UMS sites are unmetered sites typically owned by large businesses like NBN Co., Telstra, or government (local councils, VicRoads). It therefore makes little sense for consumer protections designed for residences and small businesses (small customers) to apply to UMS sites.

Additionally, the VDO Reference Price is irrelevant to UMS sites. UMS sites are not contestable I.e. customers cannot choose an alternative offer from another Retailer, nor are UMS offers marketed. Therefore the Reference Price which seeks to facilitate comparisons with other offers provides no value for UMS sites.

We also believe the intent of the 2008 Order was to exclude UMS customers. This is evidenced by clause 5A of the 2008 order, which explicitly excludes VicRoads and municipal councils from the definition of 'relevant customer' for certain public lighting sites (one type of UMS site). However, all other UMS sites are still captured in the definition.

We ask DELWP to change the 2008 Order's definition of domestic or small business customer to exclude all UMS sites. As a second alternative, DELWP could change the VDO order's definition of Prescribed Customer to resolve the issue as a temporary fix, ahead of changing the 2008 Order.

[16] S315-08.indd (reglii.com)