3 April 2018

Energy Market Review
Victorian Department of Environment, Land, Water and Planning
By email: EnergyMarket.Review@delwp.vic.gov.au

Consultation Paper: Response to the Bipartisan Independent Review of the Electricity and Gas Retail Markets in Victoria

Sumo is a small, fast-growing utility provider, with over 40,000 residential and small business electricity and gas customers in Victoria. Sumo welcomes the opportunity to respond to the Victorian Government’s Interim Response to the Independent Review of the Electricity and Gas Retail Markets in Victoria (Independent Review).

Summary of recommendations

<table>
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<th>Recommendations</th>
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<td>1</td>
<td>That the Victorian Government undertake a thorough and transparent consultation on each recommendation from the Independent Review and conduct a full cost-benefit analysis before any decisions are made, and wait for, and take account of, the findings of the ACCC’s electricity supply and prices inquiry.</td>
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<td>2</td>
<td>That, given the very material concerns with regulation of retail pricing, the Government decide not to introduce a Basic Service Offer (BSO), or other form of price regulation, and instead focus on implementing its other measures (based on Recommendations 3 – 11) and monitoring their effectiveness over time.</td>
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| 3  | The BSO is a radical idea that would impose unacceptable risks on retailers, and would ultimately lead to:  
   - a freeze on investment, including in new reliable and low-emissions generation, and in behind-the-meter innovations (such as demand response, rooftop solar and batteries); and  
   - the withdrawal of retailers from the market, leading to further consolidation of power in the ‘Big 3’ retailers, a lessening in competition in the energy retail market, and so less innovation and higher energy prices for consumers in the longer term.  
   Rather, it is recommended that the focus of Government policy should be to:  
   - enhance competition and innovation in energy markets; and  
   - address the underlying causes of rising prices – being recent movements in wholesale prices, and the wasted costs of inefficient marketing (retention and win-back) activity. |
| 4  | That, instead of a BSO, the Government ban retailer retention and win-back activity. This would lead to: |
- a significant reduction in inefficient marketing and other costs, resulting in lower prices for consumers;
- an incentive on retailers to offer all of their customers better price and service, and so reduce the ‘loyalty tax’ (the level of cross-funding from loyal customers to churning customers); and
- an increase in customer satisfaction and engagement with the switching process.

5 If implementing Recommendation 4A, that:

- it should be interpreted broadly, to mean that a price offered to customers generally may only change every 12 months, on the same date for all customers on that offer, and should not be interpreted to mean that each offer to an individual customer fixes the prices for 12 months from the date of the offer. The latter interpretation would be impractical and would impose significant cost; and
- it does not apply to all of a retailer’s offers. Rather, it could require retailers to have at least one offer for which the price can only be changed annually. This ensures flexibility and choice for consumers, allowing them to benefit either from price certainty or lower prices in the short term.

Consultation process

Sumo is concerned that a lack of adequate consultation on these reforms will lead to poor outcomes.

There was very little consultation on the Independent Review. The initial discussion paper by the Independent Review Panel did not foreshadow the extent of the recommendations ultimately made, and a draft report was not circulated for consultation. The findings were not based on actual cost and price data provided by retailers.

The Independent Review Panel’s final report was released in August 2017 and made some very significant recommendations. The Victorian Department of Environment, Land, Water & Planning (DELWP) released its interim response in March 2018 – some seven months later – and has given stakeholders just over two weeks to respond. While Sumo (and other retailers) have sought out meetings with Government stakeholders in the time since August 2017, these discussions have focussed primarily on Recommendations 1 & 2. Given the significance of all of the recommendations coming out of the Independent Review, Sumo considers it appropriate that DELWP consult fully on whether each of the recommendations is appropriate before making a decision whether to support them, and that more time is required to explore these issues properly.

Going forward, we consider that a proper process would allow all stakeholders an opportunity to provide their feedback on all recommendations and would include a full cost-benefit analysis before any decisions are made. The Government would preferably wait for and take account of the findings of the ACCC’s electricity supply and prices inquiry, to be released in July 2018.

Objectives

At the Energy Retailers Stakeholder Forum hosted by DELWP on Friday, 16 March 2018, DELWP articulated its position as being that, although it has deferred its decision on
Recommendations 1 & 2, it considers that Recommendations 3 – 11 are inadequate to address the perceived failure of the Victorian energy retail market, and that additional reform is required to meet the following objectives:

- To provide a clear price signal to the market about the reasonable price of energy
- To provide a ‘no fuss’ energy option
- To exert some immediate downward pressure on retail prices for some or all retail products.

Sumo is concerned that this position, and these objectives, will lead DELWP to a particular solution which is the BSO (or something very similar) rather than an outcome that is in the best interests of consumers. An effective market creates a clear price signal and puts downward pressure on retail prices. Many of recommendations 3 – 11 should go a long way to enhancing these competitive outcomes. It is unclear what is meant by a ‘no fuss’ energy option.

Given the very material concerns with regulation of retail pricing, our view is the Government should decide not to introduce a Basic Service Offer, or other form of price regulation, and should instead implement its other measures (based on Recommendations 3 – 11) and monitor their effectiveness.

**Basic Service Offer**

The ‘Basic Service Offer’ – or any form of retail price regulation – is a radical proposal that would introduce significant risk for the energy market and for consumers.

Retailers manage many significant, volatile costs and risks. Retailers (particularly small ones) are price takers in wholesale energy markets and must pass through network costs (which, together, make up more than 70% of the retail cost stack). The National Electricity Market is one of the most volatile commodity markets in the world. Other costs arise from environmental obligations, marketing, customer service and bad debts, and these costs can change materially following changes in market conditions and the ever-changing regulatory environment. Inability to flex pricing to reflect these changes in costs would impose unacceptable risk on retailers.

In a price-regulated environment, the regulator effectively controls how much revenue the regulated businesses can earn, but does not control the corresponding costs. Even the best attempt to set a fair regulated price will inevitably be inaccurate at the time it is set, and cannot account for subsequent changes in costs during the price path period. A regulated price that does not adequately account for all costs will invariably make the retailer unprofitable.

The risk of price regulation will put a freeze on investment. Small new entrant retailers, many of which rely on ongoing investment to sustain their growth until they achieve sufficient scale, won’t be able to secure that investment. This will threaten the viability of many such retailers and will present an insurmountable barrier to entry for prospective new standalone retailers.

Currently, much of the investment in the energy sector is driven by retailers. In a regulated environment, retailers won’t be prepared to invest. Ongoing investment is required to ensure the development of new reliable and low-emissions generation, and to progress opportunities for behind-the-meter innovations (such as demand response, rooftop solar and
batteries). In short, a threat to ongoing investment could in turn threaten reliability, leading to higher energy prices and black-outs, and also threaten the achievement of emissions targets.

The broader impact is likely to be that, as the smaller and most innovative retailers are forced to exit the market, the market will consolidate towards a few larger players. The remaining incumbent retailers will have no incentive to lower cost and drive innovation in a regulated environment. This lessening of competition will consequently lead to higher prices and less innovation and so will not be in the long-term interests of consumers. This damage will be permanent – once investors exit, they won’t risk their capital again.

See attached Confidential Appendix for information about impacts on Sumo.

Any consideration of a Basic Service Offer would need to look carefully at unintended consequences, such as the potential to adversely affect some customer segments such as hardship customers (who may already be on the most favourable pricing, and who may not get such a good deal under a Basic Service Offer). Also, any consideration of what a ‘no frills’ offer might entail must recognise that the existing standing offer is a ‘full service’ offer, providing for price certainty (standing offer prices can only be varied every 6 months), expensive over-the-counter payment channels, expensive communications methods (post), favourable payment terms and limitations on collections activity.

What will work

The Australian Energy Markets Commission (AEMC) reviews the effectiveness of competition in the Victorian energy retail market each year and has consistently found that the Victorian energy retail market is highly competitive. Retailers in Victoria compete fiercely, predominantly on price. This competition has been effective in putting downward pressure on retail margins. The ACCC identified in its preliminary report that Victorian retail margins have remained stable at around 8%.

However, some costs are beyond a retailer’s control. As was confirmed by the ACCC, the biggest contributor to rising energy prices recently has been increases in wholesale costs (and before that, rising network prices). The retail margin remains a small component of a customer’s bill.

In light of these findings, we recommend that the focus of Government policy therefore should be to:

- enhance competition and innovation in energy markets; and
- address the underlying causes of rising prices (where those causes cannot be effectively managed by competition alone).

As noted above, the most significant cause of rising prices has been rising wholesale costs. Governments should focus on policies that seek to reduce wholesale costs and volatility, including by enhancing wholesale liquidity and competition. Another significant cost is the wasted costs of inefficient marketing (retention and win-back) activity, discussed below.

Aggressive retention and win-back activity

Both the ACCC in its preliminary report and the Independent Review Panel observed that retail customer acquisition costs have increased and so the benefits of price regulation are not being passed on to consumers in full. In Sumo’s view, marketing and other costs could be reduced materially. The Independent Review also found that Tier 1 retailers have
significant market advantages over their competitors, and yet charge customers at the top of the price range – particularly those customers who have remained with them the longest.

In Sumo’s experience, large retailers are using their dominant market position to make unsustainable offers to retain customers. The benefits for retained customers are usually short-lived, and are cross-funded by a ‘loyalty tax’ from a disengaged customer base.

The opportunity to engage in retention / win-back activity is unique to the energy retail industry. Retailers receive advanced warning that a customer will churn, creating an opportunity to call the customer before they have even transferred away. Historically, this notification was given to retailers only to give them an opportunity to object to the transfer on the basis that the customer still has a debt with that retailer. In practice, the notification is used by retailers to contact the customer in an attempt to retain that customer. Larger retailers can offer unbeatable retention offers – offers which are not published nor available to all customers – because they can cross-fund them against their larger, dormant customer base (the so-called ‘loyalty tax’). These unsustainable predatory offers could force new-entrant retailers out of the market.

The success of this aggressive retention and win-back activity leads to high levels of cancelations and churn soon after sale (see diagram below). The retailer who has acquired the customer – only to have them cancel or churn back – has incurred marketing, operational and other costs, and has not had the opportunity to recover those costs from the customer. These inefficiencies are resulting in a very significant cost being incurred that must necessarily be passed on to all consumers. The costs are disproportionately high for smaller retailers, meaning that the retention and win-back practices represent a barrier to expansion for new entrant retailers. Sumo is seeking to have these costs independently quantified, and will provide the results of this work once complete.

![Relative rates of churn based on months from customer transfer](image)

Further, the success of retention and win-back efforts means there is, in fact, a disincentive on those incumbent retailers to maintain good pricing and service to their existing, loyal customers, which means they, too, are paying too much (further contributing to the loyalty tax).

Sumo is also concerned that the battle between new and old retailer often causes confusion and customer discontent. Throughout the transfer process, the customer may be called multiple times by one or both retailers. They may change their mind. They may switch from one retailer to another, and then be switched back, receiving ‘welcome pack’ material and
transfer letters on each occasion, and possibly bills from each retailer for different periods. Customers can be confused about which offer is better for them, and therefore give up and take the easiest option of remaining with their current supplier. Additionally, it can be unclear — for both the customer and the retailers — as to which retailer has the customer’s final consent to supply. This activity is time-consuming and expensive, involving multiple phone calls, market transactions and, when customers ultimately complain, managing those complaints.

Sumo considers that one of the most effective measures to reduce retailer marketing and other costs, to improve the effectiveness of competition and to discourage the ‘loyalty tax’ imposed by some retailers, is to prohibit retention and win-back activity (see figures below that explain the distinction between retention and win-back). This ban would not prevent the customer from cancelling their contract during the cooling off period, nor would it stop the customer from shopping around or even going back to their previous retailer. In short, it would not limit a customer’s access to the competitive market. It would simply restrict a retailer from contacting a customer who is about to switch away, or has recently switched away, and in so doing, convince the customer to stay or switch back.

In our view, a ban on retention and win-back activity would:

- decrease prices in the market by reducing the amount of inefficient churn and therefore lowering marketing and other costs, particularly for new entrant retailers;
- encourage retailers to provide compelling service and price to all their customers, and so reduce the level of cross-funding from loyal customers to churning customers; and
- increase customer satisfaction and engagement with the switching process.

![Figure 1: Customer retention – the transfer is withdrawn before completion](image1)

![Figure 2: Customer win-back – the customer is transferred back after completion](image2)
Contract periods, practices and variations

As stated above, we recommend that the Government engage in a thorough consultation on all of the Independent Review’s recommendations before making any decisions. However, noting the Government’s position that it has already accepted Recommendation 4, we make the following observations and comments.

Recommendation 4A proposes that retailers be required to fix any prices they are offering for a minimum of 12 months. The consumer benefit from Recommendation 4A is price certainty. Of course, fixing a price for 12 months creates a risk for the retailer, being the risk that it faces unexpected cost changes during that period (a cost increase would lead to a margin squeeze, or negative margin, for the retailer). As a result, it would be expected that fixed prices would be higher for consumers than might otherwise be the case if the price is variable. A shorter fixed period (say, 6 months) would result in a smaller risk premium.

Recommendation 4A is open to interpretation. On one reading, it could mean that a retailer must offer each individual customer a fixed price for 12 months from the date of the offer. This would be unworkable and very expensive to implement, requiring retailers to manage new pricing on a rolling monthly, weekly or daily basis (resulting in potentially thousands of different price offers). By fixing a price on such a rolling basis, the retailer would also need to build in a significant price premium to reflect the risk of cost increases. These additional risks and expenses would need to be passed on to the consumers and would not, in our view, be in their best interests. It is imperative that Recommendation 4A is not read in this way. Instead, it could be taken to mean that a price offered to customers generally may only change every 12 months, on the same date for all customers on that offer.

If implementing Recommendation 4A, our view is it should not apply to all of a retailer’s offers. Rather, retailers could be required to have at least one offer for which the price is fixed for 12 months. This ensures flexibility and choice for consumers, allowing them to benefit either from price certainty or lower prices in the short term.

It is noted that Recommendation 4B, which requires retailers to clearly disclose to customers the length of time any offered prices will be available without change, also achieves the outcome of providing price certainty to the consumer. There is some overlap in these recommendations.

If you would like to discuss any aspect of this submission, please contact me or Alex Fleming, GM – Legal & Regulatory.

Yours faithfully

[Signature]

Paul Cullinan
Managing Director & CEO