

The background of the entire page is a repeating pattern of light blue diamonds. Overlaid on this is a light blue silhouette of the state of Victoria, Australia. Within the silhouette, there are darker blue shapes representing the state's major mountain ranges and a small silhouette of a horse and rider on the eastern coast.

INDEPENDENT REVIEW INTO THE  
**ELECTRICITY & GAS  
RETAIL MARKETS IN  
VICTORIA**

AUGUST 2017

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# INDEPENDENT REVIEW PANEL

## We are pleased to present our report into the review of retail electricity and gas markets in Victoria.

This report sets out our key findings into how Victoria's deregulated retail market is operating.

We have made 11 recommendations, in accordance with the review's terms of reference, that we believe will improve outcomes for Victorian energy consumers.

Underpinning our recommendations is the principle that energy is an essential service. As an essential service, consumers must purchase energy and must participate in the retail market even if they are not interested in the product and regardless of continued price rises. Energy must be accessible, affordable, and reliable for all.

We thank all those who contributed to the review. Your input has enabled us to reach what we believe is a reasonable set of recommendations that will deliver Victorians a better deal from the competitive energy market.



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John Thwaites was Deputy Premier of Victoria from 1999–2007, and a member of the Victorian Parliament from 1992–2007. During this time, he held several Ministries, including Environment,

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John is also the Chair of Melbourne Water, Chair of the Australian Building Codes Board, and Co-Chair of the Leadership Council of the UN Sustainable Development Solutions Network ('SDSN'), launched by the UN Secretary-General to provide expert advice and support to the development and implementation of the Sustainable Development Goals (SDGs).



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Terry oversaw the Fels Inquiry into the Victorian Taxi Industry, the creation of Public Transport Victoria, the Regional Rail Project and the introduction of Protective Service Officers (PSOs) at metropolitan and regional railway stations.

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# EXECUTIVE SUMMARY

**Energy is an essential service that underpins our health, wellbeing, and social and economic participation. As an essential service, residential and small business consumers must purchase energy and are therefore participants in the retail energy market even if they are not interested in the product and regardless of continued price rises.**

When competition was introduced into Victoria's retail energy market in 2002, it was anticipated to generate consumer benefits through lower costs of supply and innovative product development. It was expected that low barriers to entry would attract new competitors and reduce the commercial advantage of the incumbent retailers market participants. Competition would be the most effective means for 'regulating' the retail energy market and delivering the best outcomes for energy consumers.

During the early years of competition, the Victorian Government played a role in price regulation by requiring retailers to have a Standing Offer with an agreed price path each year. This agreed price path then determined actual prices, which were published in the Government Gazette. From 1 January 2009, all retail price regulation was removed. Retailers were free to set the prices of both their standing offers and market offers.

Since then, the residential market has expanded to include 25 energy retailers selling electricity and 13 retailers selling gas to residential and small business customers in Victoria servicing 2.4 million households and 274,000 small businesses.<sup>1</sup> Retailers increasingly used discounts to promote their offers, starting at around a low 5 per cent and rising to over 40 per cent for some retailers in the current market. Customers transferred off standing offers and switching rates increased, which gave the appearance that the market was functioning well.

However, since 2000, prior to competition, electricity and gas prices for Victorian households have increased almost 200 per cent.

Traditional reviews into retail energy prices have focused on using either standing offers, current market offers, or a combination of the two in reaching conclusions, and not what consumers are actually paying. This gap in real data was made clear to the review panel by consumer advocacy groups at the start of the review. The review panel was unable to compel retailers to provide details of their operating costs or margins. To address this gap, the review panel commissioned new research to collect and analyse data on what Victorian energy consumers are paying, sourced from their actual energy bills. This provided critical research on actual prices being paid and benefits that could be achieved by switching.

The research results found that Victorian households are paying much higher prices than official estimates; on average around 21 per cent per year more for their electricity than the cheapest offer available in the market. Nearly one quarter of the customers whose bills were analysed for the review were paying at least \$500 more than the cheapest available offer. While wholesale electricity and gas costs have moved up and down since 2000, network prices have increased moderately and environmental costs have contributed marginally, there is no constant trend that can explain the significant increase in retail prices.

The review found that the retail charge – the component of the total bill that covers the retailer's costs and profits from selling energy – is a major contributor to energy prices in Victoria. The research found that the average retail charge for a typical customer using around 4,000 kWh per year is now \$423 before GST (or more than 10 cents



per kWh), around 30 per cent of the household bill. For most households in the research sample, the retail charge was the biggest single component of their electricity bill – bigger than the charge for producing or distributing electricity. Rises in the fixed charges as a component of the bill also contributed to the increases, locking in costs for consumers despite declining consumption.

Comparison of the Victorian market with other national markets and international markets further emphasised that the prices Victorian consumers are paying for electricity are unusually high. This was not the outcome that Victorian consumers anticipated from the competitive market and the review has concluded there is evidence of market failure that has led to this result.

The review found three main factors for the market failure:

### **1. The cost of competition**

Competition has added additional costs to the market that have not been offset with cost reductions or other benefits and these costs need to be recovered from consumers. As competition developed, retailers spent more money to compete with each other. Marketing, brokerage services, door to-door sales and other sales channels needed to acquire or retain customers were added to the retail charge.

Combined with the fact that consumers are not able to exit the market, retailers continue to increase their customer acquisition and retention costs, and pass those costs to consumers. These additional costs of competition do not benefit consumers or improve the reliability or accessibility of the product they are purchasing. Nor has innovation offset the additional costs incurred by consumers. For most consumers, energy is a homogenous product. Its purpose is to power household and business items and it is delivered in much the same way by the various retailers.

### **2. The structure of the market**

The Victorian electricity retail market has three large Tier 1 retailers, four medium Tier 2 retailers and 18 small retailers. The three Tier 1 retailers are vertically integrated ‘gentailers’ that generate electricity as well as retail it. They have significant market advantages over their competitors, including large pre-existing customer bases, established systems, and the ability to obtain lower cost wholesale energy and renewable energy certificates. The large retailers also have lower

customer acquisition and retention costs as they have customers to lose rather than customers to gain. The cost difference between large and small retailers appears substantial. Our research has shown however, despite lower expected costs, the Tier 1 retailers are charging customers towards the top of the price range. The Tier 1 retailers do not appear to have been put under competitive pressure by the smaller retailers to lower their prices. If the competitive market was working we would not expect to see the low-cost supplier at the top of the price range and the high-cost supplier at the lower end.

### **3. The practices of industry**

When consumers enter the market place to purchase their energy they are faced with a multitude of retailers, and hundreds of offers all with varying discounts, benefits, fixed and variable charges. Even knowledgeable consumers find it hard to navigate. Retailers have thus adopted discounting practices to make energy marketing seem simple. However, it is rarely clear what the discount is anchored to and what the actual price is that the consumer will pay. Discounts hide the ever increasing base rates from which they are provided, leaving inactive consumers with increasing bills to pay. High discount offers are not necessarily cheaper than low discount or no discount offers. Consumers seem unaware that a discount rate does not mean ‘the best price’. What is being presented as ‘a simple decision for consumers to make’ by retailers is in fact, a complex decision.

Consumers seeking the cheapest price need to calculate a total cost, which depends on different fixed and variable charges and how much energy they use. In addition, retailers have been increasing the level of fixed charges in retail contracts, meaning that customers have less ability to reduce their bills by managing their energy use. In many cases, discounts do not apply to the fixed charge. The increase in the level of retail fixed charges, which are now typically around a third of a customer’s bill, cannot be explained by fixed network or metering charges.

The best offers in the market are only achieved by active consumers who switch regularly and remain engaged. Even for them, there are challenges in finding the best offer. The benefits drop sharply if consumers can only find the second, third or fourth-best offer. Additionally, offers on comparator websites do not always display the least expensive offer. This means that even active consumers who

do their research on energy purchasing options may never secure the best price.

Submissions to the review highlighted that opaque and varying processes at the end of benefits periods and contracts mean that consumers either lose their 'benefits', or are transferred to seemingly good offers that on closer examination leave them worse off than what is available in the market place. Behavioural barriers to consumer engagement, such as status quo bias, mean many consumers become 'sticky' and stay with the same retailer, even when prices rise and lower-priced offers are available, including with their existing retailer. The outcome is that Victorian consumers are paying higher prices for their energy than they should.

All these elements point to the fact that the market is failing consumers.

### **A market that benefits consumers**

The benefits promised when competition was implemented have not been realised and consumers are paying more for the same service. As an essential service, it is imperative that all consumers, including low income and vulnerable customers have access to affordable energy.

The review panel has reached the conclusion that strong intervention is required to ensure better outcomes for consumers. A clearer price signal is required in the market to support consumers in making choices, marketing needs to be in real prices so that consumers can understand the actual costs of what they are signing up to, and transparent reporting on the energy market is required to identify if consumers are getting the benefits of competition.

The review panel has developed a set of recommendations to reform the market and address the failure. The panel examined regulatory structures and practices in overseas markets and industries to assist in formulating the recommendations in this report.

Key to the reforms is the implementation of a Basic Service Offer. This would require each retailer to provide a 'no frills' offer that does not exceed a regulated price. Consumers only interested in a basic 'no frills' service would have the option to select the Basic Service Offer and remain protected from the existing failures of the market. Retailers would be free to continue to offer additional offers at different prices which, may be lower than the 'no frills' option, or higher, to give consumers the choice to pay for any additional value offered by retailers. However, this Basic Service Offer would be available to all consumers and would represent a reasonable price of energy in the market. It would provide an option for consumers who just want affordable energy without the fuss.

The recommendations would place Victoria's retail energy market back on a level playing field for the benefit of consumers.

# RECOMMENDATIONS

## Recommendation 1 – Basic Service Offer

- 1A** Require all retailers to provide a Basic Service Offer that is not greater than a regulated price, based on annual usage, to be determined by the ESC.
- i.** In implementing the regulated price, the review panel recommends:
- The regulated price to be based on the efficient cost to run a retail business
  - The regulated price includes an allowance for a maximum retail profit margin
  - The regulated price must not include customer acquisition and retention costs or headroom.
- ii.** In implementing the Basic Service Offer, the review panel recommends:
- The retailer to determine the tariff type used in the Basic Service Offer, provided it stays below the regulated price for all usage levels
  - The Basic Service Offer is unconditional
  - The Basic Service Offer includes an obligation to supply
  - Retailers may make any other offers available to consumers, including offers priced above their Basic Service Offer
  - The Basic Service Offer to be made available to customers within embedded networks and where there is a single gas retailer.

## Recommendation 2 – Abolish standing offers

- 2A** Abolish the requirement for retailers to offer standing offer contracts.

## Recommendation 3 – Marketing information on prices to be easily comparable

- 3A** Require retailers to market their offers in dollar terms, rather than as percentages or unanchored discounts.
- 
- 3B** Where the retailer knows the actual usage profile for a specific customer, the marketing to that customer to be based on the estimated annual costs of the offer for that customer, and the \$ costs if conditions attached are not met.
- 
- 3C** The ESC to develop a small number of typical customer usage profiles (3–4) for use in standardised marketing material (for 2,000 kWh, 4,000 kWh, 6,000 kWh per year).
- 
- 3D** Marketing of prices to appear in a standardised format and display the actual annual cost for the 3–4 standardised customer usage profiles. Annual energy costs for the standardised customer usage profiles to be the comparison rates in marketing materials.
-

### Recommendation 3 – Marketing information on prices to be easily comparable (continued)

- 3E** The ESC to develop a standardised format for retailer information disclosure and marketing material.
- 
- 3F** Require retailers to notify a customer of the best offer available by that retailer, and reference the Victorian Energy Compare website, in advance of any price or benefits change.
- 
- 3G** Require retailers to include the following information on customer bills:
- How the customer can access the Victorian Energy Compare website
  - How the customer can access the Basic Services Offer (see Recommendation 1)
  - The retailer’s best offer for that customer based on their usage patterns
  - The total annual bill for that customer based on the customer’s current offer and usage patterns.
- 
- 3H** Require marketing material and bills to provide GST-inclusive pricing.
- 
- 3I** The Victorian Government’s customer engagement program to continue to focus on improving consumer awareness of the competitive market.
- 
- 3J** The Victorian Government’s program to continue to enhance and promote the Victorian Energy Compare website and use of smart meter data.

### Recommendation 4 – Contract periods, practices and variations to be clear and fair

- 4A** Require retailers to commit to fix any prices they are offering for a minimum of 12 months. During this period, the market contract prices cannot change. Retailers may request an exemption from the ESC to address unforeseen changes in network costs.
- 
- 4B** Require retailers to clearly disclose to customers the length of time any offered prices will be available without change.
- 
- 4C** Require retailers to roll customers onto the nearest matching, generally available offer at the end of a contract or benefit period, unless the customer opts for another offer.
- 
- 4D** Any conditional discount or other benefit offered for paying on-time or on-line billing should be evergreen. Customers should not lose the discount or other benefit when the contract ends.
- 
- 4E** Costs incurred by customers for failing to meet offer conditions are to be capped and not be higher than the reasonable cost to the retailer.

### Recommendation 5 – Promoting access to smart meter data to assist customers to manage bills and increase energy efficiency

- 5A** The Victorian Government should eliminate barriers to the use of smart meter data to encourage innovation from retailers, and energy efficiency and enable consumers to compare offers.

## Recommendation 6 – Protecting low income and vulnerable customers

**6A** The Victorian Government to provide assistance to vulnerable and disadvantaged consumers to help raise their awareness and understanding of the energy market and with managing their bills.

**6B** The Victorian Government to support programs that help low income and vulnerable households reduce their energy consumption.

**6C** The Victorian Government conduct an extensive investigation into the energy support scheme for concession card holders and adjust accordingly so consumers gain the best possible outcome from the competitive market.

**6D** The Victorian Government review the administration of the Utility Relief Grants Scheme to ensure it is serving consumers who are most in need.

**6E** The ESC to implement the outcomes of its review into improving outcomes for hardship customers.

## Recommendation 7 – Brokerage and group purchasing on behalf of low income and vulnerable customers

**7A** The Victorian Government support the pilot of a not-for-profit brokerage service for concession card holders.

**7B** The Victorian Government should consider ways to negotiate a better deal for concession card holders including a ‘group purchasing’ or single buyer scheme on their behalf.

## Recommendation 8 – Monitoring the market

**8A** Require the ESC to monitor and report on the competitiveness and efficiency of the Victorian retail energy market. The ESC should have the power to compel the provision of any information required to fulfil its functions including:

- Information on costs and margins
- Information on customer numbers and types, the contracts they are on, the prices they are paying and whether they are meeting contract conditions
- Offers that are made including ‘not generally available’ offers
- Costs and practices of brokerage services and comparator sites.

## Recommendation 9 – An energy market code based around the consumer

**9A** Require the ESC to review its regulatory codes to ensure they focus on customer outcomes and can account for new business models of service provision.

## Recommendation 10 – Full coverage of new energy services

**10A** Expand the powers of the Energy Water Ombudsman Victoria (EWOV) to cover emerging energy businesses, products and services

## Recommendation 11 – Energy market structure

**11A** Request the COAG Energy Council to review the structure of the energy market, so that it is structured to deliver long-term interests of consumers.

# INTRODUCTION

In November 2016, the Victorian Government announced an independent bi-partisan review of electricity and gas retail markets in Victoria (referred to in this report as ‘the review’).

The review was prompted by concerns that the deregulation of Victoria’s energy markets is not delivering the anticipated benefits to consumers.

Competition was introduced to Victoria’s energy markets in 2002, with full deregulation of retail prices in 2009.

It was expected that competition would reduce energy costs for consumers and that retail companies would innovate and improve the products and services they offered.

The aim of the review was to determine whether the electricity and gas retail markets are operating in the interests of Victorian consumers and to identify options that would improve outcomes for consumers.

## SCOPE OF THE REVIEW

The review examined the operation of the electricity and gas retail markets in Victoria for residential and small business consumers. References to ‘consumers’ in this report refer to residential and small business consumers – defined for Victorian regulatory purposes as consumers with annual consumption of less than 40MWh for electricity and 1,000GJ for gas.

In accordance with the terms of reference<sup>2</sup>, the review considered:

1. The characteristics of the electricity and gas retail markets, including consumer engagement, market structure, regulation and pricing – with a particular focus on retail costs and margins
2. Key drivers underlying electricity and gas retail pricing, with a focus on retail costs and margins
3. Whether the Victorian electricity and gas retail markets are operating in the interests of consumers
4. Whether the electricity and gas retail markets are competitive and whether there are potential constraints on competitiveness
5. Whether electricity retailers are taking advantage of the impending closure of Hazelwood Power Station in terms of their price offerings to consumers
6. Consumer awareness and understanding of the retail markets, including potential barriers for particular groups of customers to engage in the markets
7. A review of relevant policies and practices in other jurisdictions, nationally and internationally, to identify best practice in regulatory frameworks governing energy retail markets.

The review did not consider large commercial and industrial consumers, which are likely better placed to negotiate and manage their energy supply arrangements to minimise the retail component of their energy bills.

While the review panel acknowledged that large energy consumers are also facing price hikes in their electricity and gas costs, these increases are driven more by higher wholesale prices and market volatility than the retail market. Energy costs for large energy consumers, and the energy system more generally, are the focus of other government reviews and policy initiatives at the national and state levels.

# REVIEW METHODOLOGY

## STAKEHOLDER CONSULTATION

The review panel consulted with energy retailers, network operators, regulators, market bodies, industry groups, consumers, consumer groups and community groups.

It sought submissions on a discussion paper published in January 2017. A total of 25 submissions were received that expressed a variety of issues, and those relevant to the review's terms of reference are addressed within this report. The discussion paper and all submissions are available at [www.energy.vic.gov.au/about-energy/policy-and-strategy](http://www.energy.vic.gov.au/about-energy/policy-and-strategy).

Due to the limitations and scope of the review, not all issues raised by stakeholders were addressed by the review panel. Wherever possible, the review panel dealt with all retail pricing issues as they relate to the terms of reference.

A stakeholder forum to discuss issues raised in the discussion paper was held on 8 February 2017. The forum was attended by 69 stakeholders, representing:

- » Residential consumer and community groups
- » Business consumers and associations
- » Energy networks
- » Energy market bodies and regulators
- » New energy services and energy experts
- » Energy retailers.

The review panel also held a round-table discussion with the Consumer Action Law Centre, Victorian Council of Social Services, St Vincent de Paul Society and Brotherhood of St Laurence.

Eight retailers and one network operator offered to meet with the review panel<sup>3</sup>. The review panel accepted all their invitations and their confidential discussions with the panel provided valuable information on their operations. Where relevant, de-identified information from these conversations is referred to in this report.

## REVIEW RESEARCH AND ANALYSIS

Substantial research and analysis of Victoria's retail energy market was commissioned for the review.

Research and analysis had three key focuses:

1. Retailer marketing, pricing and practices
2. Consumer engagement in the market and what drives their choices
3. Regulatory practices and consumer outcomes in competitive energy markets in other countries.

### Retail costs, practices and pricing

Previous research into pricing in Victoria's energy markets has largely focused on the available offers from retailers in the energy market (referred to as 'generally available offers' in this report) and not what consumers are actually paying.

The review panel did not have authority to compel energy retailers to provide specific information on their retail costs or the prices they are actually charging their customers.

The panel therefore commissioned new research that involved collecting data on what Victorian electricity consumers are paying, sourced from their actual electricity bills.

When commissioning the pricing and cost analysis, the panel was aware that assumptions and differences in approach can influence the outcomes. Given the importance of this analysis to the review, the panel therefore commissioned two separate pricing studies to gain greater insights into the market.

<sup>3</sup> Retailers – AGL, Origin, EnergyAustralia, Powershop, ERM, Red/Lumo, Momentum and Simply Energy. Network Operator – United Energy.

Both studies considered the retail charge<sup>4</sup> on bills or energy offers, but each took a different approach:

1. The first study considered the prices of electricity that retailers were offering new customers.<sup>5</sup> It did not consider actual prices being paid by customers. This study is referred to as the Jacobs analysis in this report.

The Jacobs analysis considered the different costs that contribute to electricity and gas bills. Trends in electricity costs and retail standing offers from 2006 to 2017 were analysed.

2. The second study<sup>6</sup> also analysed the prices of energy contracts that retailers were offering new customers (in May 2017). The study analysed electricity and gas data (both residential and small business) in two separate reports. These studies are referred to as either CME electricity analysis or CME gas analysis.

The CME electricity analysis analysed a sample of 686 actual electricity bills from Victorian residential customers (from December 2016 to April 2017). This analysis enabled an understanding of the differences between what retailers are offering new customers and what their existing customers are actually paying (which only customers and their retailers usually know).

The CME electricity analysis also assessed the savings that Victorian energy consumers might obtain by switching to other retail contracts. It also compared what retailers were charging Victorian consumers compared with consumers in New South Wales, Queensland, South Australia and some European countries.

While gas bills were collected, they were not analysed as the seasonality in gas prices and consumption meant there was insufficient data to accurately estimate an annual bill and, therefore, an indicative retail charge. Small business bills were also collected, but due to the size of the dataset, they have not been analysed. However, as noted above, gas generally available offers for residential and small businesses were analysed by CME.

### Consumer behaviour and engagement

The panel also commissioned the Commonwealth Scientific and Industrial Research Organisation (CSIRO) to research the drivers and barriers to consumer engagement in the Victorian retail

energy market, including for vulnerable consumers.<sup>7</sup> This is referred to as the CSIRO research in this report.

The CSIRO research was based on a review of academic literature from psychology and behavioural economics as well as energy sector and government reports. It suggests potential interventions to improve the level of engagement.

The panel also commissioned Newgate Research to conduct a quantitative survey of Victorian residential and small business consumers to better understand their experience with the energy market. This is referred to as the Newgate survey in this report.

### International retail energy markets

The review commissioned KPMG to research practices in international retail energy markets.<sup>8</sup> This is referred to as the KPMG analysis in this report. KPMG considered international retail electricity and gas markets structures, arrangements, policies and regulations, and the outcomes of these for consumers.

### Other energy reviews

The review occurred alongside concurrent Australian energy reviews and inquiries relating either directly or indirectly to Victoria's retail energy markets including:

- » The 2017 AEMC Retail Competition Review – As part of this review, the Tier 1 retailers and some Tier 2 retailers voluntarily provided the Australian Energy Market Commission (AEMC) with information regarding their margins. The AEMC has found that competition in Victoria continues to be effective. The report notes that:
  - Gross margins are the highest in Victoria compared to other jurisdictions
  - Gross margins for the Tier 1 retailers were larger across New South Wales and Victoria than the gross margins of the Tier 2 retailers in 2014/15
  - There are opportunities to improve the operation of competition to benefit consumers.
- » Electricity Prices and Supply Inquiry, Australian Competition and Consumer Commission (ACCC) – This inquiry into retail electricity supply and prices in the National Electricity Market (NEM) is currently underway. The ACCC has the power to compel retailers to provide information relating to their operations, including costs. The final report is due in June 2018.

<sup>4</sup> Retail Charge is described further on pages 6 and 9 of this report

<sup>5</sup> Jacobs 2017, *Retail Price Review: A report for the [Victorian] Department of Environment, Land, Water and Planning*, prepared for the Victorian Department of Environment, Land, Water and Planning, August 2017.

<sup>6</sup> Carbon Market Economics (CME) 2017, *The retail electricity market for households and small businesses in Victoria, Analysis of offers and bills*, prepared for the Victorian Department of Environment, Water, Land and Planning, July 2017. Carbon Market Economics (CME) 2017a, *Victorian retail gas market for residential and small businesses customers, Description and analysis of commonly available offers*, prepared for the Victorian Department of Environment, Water, Land and Planning, May 2017.

<sup>7</sup> Commonwealth Scientific and Industrial Research Organisation (CSIRO) 2017, *Exploring the drivers and barriers of consumer engagement in the Victorian retail energy market*, prepared for Victorian Department of Environment, Land, Water and Planning, April 2017.

<sup>8</sup> KPMG 2017, *Energy retail markets: An international review*, prepared for the Victorian Department of Environment, Land Water and Planning, April 2017.



# THE ENERGY MARKET AND PRICE TRENDS

## ENERGY MARKET OVERVIEW

Since competition commenced in Victoria’s retail energy market, the residential market has expanded to include 25 energy retailers selling electricity and 13 retailers selling gas to residential and small business customers in Victoria. These retailers are servicing approximately 2.7 million consumers, including residential and small businesses.<sup>9</sup>

Electricity and gas is moved across the energy market from generation and production points via energy transmission and distribution networks to retail customers, as shown in Figure 1. Victoria is part of the National Electricity Market (NEM) which connects all parts of Australia except Western Australia and the Northern Territory.

While the review focused on the practices and prices of Victorian retailers, it was also important to understand how retailers interact with and are influenced by energy generators / producers and the network operators, as this influences the prices that retailers charge consumers.

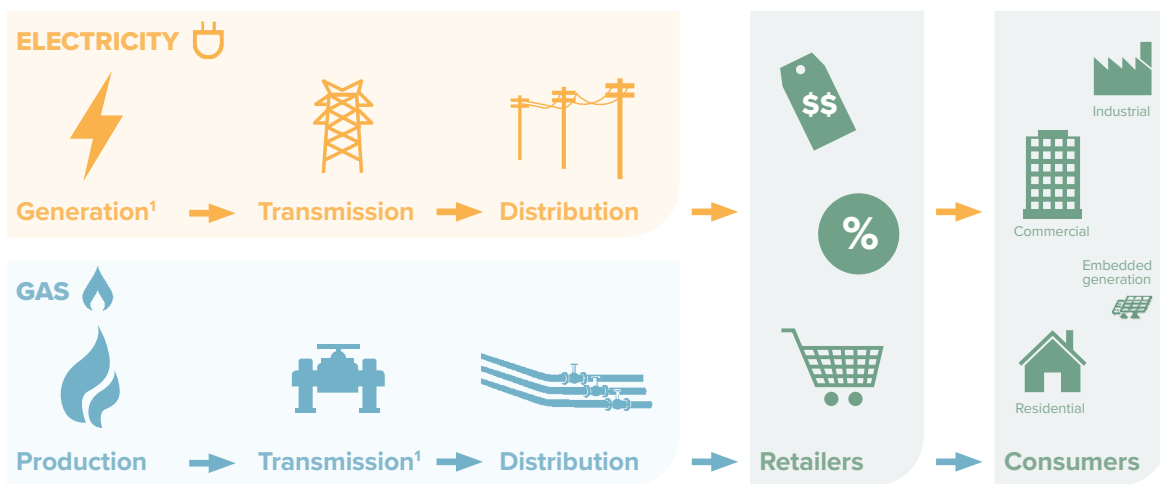
### Tier 1, 2 and 3 retailers

The retail sector is presently dominated by AGL, Origin Energy and EnergyAustralia, referred to

as Tier 1 retailers. These retailers have been in Victoria’s retail energy market since competition was introduced in 2002 and are vertically integrated businesses – they also own electricity generation and gas production businesses. Retailers who have entered the market since deregulation and have increased their market share to at least 100,000 customers and own some generation assets are referred to in this report as Tier 2 retailers, and include Red and Lumo, Simply Energy, and to a lesser extent, Momentum. The remaining retailers with smaller shares in the market of less than 100,000 customers and little or no energy generation capacity are defined as Tier 3 retailers in this report.

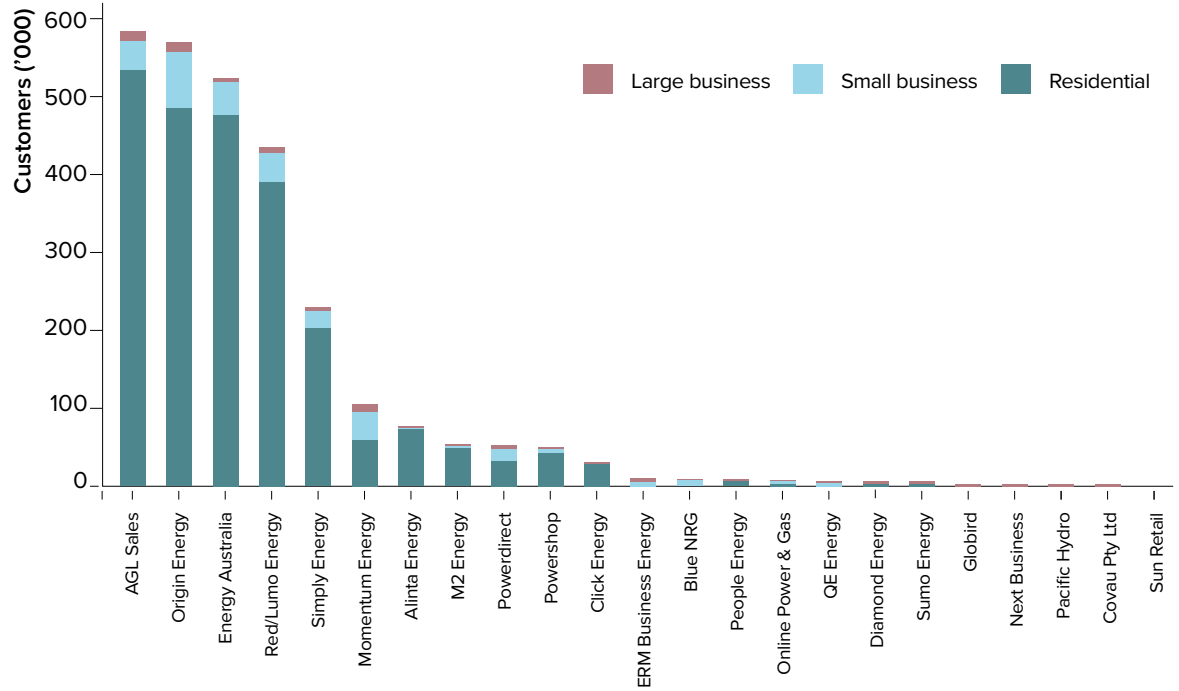
Figure 2 shows the market share of retailers in Victoria’s electricity market. Figure 3 shows the

**Figure 1:** Electricity and gas supply chains



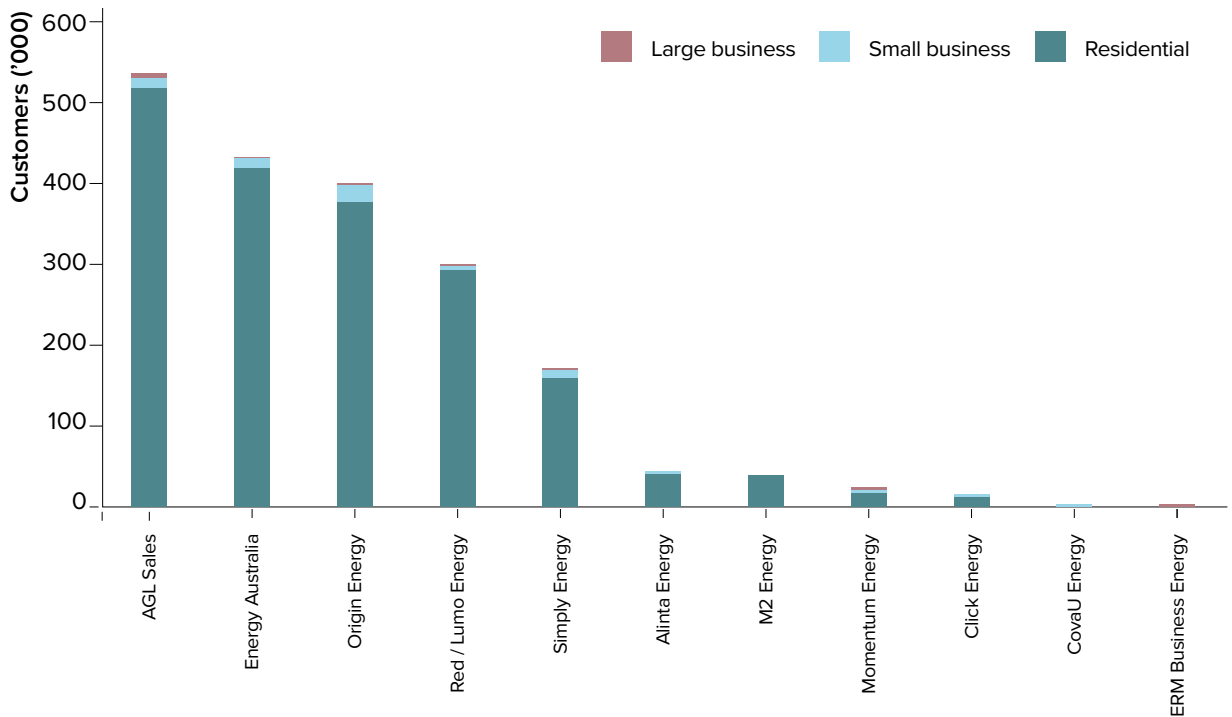
1 Gas can be used to generate electricity

**Figure 2:** Market share of retailers in the Victorian electricity market, 2015–16



Source: Based on Jacobs analysis, Figure 4, p. 14 Data sourced from ESC 2016, *Victorian Energy Market Report 2015-16*, November 2016

**Figure 3:** Market share of retailers in the Victorian gas market, 2015-16



Source: Based on Jacobs analysis, Figure 6, p. 15 Data sourced from ESC 2016, *Victorian Energy Market Report 2015-16*, November 2016

market share of retailers in Victoria's gas market. These figures represent the number of retailers with publishable market share as of 1 July 2016. Note: Additional retailers have since entered.

## ENERGY PRICE TRENDS

Retail electricity and gas tariffs in Victoria have increased significantly since the early 2000s.

Figure 4 shows that Victorian households and small businesses are paying almost 200 per cent more than they paid for electricity and gas before competition was introduced in 2002. This is not what was anticipated when the Victorian energy market was deregulated.

## WHAT MAKES UP ENERGY PRICES?

The three major contributors to the energy prices that retailers charge are:

1. **Wholesale energy costs** – Retailers purchase energy in the NEM using a combination of 'hedging contracts' or futures (where they negotiate the price they will pay for energy in the future) as well as from the 'spot' market (where they purchase a portion of energy for immediate supply).
2. **Network costs** – Energy distributors charge retailers for the costs of operating and maintaining the high voltage transmission and low voltage distribution poles and wires across the NEM and for gas distribution infrastructure. Network costs also include the cost of the meters at residential and small business premises. Network costs are regulated by the Australian Energy Regulator.

3. **Retail charge** – The retail charge includes the retailer's operating costs and profit margin. The retailer's operating costs include billing customers, customer acquisition and retention, marketing and financing.

In addition, other smaller contributors to retailers' costs include the cost of complying with government energy efficiency programs and environmental schemes.

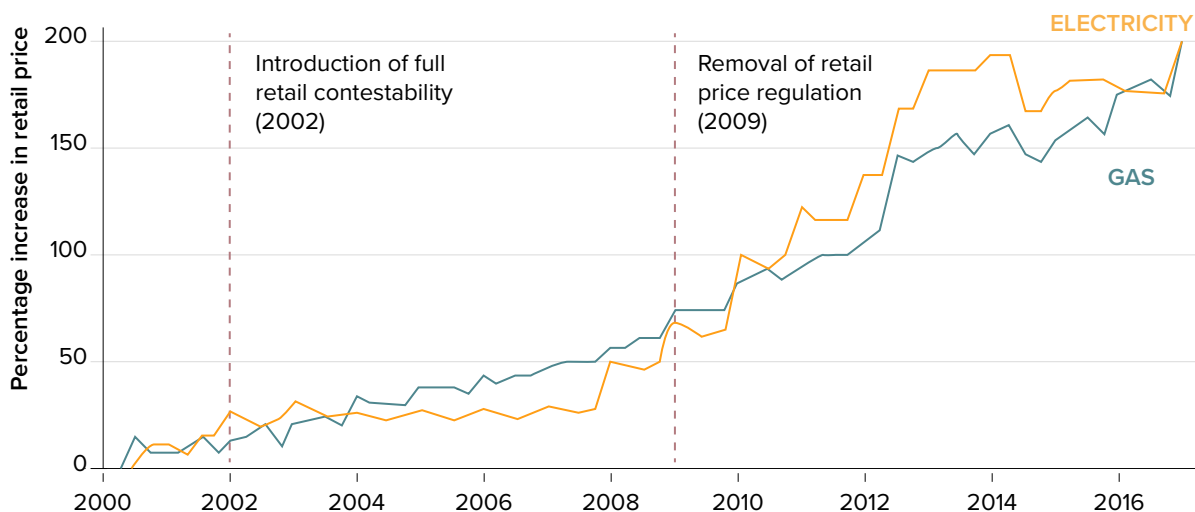
While this report acknowledges the potential impact of wholesale and network costs on consumer energy prices, the review panel's primary focus was to understand the impact of the retail charge on consumer energy prices.

### Fixed charges and variable charges

Retail energy offers usually include both fixed and variable charges:

- » **The fixed charge** is also called the 'daily supply charge' or 'service to property' charge. It is not based on how much energy a consumer uses. The fixed charge includes network costs and a component added by the retailer. It may be displayed on a customer's bill as a daily rate, but it may also appear as a single figure for a billing period. Retailers do not itemise the components of their fixed charge on residential consumer bills.
- » **The variable charge** is the cost for the amount of energy consumed. This price will depend on the terms of each customer's contract. The variable charge is listed as cents per kilowatt hour (c/kWh) for electricity and cents per megajoule (c/MJ) for gas.

**Figure 4** Victorian electricity and gas price index 2000–2017, %



Source: Review analysis of data sourced from the Australian Bureau of Statistics (ABS). The retail price index is calculated from ABS Consumer Price Index (CPI) figures. The CPI calculates the prices using retailers' standing offers.

## Wholesale costs

While wholesale electricity and gas costs have moved up and down since 2000, there is no constant trend that can explain the increase in retail prices.

Significant increases in wholesale electricity and gas prices in Victoria have occurred more recently. Both spot prices and futures contracts for electricity are currently trading at well above historical averages (as at July 2017). Wholesale spot prices have averaged more than \$100/MWh since April 2017 and forward contracts for wholesale electricity in 2018 are currently trading at more than \$100/MWh. These higher wholesale prices are expected to decline in late 2018 into 2019 as new generation assets are built.<sup>10</sup>

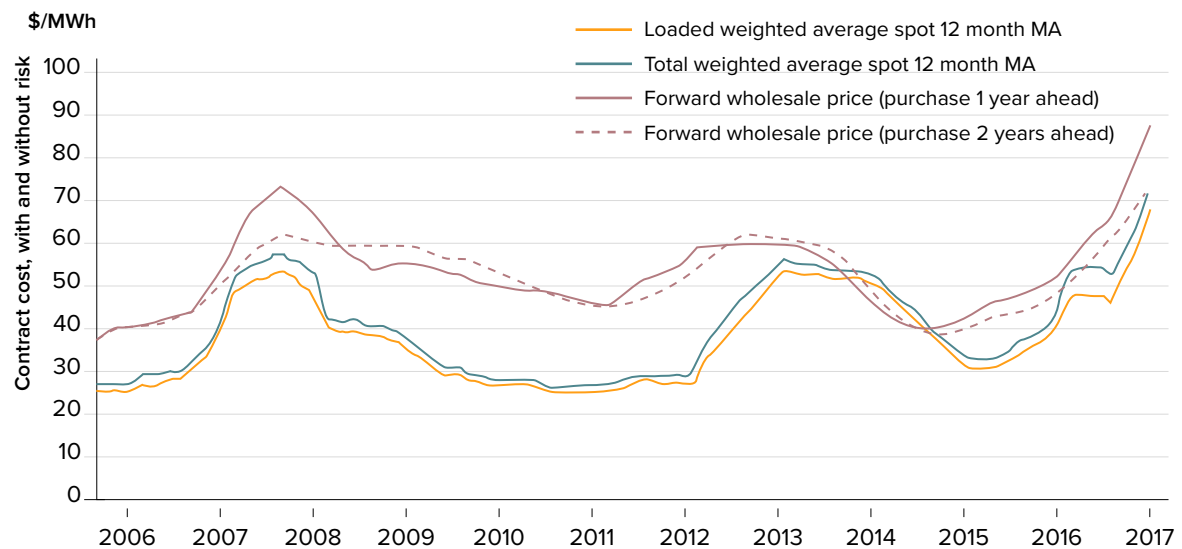
The retailers the review panel consulted with highlighted how they had insulated customers from spot wholesale price increases to date through ‘hedging’ with futures contracts where they negotiate the price they will pay for energy well in advance.

Based on discussions between retailers and the review panel, wholesale costs of electricity were assessed using a representative contracting strategy, where it was assumed that retailers incrementally purchase contracts for their future electricity needs over time. More information about contracting strategies and the detailed methodology adopted for the assessment is outlined in the Jacobs analysis.<sup>11</sup>

## Wholesale electricity prices

Figure 5 shows wholesale electricity price trends in Victoria from 2006 to 2017. Wholesale costs are based on the representative contracting strategy adopted for the Jacobs analysis, as well as moving average wholesale spot prices. Figure 5 compares the forward wholesale prices under a 1-year ahead and a 2-year ahead contracting strategy, as well as against 12-month historical moving average spot prices.

**Figure 5** Victorian wholesale electricity prices – comparison of contract purchase strategies and spot prices, 2016–2017 \*



\* This figure shows two contracting strategies where energy contracts are purchased in advance progressively over time – one where contracts were purchased from 1 year in advance and one where contracts were purchased from 2 years in advance – and two different 1-year moving averages of wholesale spot prices – one load weighted, and one time weighted.

Source: Based on Jacobs analysis, Figure 36, p. 46

## Wholesale gas prices

Figure 6 shows trends in wholesale gas contracts in Victoria since 2006. Wholesale gas prices remained relatively flat until as recently as this year, when prices of new wholesale contracts increased rapidly following the commencement of LNG export operations in Queensland. Further discussion around the drivers of wholesale gas prices in Victoria is provided in the Jacobs analysis.<sup>12</sup>

## Network costs

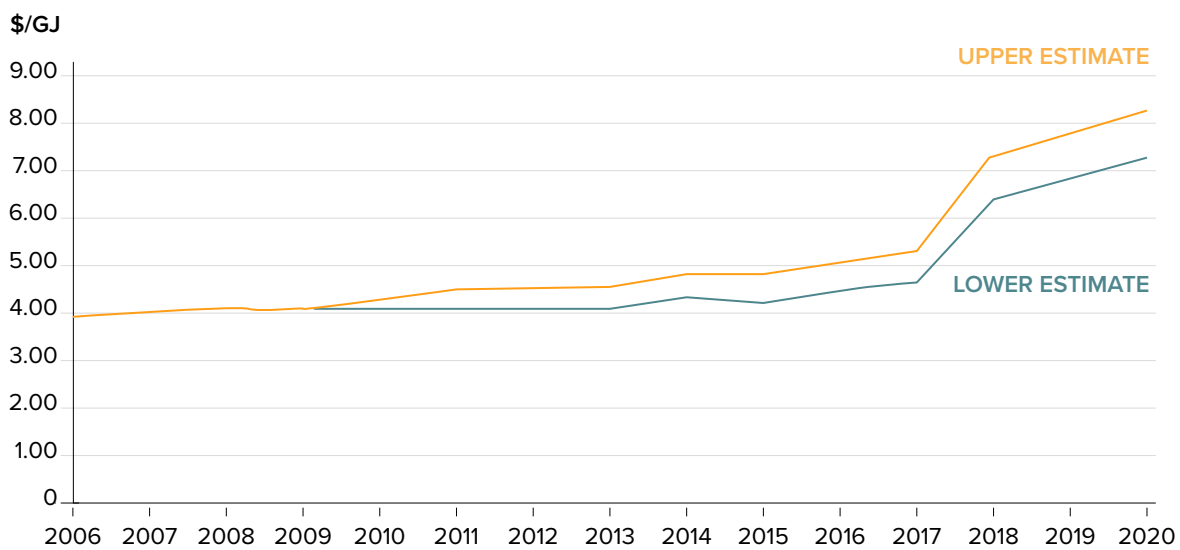
The Jacobs analysis found that network costs for electricity remained relatively flat in each of the five network regions in Victoria until around 2009,

when a steady rise in costs began which lasted until around 2015.<sup>13</sup> Much of the increase in costs was associated with the roll-out of smart meters across Victoria. These costs have started to come down in most network regions, reducing overall network costs across Victoria in 2016 and 2017.

## Electricity network

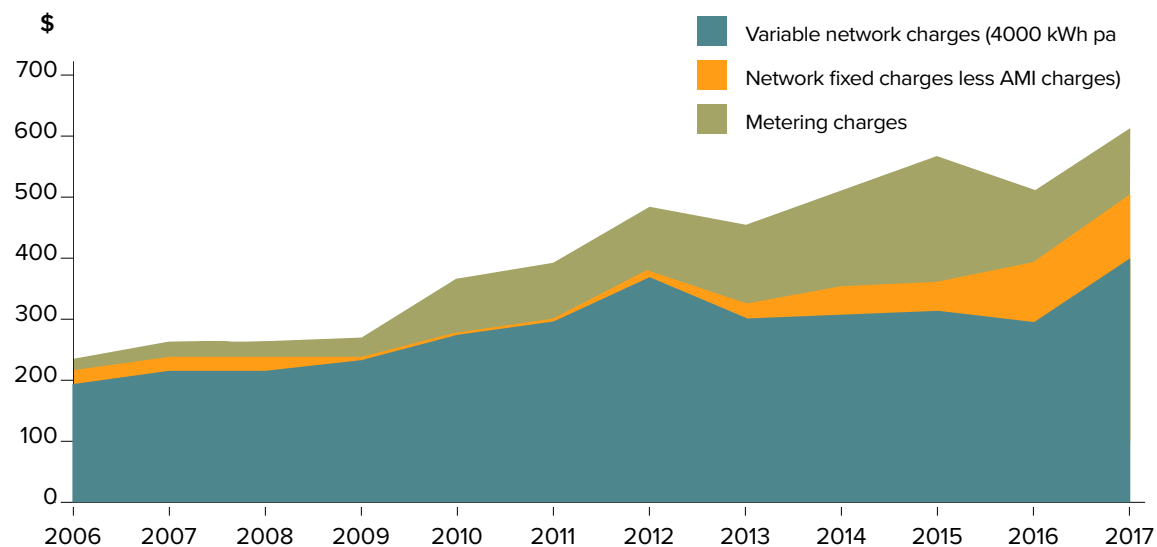
Figure 7 shows changes to electricity network costs for a representative customer in United Energy's network area since 2006, broken into the fixed charge, variable charge and metering charge. The breakdown of cost and size of price rises varies across the different network areas.

**Figure 6** Victorian wholesale gas prices – weighted average prices in existing Victorian contracts (\$2016)



Source: Based on Jacobs analysis, Figure 45, p. 55

**Figure 7** Network charges (United Energy, customer using 4,000 kWh per annum)



Source: Based on Jacobs analysis, Figure 23, p. 35

<sup>12</sup> Jacobs analysis, pp. 74-97  
<sup>13</sup> Jacobs analysis, p. 37-39

## Environmental schemes and other costs

Retailers must also pay a variety of other smaller costs, including costs to comply with various federal and state environmental schemes, solar feed-in tariffs and market fees.

The largest of these is the cost of complying with environmental schemes. In Victoria, retailers are required to purchase certificates to comply with the Australian Government's Renewable Energy Target and the Victorian Government's Energy Efficiency Target. Under these schemes, retailers purchase certificates from relevant parties (such as renewable generators) to surrender to the relevant regulator.

Feed-in tariffs are equivalent to payments for exported electricity. Retailers may also offer market feed-in tariffs, and the amount is set and paid by retailers. In Victoria, the Essential Services Commission (ESC) is required to determine the minimum electricity feed-in tariff that is paid to small renewable energy generators for electricity they produce and feed back into the grid. The minimum feed-in tariff is determined by considering wholesale electricity market prices, distribution and transmission losses avoided through the supply of distributed energy, avoided market fees and charges, and avoided social cost of carbon. These payments are made by retailers and have shifted to a financial year basis. The ESC has determined that the minimum energy value of feed-in electricity for 2017/18 is 11.3 c/kWh.<sup>14</sup>

## Retail charges

The retail charge is the amount that retailers charge for their services. It comprises the operating costs of the retailer, financing costs and their profit margin.

The retail charge is not itemised on customer bills. Regulators, energy market bodies and policy makers (among others) must estimate this charge due to the perceived commercial sensitivity around retailer operational costs. It is calculated by subtracting all other known or estimated costs (wholesale, network and environmental schemes) from an assumed total bill based on offers that are generally available to new customers.

Analysis of generally available offers is very useful, but limited. The Jacobs analysis assessed standing offers to help understand the complexity of the market and benchmark against the data from the sample of actual customer bills. It is the actual bill data that ultimately helped to determine the retailer charge and the prices that consumers are actually paying.

# RETAIL PRICING

This section outlines analysis of retail prices based on generally available offers from retailers, and then provides analysis of retail prices based on data from the sample of actual bills provided to the review by Victorian consumers.

## WHAT ARE THE ENERGY OFFERS TELLING US?

The Jacobs analysis conducted for the review analysed standing offers available in the market to enable identification of trends in the retail charge from 2009 to 2017. Both CME analyses also included analysis based on generally available offers. Both reports were based on offers available in May 2017 to provide a variety of insights, including a benchmark representative bill breakdown and retail charge. The CME analysed actual bills from Victorian energy consumers, discussed later in this report.

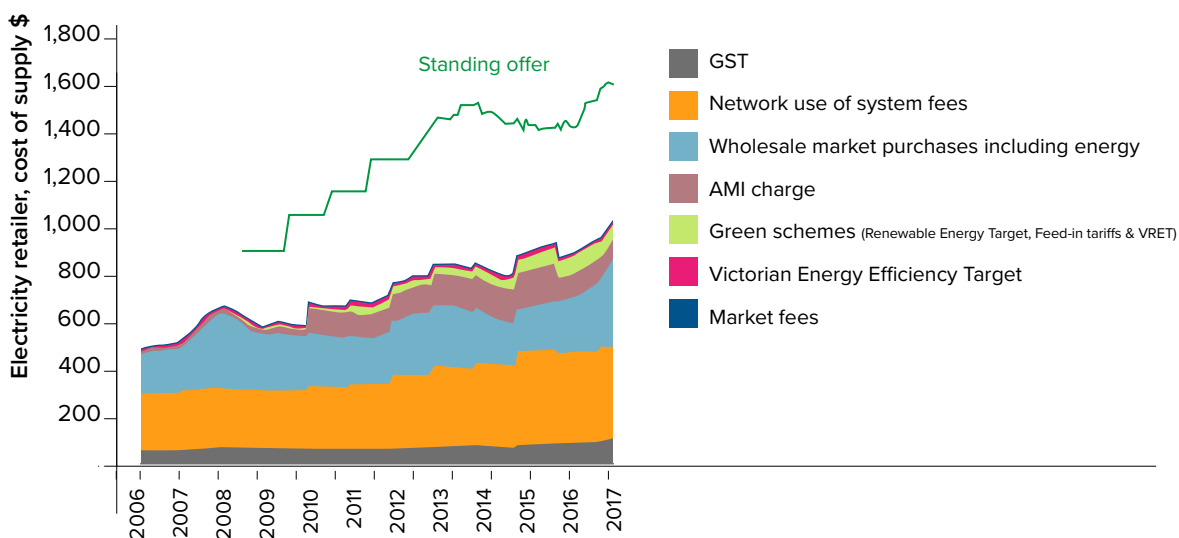
Generally available offers are those that are publicly identified and are generally made available to consumers. Information on these offers is contained in Energy Price Fact Sheets on websites of energy retailers and are provided on the Victorian Government's *Victorian Energy Compare* website. Some retailers may provide

other offers to individuals or groups of customers that are not 'generally' available. For example, some retailers may offer additional discounts to some consumers if they attempt to switch to a competitor or call to negotiate a better offer. Details of these individual offers are not available publicly and are not used in the Jacobs analysis. Similarly, some consumers may remain on old, now retired offers, or are receiving older, lower discounts that are well below those currently available from their retailer. Further discussion on this is outlined in the *Industry practices and regulation* section of this report.

While analysis of generally available offers provides useful insights, it does have limitations. Despite these limitations, analysis of offers over time using a consistent methodology to provide an indicative retail price provides useful analysis of trends in prices and the 'retail charge'.

Figure 8 shows the growth in costs and retail standing offers in Victoria from 2009 to 2017.

**Figure 8** Overview of costs of electricity supply – average 4MWh Victorian energy customer (excludes retailer own costs), 2006–17

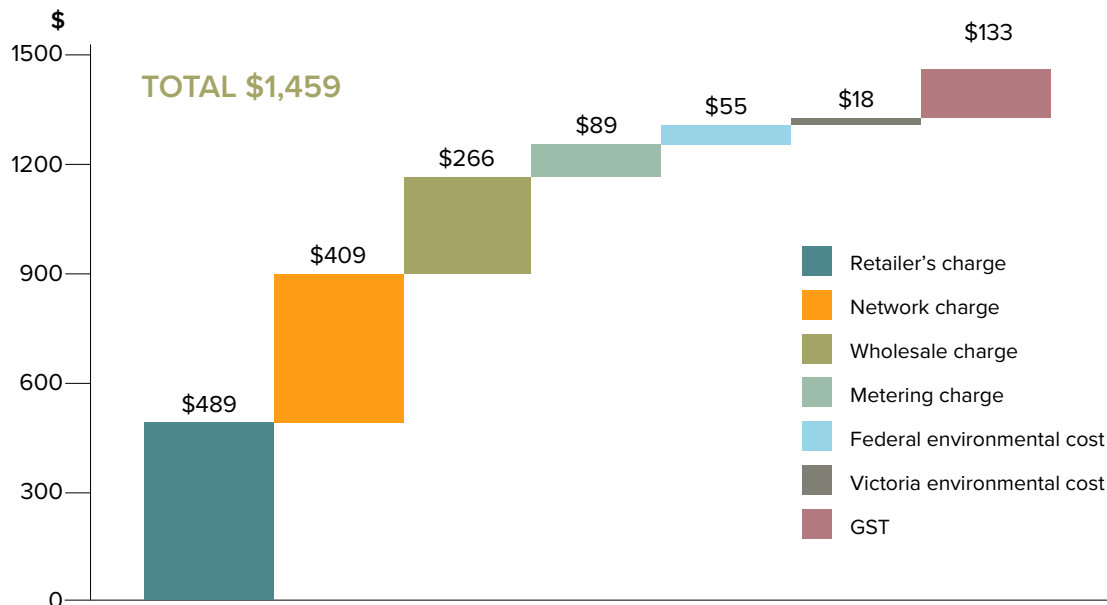


Source: Based on Jacobs analysis, Figure 10, p. 22

The CME analyses of residential offers available in May 2017 showed a representative retail charge of \$489 for electricity<sup>15</sup> and \$472 for gas<sup>16</sup>, or roughly 30 per cent of the total bill for both. Figure 9 and Figure 10 show the bill breakdown

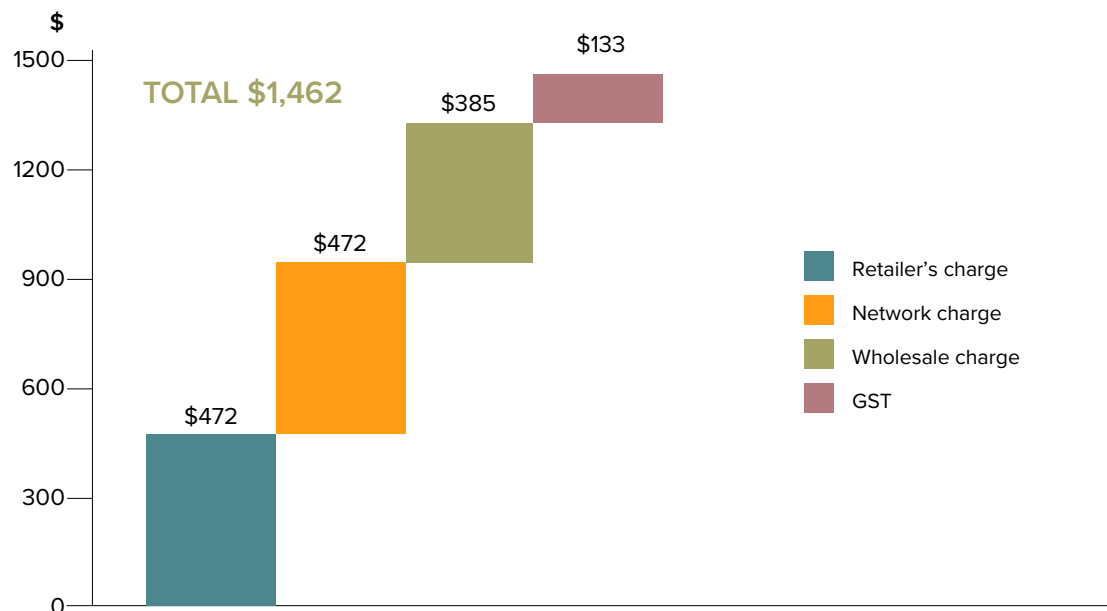
for a representative residential electricity and gas customer, respectively. The analysis was based on an assumed combination of generally available offers to estimate a representative total bill.<sup>17</sup>

**Figure 9** Residential bill disaggregation based generally available offers, 4 MWh p.a. electricity



Source: Based on CME electricity analysis, Figure 14, p. 42

**Figure 10** Residential bill disaggregation based generally available offers, 55GJ p.a. gas



Source: Based on CME gas analysis, Figure 11, p. 19

<sup>15</sup> CME electricity analysis, Figure 14, p. 42

<sup>16</sup> CME Gas analysis, Figure 11, p. 19

<sup>17</sup> The total bills were estimated by selecting each retailer's median market and standing offer for each network area, and weighting each offer by the number of customers on standing and market offers for each retailer, as well as weighting offers from each distribution network area based on customer numbers. The estimate also assumed that 50 per cent of consumers receive conditional discounts and 50 per cent do not.

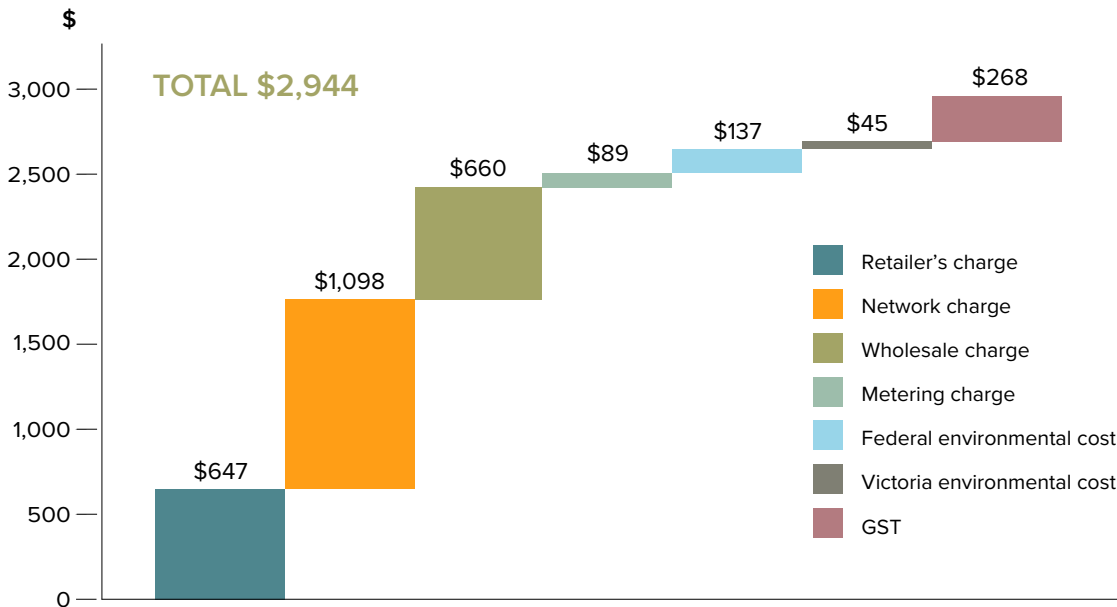


The CME analysis also analysed generally available electricity and gas offers for small business customers available during May 2017. It estimated the retail charge for a representative small business customer was \$647 for electricity, and \$1,755 for gas.<sup>18</sup> Figure 11 and Figure 12 show the bill breakdowns for a representative small business electricity and gas customer,

respectively. The representative total bill was based on the same assumptions used to calculate a representative residential bill, based on offers.

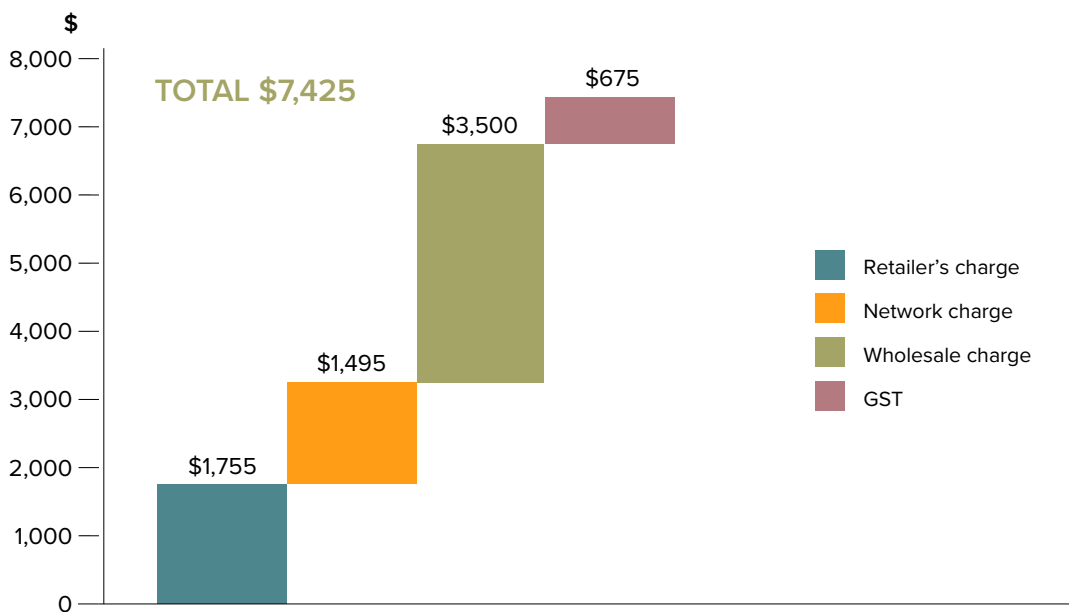
The CME gas analysis demonstrates that wholesale costs for small business gas customers is a significant portion of the bill.

**Figure 11** Small business bill disaggregation, 10 MWh p.a. electricity



Source: Based on CME electricity analysis, Figure 15, p. 42

**Figure 12** Small business bill disaggregation, p.a. 500GJ gas



Source: Based on CME gas analysis, Figure 12, p. 19

### The rise in fixed charges

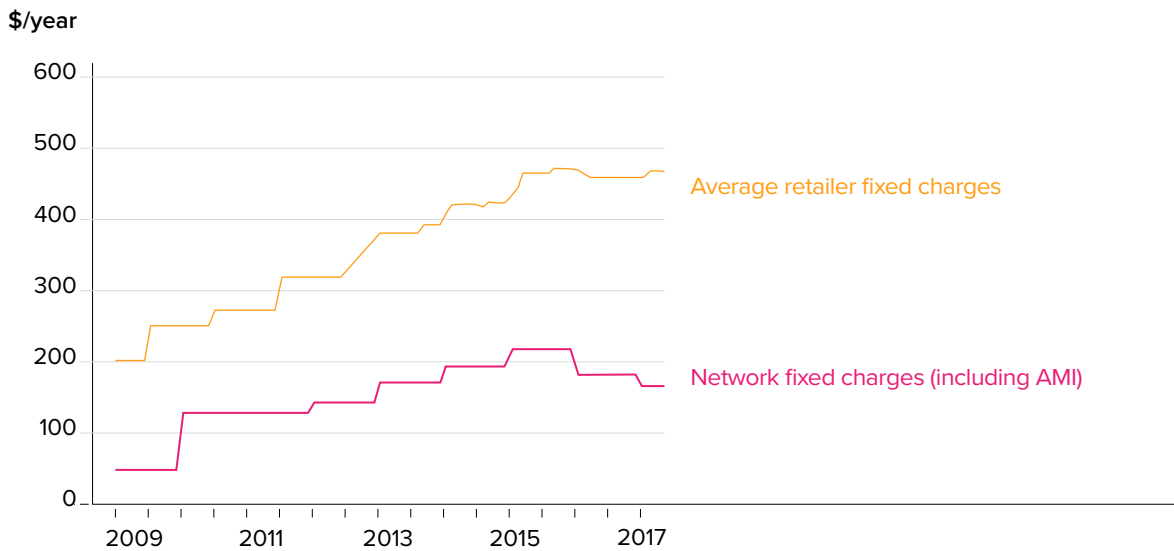
The price that consumers pay for their energy use comprises two charges: fixed and variable charges. Other industries with fixed and variable costs, such as the petroleum industry, do not charge consumers two separate tariffs – customers are charged just a single price at the fuel pump. Those industries understand their costs and risks sufficiently to charge a single price or tariff for the service and remain profitable. It is much easier for a customer to determine what they are paying at the fuel pump (i.e. \$ per litre of petrol) than for an electricity or gas consumer who must complete a complex calculation based on days supplied, the fixed

charge per day, the variable cost per kWh or GJ and the amount of electricity or gas used.

The Jacobs analysis showed that fixed charges have increased substantially for Victorian electricity customers since deregulation in 2009.<sup>19</sup> Figure 13 shows the average fixed charge in standing offers more than doubled.

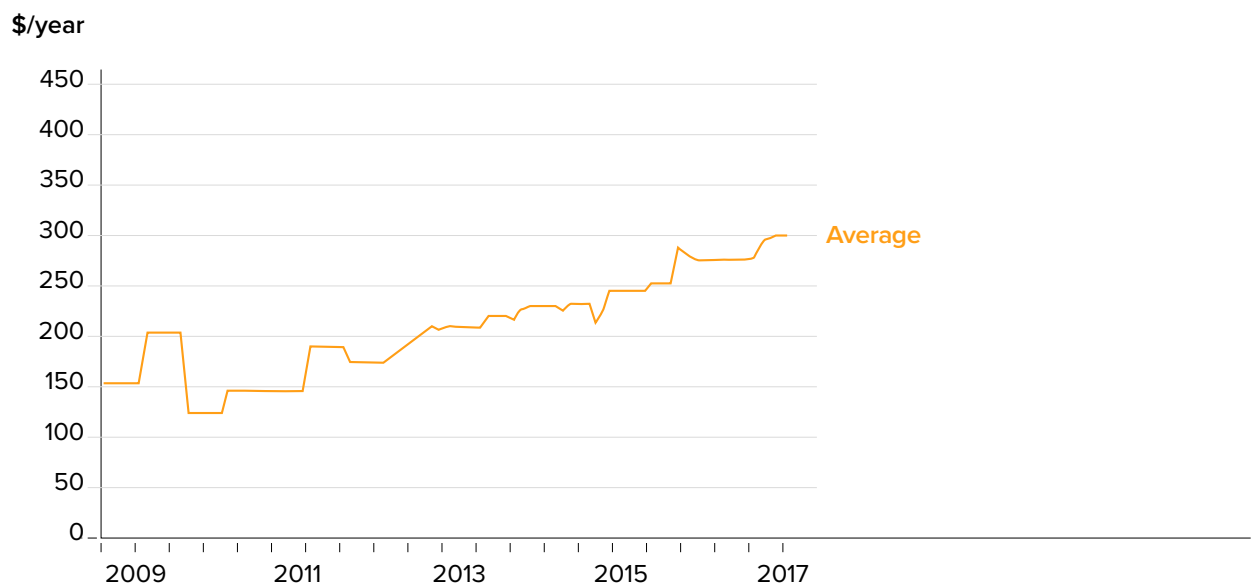
The retail component of the fixed charge has increased faster than the network fixed charge. Although smart meter costs began to fall in 2016, this is not reflected in a reduction of total retailer fixed charges. Figure 14 shows that the average retail fixed charge (i.e. after network and metering costs are removed) has grown since 2006.

**Figure 13** Fixed retail charges vs fixed network charges, average Victorian residential customer, 2009-2017



Source: Based on Jacobs analysis, Figure 11, p. 24

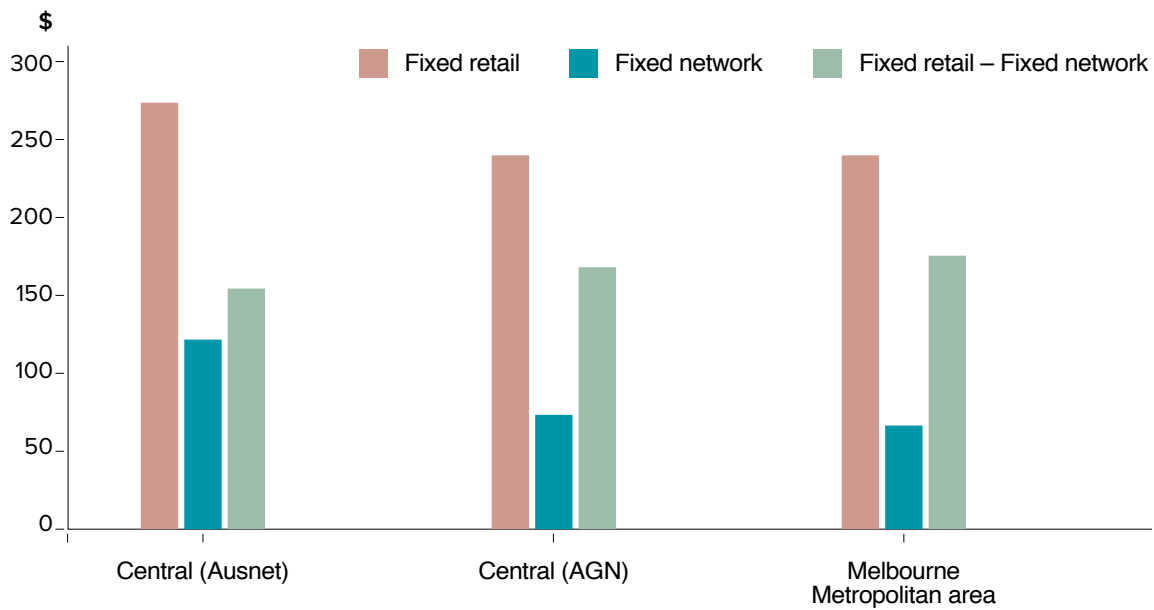
**Figure 14** Fixed retail charges less fixed network charges, average Victorian residential customer, 2009–2017



Source: Based on Jacobs analysis, Figure 12, p. 24

Figure 15 shows that fixed charges are high for gas offers in Victoria. The retail fixed charge is more than \$150 above the network fixed charge.

**Figure 15** Annual gas fixed retail charge and fixed network charge, generally available offers May 2017



Source: CME gas analysis, p. 15

## WHAT CONSUMERS ARE ACTUALLY PAYING

The CME electricity analysis reviewed a representative sample of actual bills from Victorian residential consumers for electricity billed from December 2016 to April 2017.

The share of retailers across the sample was a reasonably close to the market shares of retailers compared with the population, although there are some differences.<sup>20</sup>

Table 1 lists the estimated annual charges per customer each year for each retailer in the bill sample<sup>21</sup>, excluding government concessions.

**Table 1. Summary statistics of estimated annual bills (\$ per customer per year)**

Retailer	Number of bills	Median \$	Average \$
AGL	131	1,331	1,518
Origin Energy	119	1,267	1,397
Energy Australia	100	1,269	1,414
Simply Energy	86	1,049	1,220
Red Energy	51	950	1,185
Momentum Energy	46	1,115	1,244
Lumo Energy	35	1,208	1,392
Powershop	34	955	1,167
Dodo	18	1,049	1,167
Alinta	16	1,228	1,436
Click	15	1,214	1,361
GloBird Energy	12	756	700
Powerdirect	10	1,645	1,785
Pacific Hydro	5	742	1,023
Sumo Power	4	1,302	1,549
Online Power & Gas	2	1,191	1,191
Next Energy	1	1,986	1,986
People Energy	1	581	581

Source: Based on CME electricity analysis, Table 13, p. 55

<sup>20</sup> CME electricity analysis, p. 49

<sup>21</sup> The bills, typically for 30 or 90-day billing periods are annualised assuming that the consumption is representative of the annual consumption and pattern of that customer.

Notably, Table 1 shows a significant difference between the median and average total bills for most retailers. This is due to a skew in the distribution of consumption within the sample towards lower consumption, which is also seen in the population. This can be an important factor because the selection of the 'typical' customer is often based on the median. Since the median is less than the average, the 'typical' customer consumes less than the average and, assuming unchanged prices, the typical customer's bill will be less than the average bill.<sup>22</sup> Figure 16 shows the consumption distribution of the bill data.

### Retail charge

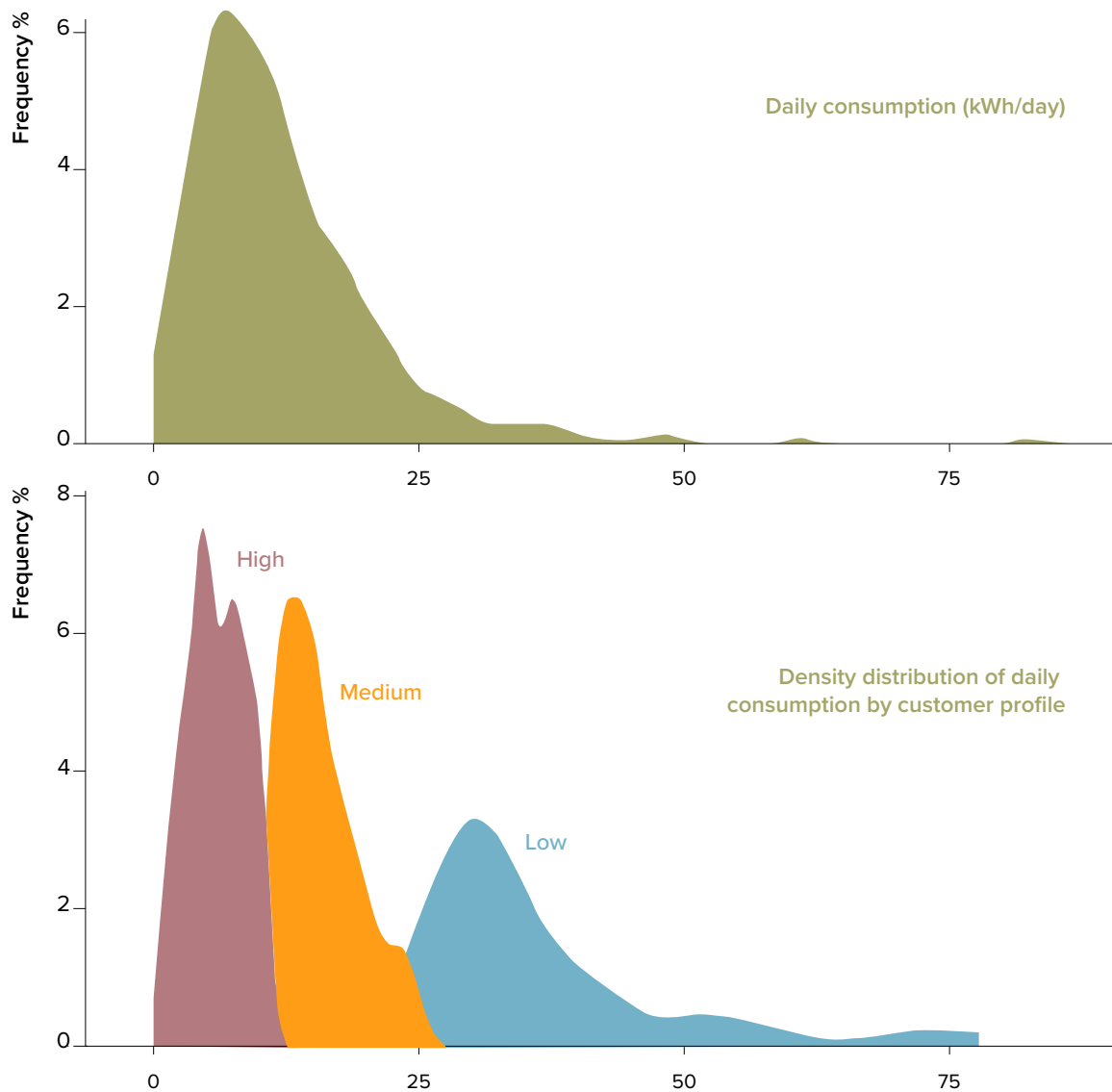
The CME electricity analysis calculated the retail charges by subtracting from each individual total bill the known costs: the wholesale charge (electricity production); the network charge (transmission

and distribution); the regulated charge for smart meters; and the charge for Australian and Victorian government environmental programs.

The CME electricity analysis considered the retail charge based on each retailer's sample of bills. Figure 17 shows the average retail charge (expressed as \$ per customer per year) by retailer from the full usable bill sample. It highlights that Tier 1 retailers with the largest market share (EnergyAustralia, AGL, Origin) have some of the highest charges for their services. The difference between the Tier 1 retailers and many of the newer Tier 3 entrants to the market is significant.

The difference between Tier 1 and smaller Tier 3 retailers is even more stark when the retail charge is calculated as a percentage of the total bill for each retailer, shown in Figure 18. Looking at the distribution of the retail charge as

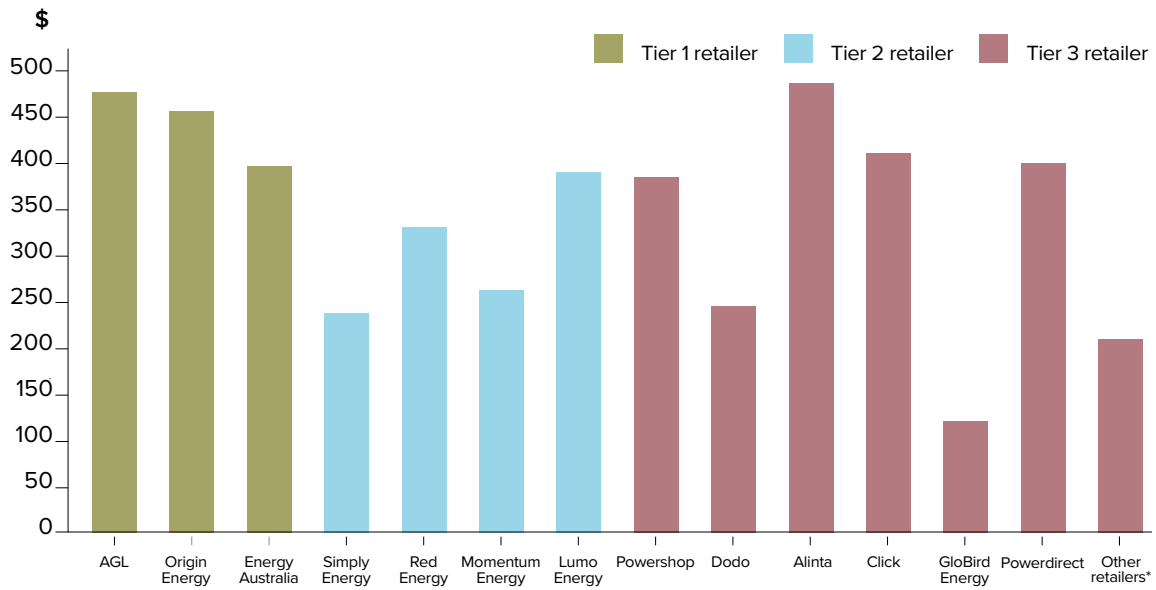
**Figure 16** Distribution of daily consumption by cluster and in aggregate



Source: Based on CME electricity analysis, Figure 21, p. 48

<sup>22</sup> The median is the middle value within the range of bills, i.e. the value of the bill where half the bills in the sample are lower and half are higher.

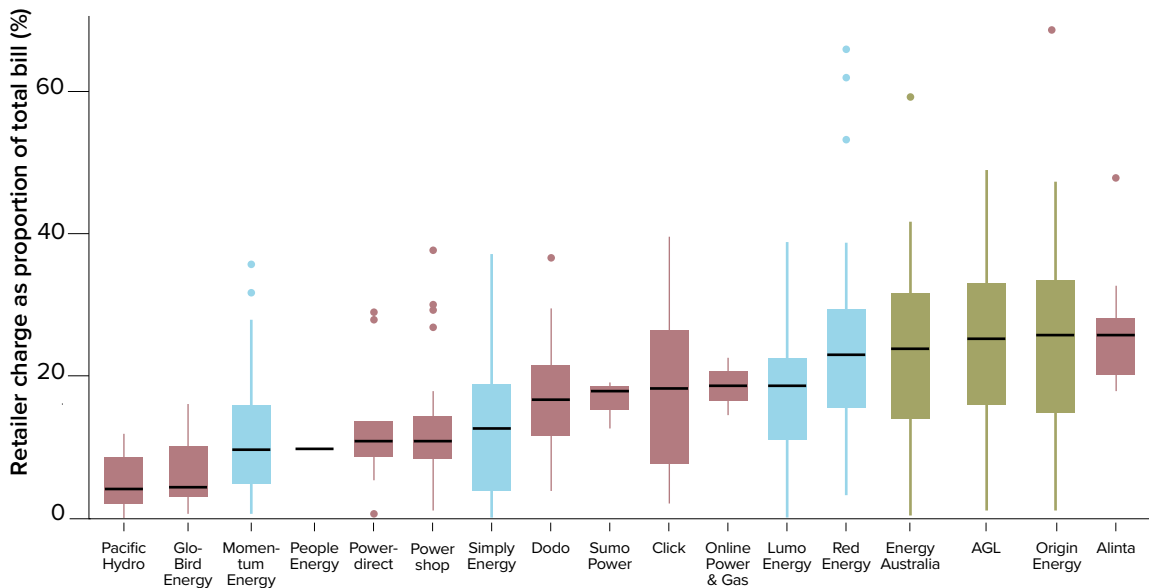
**Figure 17** Average retail charge of Victorian retailers, \$ per customer\*



\* Retailers with less than 10 bills provided in the bill dataset were grouped together. These retailers include Pacific Hydro, Sumo, Online Power and Gas, People Energy and Next.

Source: Based on CME electricity analysis, Table 16, p. 66

**Figure 18** Distribution of retailer charge as proportion of total bill\*



Understanding a box and whisker diagram: A box and whisker diagram is an exploratory graphic used to show the distribution of a dataset. In this case, it helps to show the distribution of the retailers' charge for every electricity bill in the dataset. It also shows the skew in the distribution and whether there are any unusual observations. The black line in each box indicates the halfway point, or median. Using EnergyAustralia as an example, the halfway point retailer charge value is approximately 23 per cent. That means that 50 per cent of the bills had a retailer charge greater than 23 per cent, and 50 per cent had a retailer charge lower than 23 per cent. Those bills with a retailer charge at the top and bottom 25 per cent are represented by the top and bottom ends of the box. The whiskers show the maximum and minimum retailer charges and the dots represent those bills with an unusually high or low retailer charge (these are referred to as outliers).

Source: Based on CME electricity analysis, Figure 34, p. 67

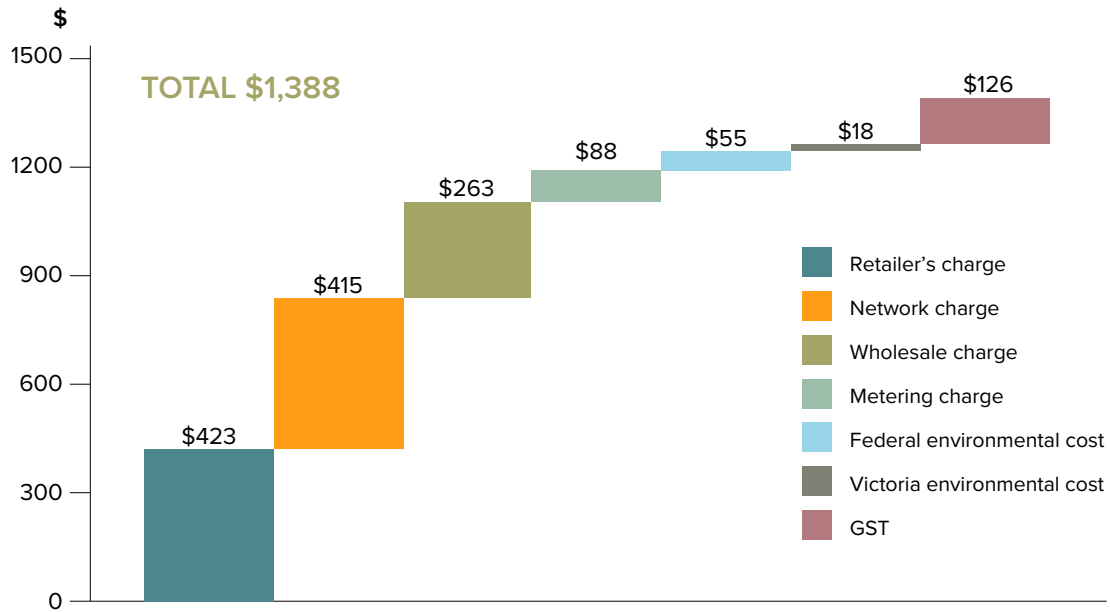
a proportion of the bill helps to account for differences in consumption across different retailers in the sample, particularly those retailers with a smaller market share for which a small sample of bills was collected.

The CME electricity analysis also sought to analyse the retail charge for a representative customer whose annual consumption is typical of the population (4,000kWh per year). To characterise a representative customer, the CME analysis

selected electricity bills of customers whose consumption was within 3.75 per cent of the typical representative consumption of 4,000 kWh. There were 36 bills in this range in the sample. A bill breakdown into each of its components based on the average of this sample is shown in Figure 19.

This demonstrates that, for a representative or typical Victorian residential customer, the retail charge is \$423, far greater than the wholesale charge, and similar to the network charge.

**Figure 19** Residential bill disaggregation based on average bill from sample (4 MWh)



Source: Based on CME electricity analysis, Figure 30, p. 63

### Comparison with other jurisdictions

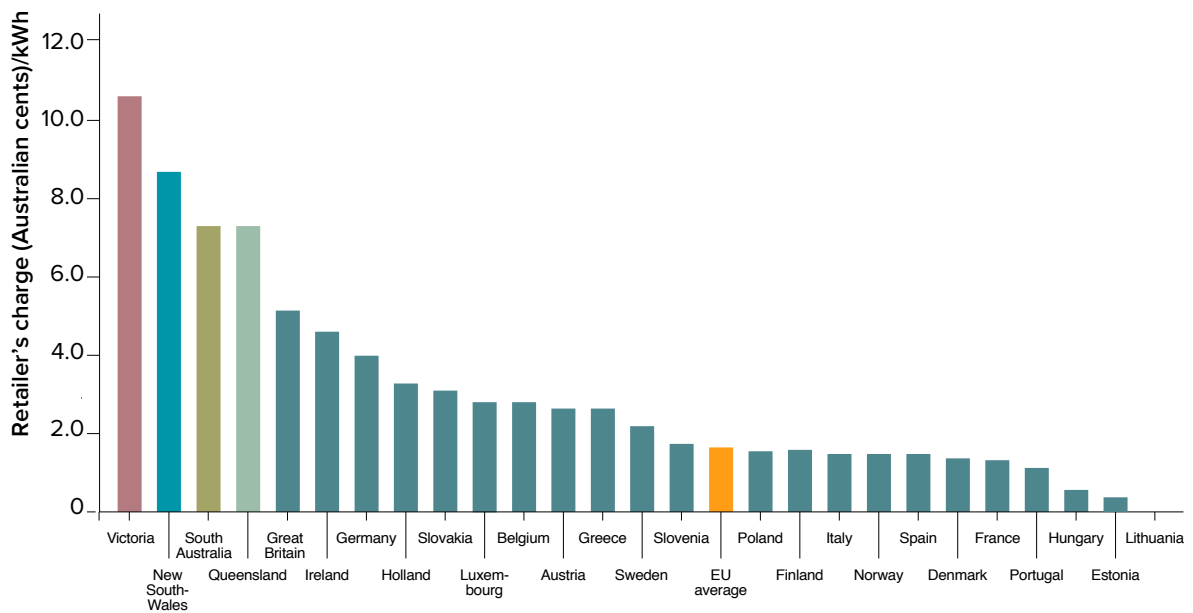
The average retail charge in Victoria based on the sample of customer bills compared with the retail charge in other Australian jurisdictions in the NEM (based on offers) and several European countries<sup>23</sup> is outlined in Figure 20. This shows that Victoria has the highest retail charge compared

to other competitive jurisdictions in the NEM and that it is remarkably high compared with European countries.

### Profit margins

The retail charge comprises the operating costs of a retailer and its profit margin. The review panel was unable to compel retailers to provide details

**Figure 20** Interstate cross country comparison of retailer charges for their retail services, to residential customers (cents per kWh)



Source: Based on CME electricity analysis, Figure 35, p. 68

<sup>23</sup> The retail charges for the European countries is sourced from the Agency for the Cooperation of Energy Regulators and the Council for European Energy Regulators annual report (2015), *ACER Market Monitoring Report 2015 – Electricity and Gas Retail Markets*, November 2015. Further details, including discussion around the comparability of these figures, is outlined in the CME Electricity analysis, pp. 67–70.

of their operating costs or margins, and retailers provided limited information about these. As such, no clear observations about Victorian retailer profit margins could be made.

Instead, the review considered the retail operating costs accepted by regulators in other jurisdictions where price regulation remains (or remained until recently) to provide a benchmark of efficient retail operating costs. The review also considered the retail operating costs in Victoria before price regulation was removed.

Retail operating costs traditionally include billing, call centres, IT systems, corporate overheads, and regulatory costs. These business costs do not vary greatly across jurisdictions, particularly as many retailers manage these functions nationally.

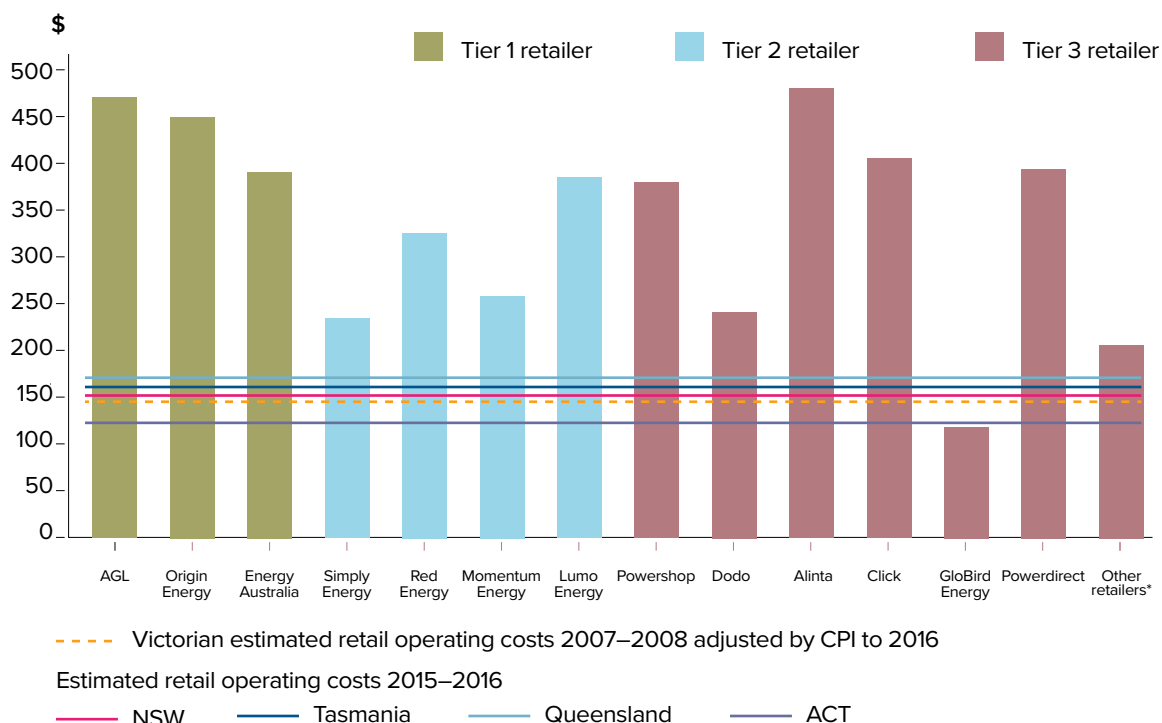
Figure 21 shows the average retail charges (\$ per customer per year) for each retailer from the electricity bill sample (including margin) and compares them with the retail operating costs developed by regulators in Queensland, New South Wales, ACT and Tasmania in 2015/16.<sup>24</sup> These cost lines do not include a profit margin (5.7 per cent was recognised on as an acceptable

profit margin in these regulatory decisions). The broken horizontal line is the estimate of retail operating costs in Victoria before price deregulation in 2009, adjusted to 2016 using the CPI to reflect inflation. ACT estimated retail operating costs are lower in part due to the ICRC's decision to not include an allowance for customer acquisition and retention.

The figure shows the average retail charge of most Victorian retailers, particularly the large Tier 1 retailers, is well above the estimated retail costs for retailers in other, similar jurisdictions in the NEM. This could be because the costs associated with competition in Victoria are high, or the profit margins of some retailers are greater compared with other states or before deregulation.

The recently released 2017 AEMC Retail Competition Review reported gross margins (referred to in this report as the retail charge) are the highest in Victoria compared with other jurisdictions. Gross margins for the Tier 1 retailers were larger across New South Wales and Victoria than the gross margins of the Tier 2 retailers in 2014/15, but similar in 2015/16.<sup>25</sup>

**Figure 21** Victorian average retail charges by retailer, compared with estimated retail costs in Qld, Tas, ACT and NSW (\$ 2016)



Source: Based on CME electricity analysis, Table 16, p. 66; and Jacobs analysis, Table 3, p. 30

<sup>24</sup> Jacobs analysis, p. 30

<sup>25</sup> Australian Energy Market Commission (AEMC) 2017, *2017 Retail Energy Competition Review, Final report*, July 2017, p. vi

### High fixed charges

Figure 22 shows the difference between the fixed charges in the sample of retail bills (after all relevant discounts) and compares it against the fixed network charge, fixed metering charge and fixed retail charge. It demonstrates that the retail component of the fixed charge (i.e. total fixed charge minus network and metering charges) based on the bill sample is around \$200 or more, depending on the network area.

Although slightly lower than the average fixed charge identified in generally available offers, the bill data confirmed that consumers are paying a considerable sum in fixed charges to retailers (beyond network and metering costs) even before they consume any energy.

#### The impact of high fixed charges

The retail component of the fixed charge paid by Victorian customers is now the largest component of the fixed charge.

Retailers in Victoria are increasingly recovering their operational costs through fixed charges rather than variable usage charges. Submissions from retailers to the review also highlighted that retailers are recovering a broad range of operational costs through fixed charges. This transfers the profit risk from retailers to consumers, and reduces the ability of consumers to reduce their total energy costs by reducing their energy consumption. Although the charge for smart meters has more recently reduced in some distribution areas, this has not generally been passed to customers through a reduction in fixed charges.

When asked about its fixed charges, a Tier 1 retailer (de-identified) advised:

*...fixed charges are set to recover the network fixed component and the retail allocation of operational expenses to support and grow our customers.*

*...increased its fixed charges significantly in previous years in Victoria to incorporate the large interval meter charges which were being passed-through by networks as fixed charges. When the network's interval meter charges were reduced by the regulator (AER) for 2016, ... made a decision to keep its fixed charges at the current level and to instead to limit the variable rate increase for customers.*

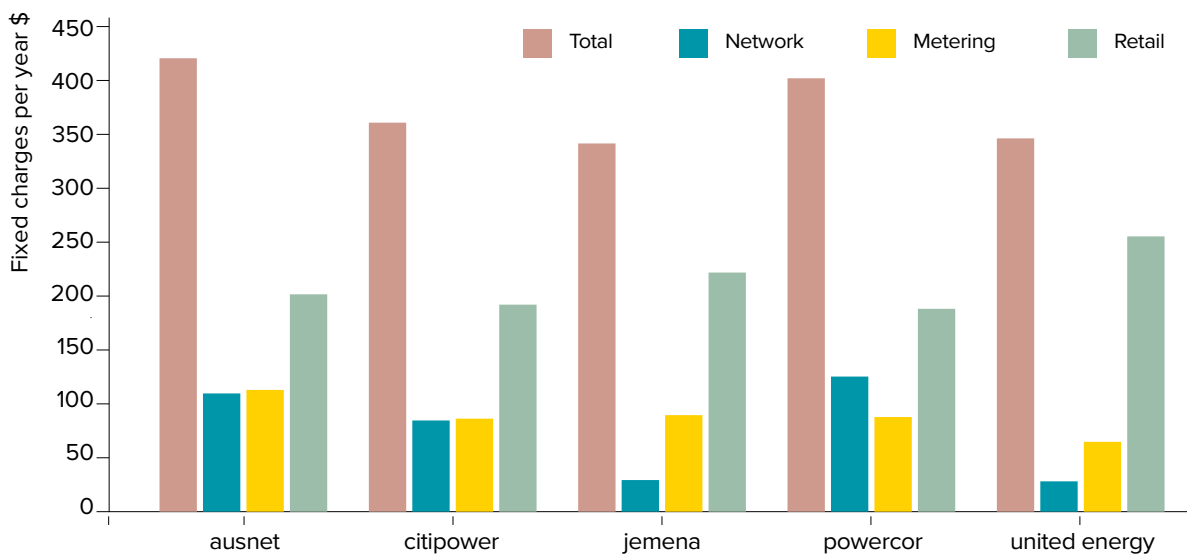
#### Vulnerable consumers and fixed charges

High fixed charges impact negatively on pensioners and other concession card holders who use low amounts of energy. The Victorian Utility Household Consumption Survey 2015 showed that concession card holders hold energy plans and conditions that are similar to the broader Victorian population, but their energy consumption is lower, particularly if they are aged.<sup>26</sup>

High fixed charges result in low-income, low-usage customers paying a higher charge per unit of energy consumed than the broader population. High fixed charges also limit their ability to manage energy costs by managing usage and energy efficiency.

The review panel considers that all consumers, but particularly vulnerable and low-income consumers, should be able to manage their energy costs by

**Figure 22** Annual fixed retail, fixed network and metering charges, bill data



Source: Based on CME electricity analysis, Figure 23, p. 50



managing usage. The practice of increasing the retail component of fixed charges has significantly impacted their ability to do this.

The review considers that the incidence of high fixed charges in Victoria is a key indicator of the market failing to deliver outcomes in the best interests of consumers.

### Potential savings from switching

The review panel sought to understand the savings that consumers could achieve if they switched energy retailers or offers to the best price, based on their own consumption volume and pattern.

The CME electricity analysis calculated potential switching savings by comparing each sample customer bill with all market offers generally available in the same month as the bill was issued.

This involved pricing all competing offers with the same parameters specific to a particular customer (including annual consumption, consumption pattern if applicable, existence of solar feed-in, and existence of controlled load). The analysis was also limited to offers with the same tariff structure of a bill. While in principle, customers can choose to switch from one tariff structure to another, in practice few retailers allow this.

Table 2 summarises estimated annual savings that customers in the bill sample could achieve if they switched to the least expensive market offer available. It also shows that customers served by Tier 1 retailers (AGL, Origin and EnergyAustralia)

would tend to save more than customers with Tier 2 and Tier 3 retailers.

The CME electricity analysis also assessed the potential switching savings for different categories of consumption. Figure 23 shows the savings expressed as an annual dollar amount and as a percentage of the total bill for the three consumption clusters (high, medium and low) described above in Figure 16. This shows the wide range of savings in dollars in each cluster, but also that the median savings rate in each cluster is similar, at around 21 per cent. Customers were paying an average \$294 per year more than the cheapest offer available.<sup>27</sup>

The CME electricity analysis also looked at how the size of potential annual savings were distributed throughout the sample of bills. Figure 23 shows the potential savings, grouped into three clusters based on the size of the savings available if customers switched to the cheapest offer for them in the market:

- » The 'low saving' cluster accounted for 204 out of the 686 bills. The median saving for customers in this cluster was \$84 per year
- » The 'moderate saving' cluster had 280 bills and a median saving of \$223 per year
- » The 'high saving' cluster had 155 bills with a median saving of \$501 per year.

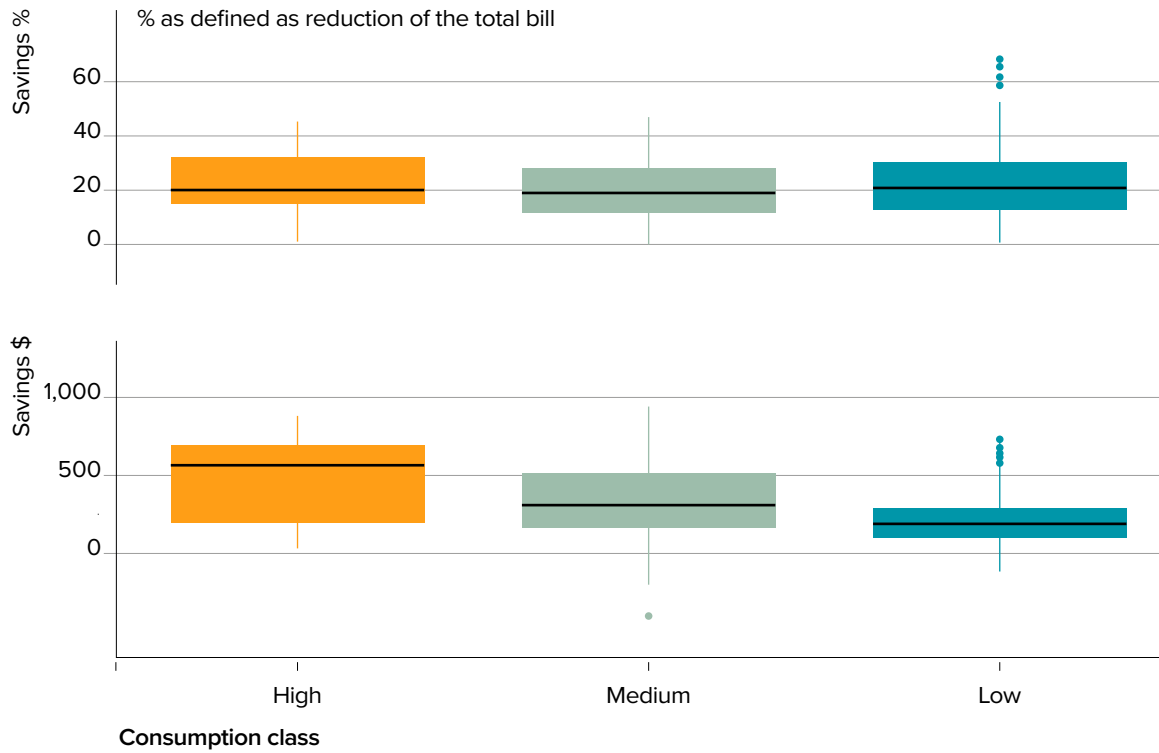
In addition to bills in these three clusters, there were 33 bills that were cheaper than any offer in the market and eight bills with potential savings of more than \$1,000.

**Table 2. Summary of estimated savings from switching to the lowest market offers (\$ per customer per yr)**

Retailer	Number of bills	Median \$	Average \$
AGL	131	295	380
Origin Energy	119	296	372
Energy Australia	100	272	333
Simply Energy	86	97	124
Red Energy	51	231	278
Momentum Energy	46	123	140
Lumo Energy	35	252	287
Powershop	34	162	209
Dodo	18	152	193
Alinta	16	288	377
Click	15	266	265
GloBird Energy	12	65	71
Powerdirect	10	161	266
Pacific Hydro	5	22	26
Sumo Power	4	196	231
Online Power & Gas	2	212	212
Next Energy	1	23	23
People Energy	1	259	259

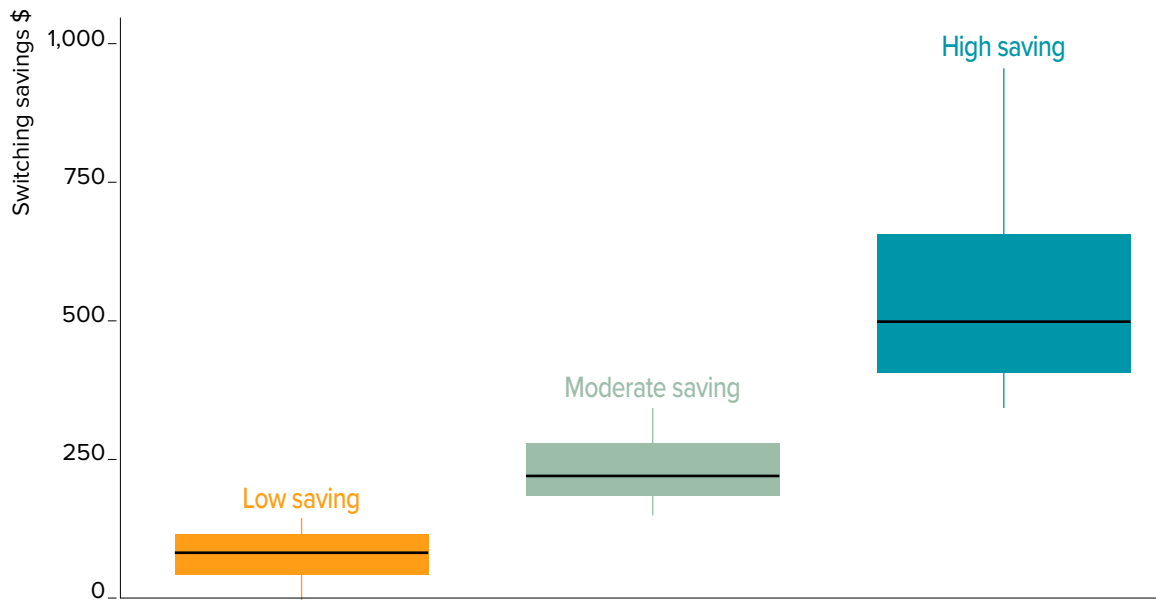
Source: Based on CME electricity analysis, Table 17, p. 72

**Figure 23** Distribution of savings by level of consumption



Source: Based on CME electricity analysis, Figure 41, p. 76

**Figure 24** Savings that could be achieved if consumers switched electricity offers



Source: Based on CME electricity analysis, Figure 42, p. 77

Analysis of these clusters showed that most consumers could make significant savings from switching. Around a third could make relatively modest savings, suggesting that consumers who are highly active, regularly shop around and can navigate a complex market may find some of the lower prices available in the market. However, even most of these consumers could achieve additional savings.

Around two-thirds of consumers could make large savings from switching and nearly a quarter could save at least \$500 a year. This indicates the market is failing to deliver good outcomes on price for many residential electricity consumers in Victoria and competition is failing to effectively constrain retail prices. These poor outcomes on price are driven by a range of factors described in more detail throughout the remainder of this report.

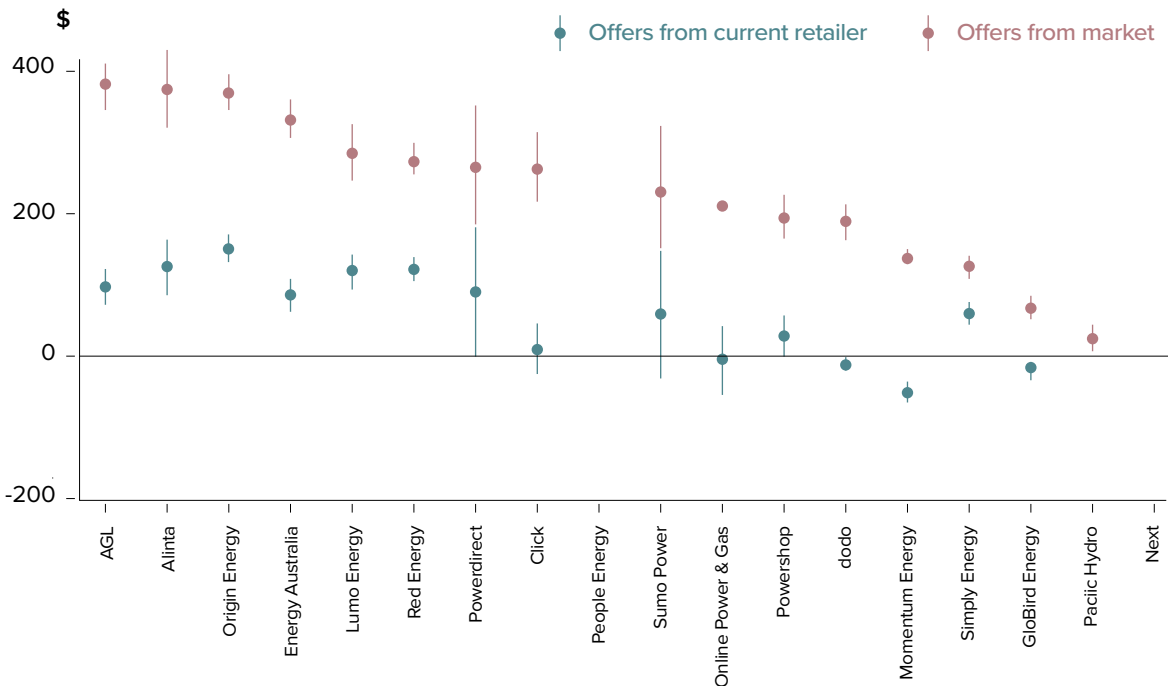
Most customers, particularly those supplied by the Tier 1 retailers, would pay considerably less by switching to the lowest offer in the market, rather than the lowest offer available from their retailer, although most customers would also pay less if they switched to a cheaper offer from their existing retailer. The median savings from switching to the cheapest offer in the market or to the cheapest with their current retailer is shown in Figure 25.

It is important to note that these savings are based on the assumption that a customer is able to identify and switch to the cheapest offer based on their consumption profile and other variables. The CME electricity analysis found a significant gap exists between the savings that customers would achieve if they selected the cheapest offer (on average \$294), the savings achieved if they selected the second cheapest offer (on average \$228) and the savings achieved if they selected the third-cheapest offer (on average \$205).

Identifying the cheapest offer requires sophisticated and data intensive analysis that is beyond all but the most interested, informed and skilled customers. In addition, offers on price comparator websites will not always display the least expensive offer (as they do not feature all generally available offers). Consumers often rely on these websites to research energy offers, so this means they may not be seeing the cheapest offer(s) when selecting a market contract.

These issues are discussed in detail in subsequent sections.

**Figure 25** Median saving (\$ per customer per year) by switching to the lowest market offer vs lowest offer from a customer's existing retailer



Source: Based on CME electricity analysis, Figure 44, p. 80

# WHAT IS DRIVING THE HIGH RETAIL CHARGE AND POOR CONSUMER OUTCOMES IN VICTORIA?

Based on the analysis of retail prices and costs, the review panel concluded that the competitive energy market in Victoria is not delivering outcomes in the best interests of consumers, evidenced by:

- » Significant increases to energy prices
- » A retail charge that is significantly higher than retail costs that would be incurred in a regulated or efficient market
- » Significant differences between the cheapest offers available in the market and the prices that consumers are actually paying (even with their existing retailer) – suggesting that competition is not effectively constraining the pricing behaviour of retailers
- » Large increases to the fixed component of retail bills that do not reflect underlying changes to network tariffs, and the failure of the market to deliver low (or zero) fixed charge products for consumers.

The poor consumer outcomes, including the high retail charge that Victorian energy consumers are paying compared with consumers in other Australian states, can be attributed to:

- » Increased retail costs driven by competition
- » The structure of the market
- » Industry practices that constrain competition and make customer engagement difficult.

Each of these factors affect outcomes for both residential and small business customers in Victoria.

## INCREASED COSTS OF COMPETITION

A number of retailers stated that competition had increased costs associated with marketing, customer acquisition and retention cost (CARC). The review panel was told by retailers it consulted with that winning new customers is a significant expense.

Brokerage fees for comparator sites to acquire a single customer were suggested by many retailers to be around 10 per cent of a total annual customer bill. One retailer indicated that the cost

of marketing, customer care, onboarding and sales can be around 39 per cent of their total operating costs. Smaller Tier 3 retailers without an existing customer base and seeking to grow will likely have even higher operating costs to account for the need to acquire additional customers.

As competition develops, retailers continually learn which marketing techniques and pricing strategies enable them to attract and retain customers. In particular, retailers seek to reduce their acquisition costs by creating incentives for customers to remain with them. 'All you can eat' fixed price contracts, dual fuel contracts, earning frequent flyer points and other forms of bundling all contribute to making customers more 'sticky' (i.e. likely to remain with a retailer). International experience suggests retailers earn higher margins on these 'sticky' customers over time.<sup>28</sup>

Other than increasing costs of competition to acquire and retain customers, the panel heard limited explanations from retailers to explain their increases in retail charges. Some retailers suggested that increased retail margins were needed to attract competition.

Recently the Australian Capital Territory Independent Competition and Regulatory Commission (ICRC) considered the customer acquisition and retention as part of its 2015/16 pricing regulation. Weighing considerations on both sides the ICRC reported:

*The Commission believes that an increase in prices resulting from a CARC allowance or a competition allowance could only be justified if prices will reduce to efficient levels over time and longer-term benefits from competition would more than offset the cost burden faced by small customers from including a competition allowance. The Commission considers there is little evidence to indicate that a competition allowance would realise net benefits.<sup>29</sup>*

These additional costs of competition that consumers are paying for have not improved the reliability or accessibility of the product they are purchasing. Nor have the benefits of competition offset the additional costs incurred by consumers. As consumers cannot opt out of the energy market, the costs of competition increase prices for consumers. Without any strong mechanism to constrain prices for all consumers, the prices that Victorian consumers pay will likely remain high.

## MARKET STRUCTURE

In 2002, Victoria moved to full retail competition for small customers, with some price regulation until 2009. The number of retailers serving residential and small business customers has grown from three to 25, with various new entrants to the market in recent years.

The retail energy market is presently dominated by AGL, Origin Energy and EnergyAustralia, as the Tier 1 retailers. These retailers have been in Victoria's retail energy market since competition was introduced in 2002 and are vertically integrated businesses – they also own electricity generation and/or gas production businesses. The largest, AGL, has sufficient generation capacity to cover its electricity customer load, while EnergyAustralia and Origin Energy only cover a proportion of their electricity customer load.

Vertical integration can provide key competitive advantages such as:

- » Ability to self-hedge against electricity and gas price volatility, reducing reliance on liquidity of hedging markets or unaligned suppliers
- » Lower earnings volatility (generation earnings balancing out retail earnings)
- » Investment-grade credit rating, providing the ability to borrow and to support market to market hedge exposures in volatile markets more readily and cheaply
- » Lower cost of financing – demanding lower returns than an ungeared competitor
- » Economies of scale (more customers)
- » Economies of scope (multiple products to offer like gas, large business services)
- » Customer information and billing systems that are generally more sophisticated, allowing for differentiation of customers (customers' credit quality, their usage volume, or churn propensity).<sup>30</sup>

Despite these advantages over new entrants, the market share of the three incumbent Tier 1 retailers has declined to about 62 per cent of the residential

electricity market and 70 per cent of the residential gas market. In the small business market, the market share of Tier 1 retailers has declined to about 54 per cent of the electricity market and 73 per cent of the gas market. The competitive market offers more choices of retailer, with a generally prominent level of customer awareness of retail competition, and relatively strong rates of customer switching between retailers.

Retailers that have entered the market since deregulation, which now hold a sizeable proportion market share and also own some generation assets are defined as Tier 2 retailers in this report. These retailers are Red and Lumo (Snowy Hydro), Simply Energy, and to a lesser extent, Momentum. These energy retailers are backed by international businesses and/or government and have a mix of generation capacity to support their growing customer load. Simply Energy, owned by French energy company Engie, has ownership of baseload and peaking generation. Red/Lumo, backed by Snowy Hydro, has mainly hydro generation assets. The remaining dozen or more retailers with small shares in the market and little or no energy generation capacity are defined as Tier 3 retailers in this report.

The Tier 1 retailers have supported promoting competition and have called on regulators to allow additional costs to be included in prices to allow for competition to flourish, arguing that competition will lead to innovation and better value for consumers in the long term.<sup>31</sup> An effective and efficient competitive market with low barriers to entry should allow smaller entrants into the market and drive service levels up and costs down, and ultimately deliver benefits to consumers in innovation and reduced energy prices.

This does not appear to be the case in Victoria's retail electricity market. With customers unable to exit the market, and with likely higher costs for new entrants and increasing costs related to competition, consumers are still waiting for the benefits to accrue eight years after price deregulation.

Confidential conversations with retailers indicated the Victorian market is viewed as having higher margins than other jurisdictions and that the lower retail margins in other states were impeding competition. Increasing prices and retail charges seem set to continue for Victorian consumers.

The CME analyses showed that three Tier 1 retailers are charging among the highest retail charges in the Victorian energy market. The analyses suggest the market is not driving prices towards an efficient cost, but rather increasing to

<sup>30</sup> Energy Consumers Australia (ECA) 2017, *Retail Energy Market research*, April 2017.

<sup>31</sup> Independent Competition and Regulatory Commission 2017, *Standing offer prices for the supply of electricity to small consumers from 1 July 2017*, Report 6 of 2017, Final report, June 2017, pp. 25-28; Queensland Competition Authority 2015, *Regulated retail electricity prices for 2015-16*, Final Determination, June 2015, p. 65

an equilibrium where Tier 2 and Tier 3 retailers, with higher operating costs, are offering the lowest prices to consumers. These lower prices appear to do little to constrain the prices that Tier 1 retailers are charging many customers. Despite their likely lower operating costs, Tier 1 retailers continue to charge a premium.

Research from Energy Consumers Australia (ECA) indicates the smaller Tier 2 and Tier 3 retailers incur higher operating costs than Tier 1 retailers.<sup>32</sup> Based on publicly available information, the smaller retailers appear to have a higher cost base (for customer acquisition, service, and financing) than the established Tier 1 retailers.

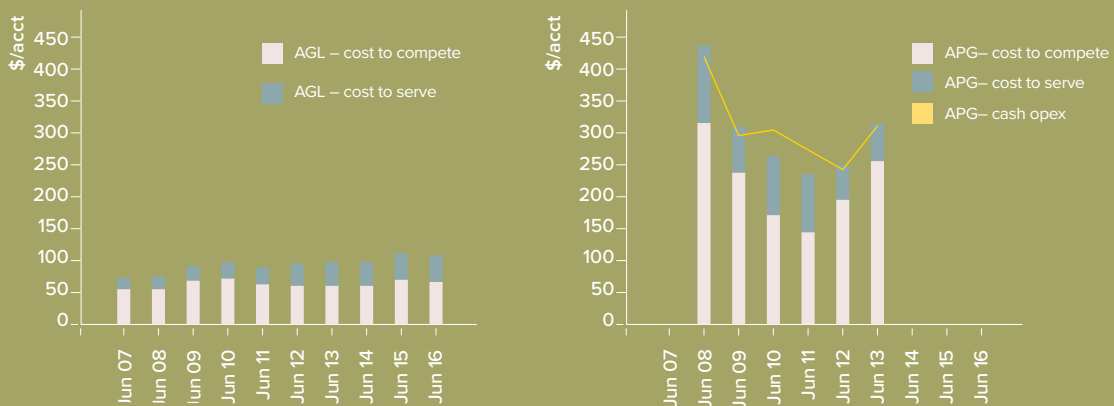
Case study 1 demonstrates the operating cost advantages of Tier 1 retailers compared with Tier 3 retailers. It documents the experience of Tier 3 retailer Australian Power and Gas (APG) and Tier 1 retailer AGL, highlighting the retail operating costs for APG were three times greater than for AGL. This is due to lower costs to service and the lower customer acquisition costs that Tier 1 retailers enjoy with their existing customer base.

Active consumers switch from the Tier 1 retailers to Tier 2 and Tier 3 retailers for the lower prices. They then switch between the Tier 2 and Tier 3 retailers much more regularly.<sup>33</sup>

## CASE STUDY 1: TIER 1 VS TIER 3 RETAILER OPERATING COSTS

Energy Consumers Australia contracted Finncorn Consulting to study the energy market based on investor reports and publicly available financial information. Specifically, the study assessed publicly listed retailers AGL (a large, vertically integrated Tier 1 retailer) and Australian Power and Gas (APG) (a smaller Tier 3 new entrant).

APG entered the market in 2007 and gained market share rapidly. Customers peaked at 342,000 in 2012. Despite this growth, APG's retail operating costs per customer remained three times greater than AGL's, resulting in APG running operating losses early in its business and again in 2013.



In contrast, AGL evolved from a retailer with minor generation to a fully-integrated 'gentailer', becoming one of three large retailers in the Victorian and national market, with sufficient generation capacity to cover its retail demand. Since 2007, AGL's cost to serve has remained broadly stable, while its costs to compete have increased, suggesting more competitive activity as it manages customer churn.

As APG and other small retailers entered the market, the cost to compete appears to have increased across the industry, and was higher for the small retailer as it sought to maintain a customer base with a high churn propensity. At the same time, APG's cost to serve was much higher than for AGL as its operational costs were spread over a smaller customer base.

In 2013, APG's customer growth stalled, earnings fell to negative, financial facilities were in breach of covenants, and the company appeared to be facing very serious challenges as a stand-alone entity.

AGL eventually acquired APG at a value of \$446 per customer. These customers, though unprofitable for APG, became profitable for AGL due to lower operating costs.

While the operating costs outlined in this case study are national costs and are drawn from a limited sample of a single Tier 1 retailer and single Tier 3 retailer, it provides a useful insight into the cost structures of the retail market in the absence of confidential financial information from retailers.

Source: Energy Consumers Australia (ECA) 2017, *Retail Energy Market research*, April 2017. Note APG's ASX ticker code was APK.

Inactive customers (called ‘sticky’ customers), who are cheaper to serve because retailers do not incur acquisition and retention costs for their customers, tend to remain with the Tier 1 retailers and pay a premium for loyalty. The more expensive (because of acquisition and retention costs) active consumers dance between Tier 2 and Tier 3 retailers.

Over time, the Tier 1 retailers are slowly losing market share, but maintaining a price premium remains a profitable strategy and the rate of customer loss is not sufficient to properly threaten their business. This indicates that competition from new entrants is not providing an effective price constraint for most consumers. It may also provide a continuing incentive for further entry of new Tier 3 retailers, who in turn add additional costs of customer acquisition and retention into the market, which are ultimately borne by consumers as they have no ability to exit the market and restrain prices. Some of this entry may not occur in a market where prices for more consumers are driven towards more efficient costs.

This suggests the retail energy market and the cost imbalance between Tier 1 retailers and Tier 2 and Tier 3 retailers are not generating beneficial outcomes for consumers. The current market structure may not be able to deliver benefits in the long-term interests of consumers.

## INDUSTRY PRACTICES CONSTRAINING EFFECTIVE COMPETITION

Competition was introduced to deliver benefits to consumers. However, many features of the market remain that prevent competition from achieving this objective. Many of these features are a result of industry practices and the regulatory framework, and include:

- » Discounting practices
- » Benefit and contract periods
- » Tariff structures, including the persistence of both fixed and variable components of tariffs
- » Customer acquisition and retention strategies
- » High fixed charges.

These industry practices make it difficult for consumers to engage with the market and obtain the best offers for their needs. This in turn dampens competitive pressure within the market as it is more profitable for retailers to engage in these practices than to provide better and more innovative services or to reduce costs to customers. The *Industry practices and regulation* section discusses these practices further.

The substantial number of different retail contracts

confuses consumers. The market contains a complex array of prices, tariffs, discounts and contract terms. Most consumers have difficulty making an informed decision. They resort to simplistic evaluation tools such as the discount on offers. Consumers, especially those who are vulnerable and disadvantaged, tend to defer more difficult decisions entirely.<sup>34</sup> More discussion about consumer engagement is provided in the *Consumer engagement in energy markets* section.

Even customers who engage with the market and obtain a market offer may lose a discount or other benefit before their contract ends. Given that energy is an essential service and the market is complex and confusing it is inappropriate to blame customers for failing to navigate the market and identify the best offer.

## CASE STUDY 2: ELECTRICITY BILL – HANDWRITTEN NOTE TO THE REVIEW

One of the bills collected during the review was accompanied by a letter that highlights the frustration of consumers, especially vulnerable consumers, who are not benefitting from the current state of the energy market.

The full letter is quoted below:

“Some comments – My husband is 86. I am 80. We are self-funded retirees who carefully monitor our expenditure.

Re- Power bills

Our biggest complaint is the system since privatisation. It’s confusing and misleading, especially as phone contact with our supplier is useless. We have no internet etc

The basic supply charges are too high. Even if we’re away from home, not occupying the house for a while, the SUPPLY CHARGE for ELECTRCITY is \$... for 18 days!

Also, there is no reward for paying on time or EARLY.

NOTE: The electricity bill enclosed shows a \$..... credit. That dates from 6 months ago when they overcharged nearly \$300, billing us twice for the same quarter. It took a lot of trouble for them to acknowledge that. They didn’t REFUND the money – but allowed it as credit over 2 quarters. I asked if we could have a reduction, as a form of compensation, but they refused.

It’s all very difficult for OLD PEOPLE.”

# INDUSTRY PRACTICES AND REGULATION

## CONTRACTS

There are two types of energy contracts in Victoria for residential and small business consumers: standard contracts and market contracts.

### Standard contract (or offer)

Consumers who have not changed their energy contract since 2002 when retail contestability came into force remain on a standard contract (often referred to as a standing offer). Consumers might also be on a standard contract by default if they did not choose an energy retailer when they moved house. Some retail contracts stipulate that a customer will be moved to the retailer's standard contract if they fail to make new arrangements at the end of their retail contract.

In Victoria, the retailer sets the price of its standard contract, so they vary between retailers and contracts. The price of energy used on a standard contract is typically significantly higher than a market contract.

Around 9 per cent of residential electricity and 11 per cent of residential gas consumers in Victoria remain on standing offer contracts, and around 17 per cent of small businesses electricity customers and 22 per cent of small businesses gas customers are on standing offers.<sup>35</sup>

### Market contract (or offer)

A market offer is one that a retailer makes available and a consumer chooses – the 'competitive offer' in the market. In the early days of Victoria's deregulated market, market contracts were generally 'fixed-term' contracts for 2 to 3 years but over time, retailers have reduced them to as little as 1 year. The Energy Retail Code requires retailers to advise customers in writing at the end of their contract (section 48 of the Code). It was anticipated this would trigger a customer to consider other retailers and contracts in the market.

However, many customers are not taking action when a retailer advises their fixed-term contract is about to end. This means they are losing benefits, or their retailer is reverting them to another type of contract, such as a standard contract which charges more for energy used.

This means a customer may take up a 1-year contract that offers a substantial discount on the costs of the energy they use (on the variable charge, but not on their fixed charge or total bill). If they fail to take action at the end of the contract, the retailer may move them to a much less competitive standard contract with no discounts.<sup>36</sup>

Submissions to the review also highlighted differing retailer practices when a customer's market contract ends. Several retailers shared that existing regulations require them to place a customer on a standing contract at the end of a market contract, unless that customer provides explicit informed consent to enter into a new market contract.<sup>37</sup>

### Evergreen contracts

In recent years, retailers have also introduced 'evergreen' contracts, meaning they are ongoing and without an end date. This avoids the need to advise a customer of a contract end and thus avoids triggering them to explore alternative retailers and contracts. Customers who fail to take action at the end of their fixed-term contract may be rolled onto an evergreen contract.

<sup>35</sup> Essential Services Commission (ESC) 2016, *Victorian Energy Market Report 2015-16*, November 2016, p. 86  
<sup>36</sup> Ben-David, R. submission to the review, p. 17  
<sup>37</sup> Origin Energy submission to the review, p. 15



## Prices can change anytime

A key criticism of retail contracts is the retailer's ability to change the price at any time during a market contract, even if a customer has just signed up.

Research by the Consumer Utilities Advocacy Centre has revealed that many consumers misunderstand that a 'fixed-term' contract relates to the time duration of their contract, and does not mean a 'fixed price'.<sup>38</sup> Some retailers offer a fixed price for a defined period of the contract (for example, the first 6 months of a 2-year contract) which can be called a price guarantee or price freeze, but the consumer cannot predict what price the retailer will charge once that defined period is up.

The Energy Retail Code does not necessarily require a retailer to alert a customer before they change the price during a market contract. Section 46 of the Code stipulates they must advise the customer as soon as practicable and otherwise no later than their next bill. The contents of this notification are at the discretion of the retailer – including the extent of the price variation and how much extra the customer will pay. The timing of the notice (on their next bill) may mean a customer may not become aware of the new price until it has been changed and they have been charged, and so they lose the opportunity to consider alternative options.

## PRICES AND CONTRACT TERMS

Complaints received by the Energy and Water Ombudsman Victoria (EWOV) relating to energy contract variations often involve a customer upset about prices increasing during fixed-term market contracts. The customer confuses 'fixed-term' as 'fixed-price'. These variations are sometimes combined with a loss of discounts – such as for paying on time – after a fixed period, often resulting in unexpectedly high bills. In 2015–16, the EWOV received 844 energy cases relating to contract terms.

Many customers complained they were not aware prices could increase during fixed-term contracts or that discounts or other benefits would cease before their contract ended. Sometimes this confusion was caused by incorrect or inadequate communication during the marketing interaction or unclear terms and conditions in the contract.<sup>39</sup>

## Benefit periods

In 2013, the Tier 1 retailers in Victoria began using the term 'benefit period' and most retailers now use this term.<sup>40</sup> 'Benefit period' was initially understood to mean just the period that additional benefits were offered on a contract (such as discounts for the first year of a contract) but some retailers also now apply the term to an entire contract (base rates as well as discounts).<sup>41</sup> This illustrates how definitions in the market can change, which can further confuse consumers.

The review examined these issues and found that current retailer practices and existing regulations have resulted in a situation where customers need to contact their retailer before their contract term or benefit period expires and select a new offer. Otherwise, they may lose their benefits or are automatically rolled on to a standing contract or another market contract (based on the terms and conditions in their original contract) which could leave them substantially worse-off (i.e. paying a high price).

<sup>38</sup> Consumer Utilities Advocacy Centre, *Fixing up fixed term contracts for energy customers*, 2012, p. 1.

<sup>39</sup> Energy and Water Ombudsman of Victoria submission to the review, p. 4

<sup>40</sup> St Vincent de Paul 2016a, *The NEM: A hazy retail maze—Observations from Vinnies*, December 2016, p. 53

<sup>41</sup> *Ibid.*, p. 53

Many consumers may not realise the benefit period is distinct and always shorter than the life of their market contract.<sup>42</sup>

For example, the website of one energy retailer offers three market contracts that are all ‘evergreen’ and ongoing, and all have a 12 month benefit period. Each contract states: “Your Market Contract has no fixed term and includes variable rates, which can change at any time with notice to you. However, at the end of your Energy Plan [benefit] Period you will be placed on a New Energy Plan which may include a different set of variable rates. We will write to you before this occurs”.<sup>43</sup>

While retailers say they will and do write to the customer before their benefit period ends, there is no actual requirement for this if the contract is an ‘evergreen’ ongoing contract under the Energy Retail Code.

In addition, retailers follow different practices relating to:

- » Pre-contract communications with customers about the nature and length of a benefit period, and what happens when it ends
- » Whether, and how, retailers notify customers when a benefit period is about to end
- » Whether customers are automatically placed on a new contract at the end of a benefit period, which can include a standing contract (which is usually more expensive)
- » Whether retailers give customers an opportunity to consider their options before the end of a benefit period, and whether this is an additional benefit period, a new contract, a standing contract or other arrangement
- » How retailers communicate end-of-benefit-period options. Some retailers will only list options over the phone (requiring a quick, on-the-spot decision) and do not provide them in writing to enable a customer to make more considered decision.

Without this information, consumers cannot assess the risks of benefit period deals, and they may agree to revert to a contract that charges them more after a relatively short period of time.

## DISCOUNTING PRACTICES

While some retailers offer one-off incentives on market contracts (such as a free month of energy, a \$50 credit or free movie tickets<sup>44</sup>), discounted offers comprise most competitive offers to consumers in Victoria’s energy market.

The most prominent feature of an energy retailer’s website or advertising is usually the discount they offer. Discounts have proven appealing to consumers because they seem simple to understand.

Energy retailers consulted for the review confirmed that consumers prefer discounted offers over non-discounted offers<sup>45</sup>, and the practice has been successful in promoting consumer engagement.<sup>46</sup> This has seen the type of discounts offered by retailers increase and evolve over the years.

The Newgate research found that 84 per cent of consumers surveyed said that discount offered was “very important” in their decision to switch retailers.<sup>47</sup> Discounting was the most determining factor in their choice to switch to another retailer by a significant margin.

### RESEARCH INTO CUSTOMER UNDERSTANDING OF DISCOUNT PRACTICES

An energy retailer shared with the review panel the findings of a marketing research project which involved asking 12 small to medium-sized business customers to compare three different offers: a no discount offer, a 12 per cent discount offer, and a 33 per cent offer.

Eleven of the 12 customers considered the 33 per cent discount offered the most value, even though it offered the least value. This demonstrates how customers have difficulty understanding discounting practices and identifying the best value offer.

<sup>42</sup> Alternative Technology Association submission to the review, p. 3

<sup>43</sup> <https://www.agl.com.au/residential/energy-plans/electricity-and-gas-plans> (accessed 28 June 2017)

<sup>44</sup> CME electricity analysis, p. 27.

<sup>45</sup> Origin Energy submission to the review, p. 15

<sup>46</sup> AGL submission to the review, p. 13

<sup>47</sup> Newgate Research 2017, *Consumer research for the Victorian Government’s review of the state’s energy market*, prepared for the Victorian Department of Environment, Land, Water and Planning, May 2017, slide 23

However, the review panel found that discounts can be difficult to understand and may mislead consumers. It is often not clear what the discount is from (the total bill or just on the variable charge/cost of the energy used) and what the actual price is that the consumer will pay. Consumers seem unaware that a discount rate does not mean 'the best price'. What is being presented by retailers as 'a simple decision for consumers to make' is in fact, a complex decision.

In addition, discounts, particularly conditional discounts, can disadvantage low income and vulnerable consumers.

### Types of discounts

The review found that retailers are offering various types of discounts. Some are conditional – such as a customer must pay on time, or by direct debit to receive the discount. Some are unconditional – such as a discount if a customer signs electricity and gas contracts with the same retailer (dual service, or bundling). The CME analysis of the sample of Victorian customer electricity bills found the most widely used discounts were conditional discounts on energy used (the variable charge). For example, a customer received a 10 per cent discount on the costs of energy they used (usually during a benefit period of a contract) if they paid on time, or by direct debit. The price for the fixed charges remained the same. This is not always made clear to customers; and even if it is made clear, it is not easily understood.

### Discounts are confusing

Understanding the detail of the discount, and the rates which it applies to, is vital in evaluating the offers to find the best value offer. However, this can be difficult due to the various and differing practices of retailers.

The variation in the discounts that retailers offer has steadily increased over time. When retail competition was introduced, discounts of 5 per cent were the most common, but these have since significantly increased in size.<sup>48</sup>

Confidential evidence provided by retailers to the review also indicated that an increasing proportion of consumers are being offered higher discounts. A Tier 1 noted that in its market testing, consumers preferred the larger pay-on-time discount (conditional) over a lower guaranteed (unconditional) discount.

The CME analysis of the sample of Victorian electricity bills also found that some customers were receiving larger discounts than retailers

advertised – including discounts above 40 per cent.<sup>49</sup> This indicates that if a customer contacts a retailer, they may be offered a bigger discount, and customers who have not contacted a retailer (i.e. just looked online) or have not switched retailers or contracts recently are often on lower discounts.

## CASE STUDY 3: IMPOSSIBLY HIGH DISCOUNTS

While the size of discounts that retailers offer customers has increased significantly from the original 5 per cent when competition was introduced, no retailer has hit the 50 per cent discount mark yet – or have they? Some customer bills collected for the review revealed extraordinarily high discounts.

One AGL bill that was analysed provided a 63 per cent discount off the customer's variable usage charge. The discount was compounded and included conditional and unconditional discounts: a 27 per cent discount for direct debit, a 28 per cent discount if they paid on time and an 8 per cent guaranteed discount. The bill also contained a concession amount in addition to the heavy discounts. These highly competitive offers are never advertised and not accessible to other customers.

This highlights the discounting practices that some retailers are adopting to retain individual customers, possibly at the expense of their other customers.

In addition, customers may be asked to sign up on the spot with a door-to-door salesperson, not being given time to consider the discount or the risk if they fail to meet the conditions of that discount offer.

The CME electricity analysis of the sample of customer bills as well as offers that retailers are making new customers in the market highlighted that a larger discount does not necessarily relate to a better offer. Indeed, the CME analysis showed that some bills in the customer sample that had no discount were hard to beat in the market.<sup>50</sup> This is because the critical factor is the *actual* fixed and variable charge, not the discount.

48 Ben-David, R. submission to the review, p. 15

49 On their usage costs, not their total bill; CME electricity analysis, p. 24.

50 CME electricity analysis, p. 53.

Further, the actual cost to the customer will depend on whether the discount is from the total bill or just the variable charge (cost of electricity used). For a consumer to understand a discount offer, they must examine the discount available as well as the rate on which the tariffs being offered are calculated. Without that information, and time and interest to understand the price impacts, consumers are unable to effectively choose.

### CASE STUDY 4: DISCOUNTS – WHEN LESS IS MORE

Applying discounts off different bases makes the market extremely confusing and can lead to poorer outcomes for consumers.

What if a 10 per cent discount represents a greater saving than a 50 per cent discount? Discounts are relative – \$10 dollars off \$20 is regarded greater than \$10 dollars off \$100 even though the absolute discount of \$10 is the same. A 50 per cent discount is regarded as much greater than a 10 per cent discount, but relative to what?

The customer bills analysed for the review showed that retailers do not apply consistent approaches to discounting, or are discounting off the costs for energy used (variable costs) vs the total bill costs (fixed and variable costs combined). GloBird Energy bills showed that while most discounts were taken off the total bill, some discounts were based only on costs of energy used. One customer received a 40 per cent discount while another in the same network zone received a 33 per cent discount. At first glance, the 40 per cent discount looks better. However, if that discount was applied only to the variable charge (cost for energy used) while the 33 per cent discount applied to the total bill, the lower discount provided a greater saving.

In addition, not everyone gets offered the same discounts. The discount offered also may consider the circumstances of the customer, meaning it is less likely that some discounts will be offered to a customer with a poor credit history with the retailer. This means that lower income consumers who may have experienced extreme difficulty paying energy bills in the recent past will not be offered the same discount as a customer who has always paid on time.

Case study 5 demonstrates how discounts doesn't always offer the good deal a consumer believes and how discounts can confuse consumers.

### CASE STUDY 5: KEEPING UP WITH THE JONESES

Some retailers have adjusted their practices of offering higher discounts and discounts off the costs of energy used (the variable charge) vs the total bill to retain only their headline discount so that it matches their competitors, with no genuine focus on reducing their prices or improving their service to customers.

One customer provided the review a copy of their price change notification letter from their retailer. The letter stated:

*Your energy plan changed recently and any discounts on your new plan are applied only to your usage charges. This change brings us in line with other major energy retailers, making it easier for you to compare energy plans.*

This communication does not provide a very clear and transparent rationale for the change in discounting or what this change means for the customer in terms of the price they will pay. In addition, the letter is misleading because many retailers offer discounts on total charges, including the Tier 1 retailers. For example, on 27 July 2017, AGL was prominently offering a discount off fixed (supply) and variable (usage) charges on its website.

### The high risk of conditional discounts

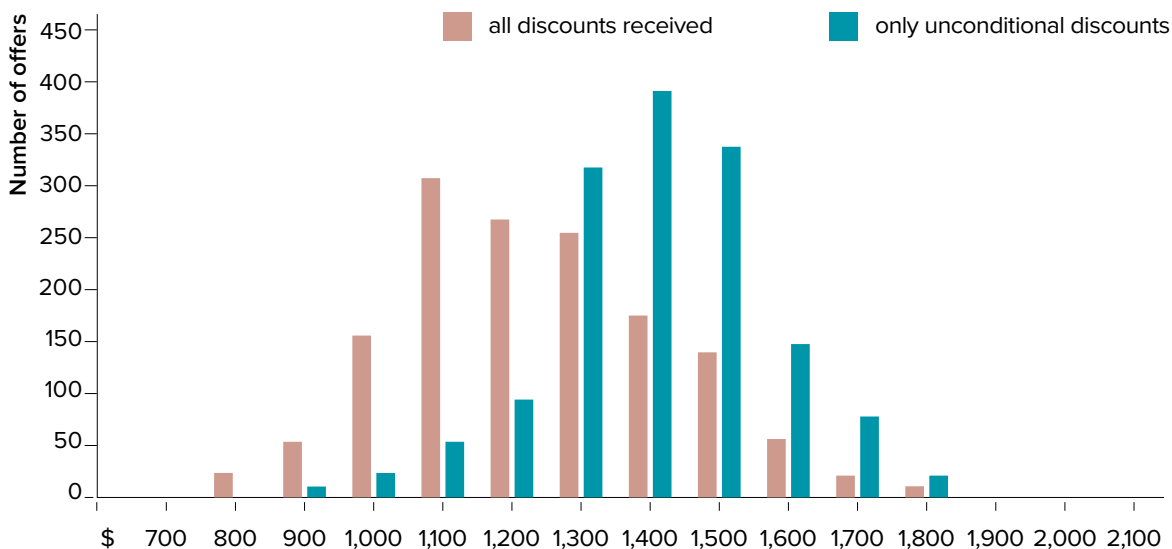
Retailers promote conditional discounts such as pay-on-time discounts to consumers because if they pay on time it supports the retailer with managing its financing and cash flow.

However, these conditional discounts can also lead to substantial cost to a consumer if they pay late. Community-based organisations highlighted to the review panel that conditional discounts are in fact the equivalent of a late payment fee, which the Victorian Government banned in 2005.

While it is recognised that late payments impose a cost on retailers, a vulnerable consumer who takes up a market offer with a high conditional discount based on pay-on-time and then experiences financial difficulty and pays late can end up paying hundreds of dollars more for their energy.

Figure 26 shows the annual charges on the offers in the market with conditional discounts and demonstrates that if the conditions are not met, annual charges are typically in the range of \$1,300 to \$1,500 per year. If the conditions are met, the annual charge is most frequently in the range of \$1,100 to \$1,200 per year.

**Figure 26** Charges with and without conditional discounts (4MWh per year household)



Source: Based on CME electricity analysis, Figure 44, p. 80

### Discounts and retail charge

As one submission to the review highlighted, if retailer margins are traditionally estimated at 15 to 17 per cent, then how can the retailers be offering 30 per cent and 40 per cent discounts on electricity prices unless the basis rates on which those discounts are offered are inflated.

The increasing standing offer prices and spread in the market suggest that standing offers are being increased, to allow for ever larger discounts to be offered to consumers.

*...some retailers are pricing higher and offering large discounts to attract customers. This can result in customers switching to retailers or products that do not result in better value.<sup>51</sup>*

Often the rates upon which the discount is applied is hidden from the consumer. While retailers must publish the tariffs and fees on their price fact sheets, these are embedded within their websites, multiple clicks away from where the available discount is displayed.

Should the customer want to know the actual price to determine if the discount will provide better value, they need to open the price fact sheet,

know their energy consumption amount, know the fixed supply charge, know whether to apply the discount to the variable charge (cost of energy used) or the total bill, and then calculate the likely price outcomes.

Notably, the cheapest offer on the CitiPower website did not offer any discounts at the time of this report's writing (July 2017). This obscures the market further, as consumers accustomed to other markets would not expect that for the same product, the discounted price is more expensive than the undiscounted product.

Discounts linked to pay on time, or on-line billing disadvantage low-income and vulnerable customers, despite the fact that energy is an essential service.

These concerns with discounting practices have led many commentators to argue that discounting is not producing the best outcomes for consumers and that government intervention is required. Energy retailer EnergyAustralia acknowledges that discounting practices erode customer confidence that they are receiving value for money.<sup>52</sup>

<sup>51</sup> EnergyAustralia submission to the review, p. 15  
<sup>52</sup> Ibid, p. 7

Case study 6 demonstrates how individual high discounts offered to some customers mean that others invariably pay, and how customer loyalty is not always rewarded.

### CASE STUDY 6: PENALISING LOYAL CUSTOMERS WITH A 'LOYALTY TAX'

Customer bills collected for the review confirmed that some customers are penalised for loyalty to their retailer. In the Powercor distribution network area, one customer who had remained with EnergyAustralia since October 2011 was receiving a 7 per cent conditional and 3 per cent unconditional discount on their variable charge (costs of energy used), savings of around \$900 since 2011. However, a new customer who switched to EnergyAustralia in February 2016 was paying the same fixed supply and variable usage charges but enjoying a much higher 37 per cent conditional discount on the variable charge, and had already earned discount savings of around \$400 in their first year with EnergyAustralia.

Another EnergyAustralia bill showed that a loyal customer since November 2006 was receiving a 13 per cent pay-on-time discount and a 3 per cent unconditional discount on their total bill, saving around \$900 through discounts since November 2006. A new EnergyAustralia customer since January 2016 on the same underlying supply and variable charges was receiving a higher 30 per cent discount on usage, saving around \$250 in a single year.

## CUSTOMER ACQUISITION AND RETENTION PRACTICES

Retailers engage in a variety of customer acquisition and retention practices. These include marketing campaigns, telemarketing, discounting and one-off incentives for customers to switch retailers or offers, or to encourage an existing customer to stay with them.

As discussed in previous sections, costs of customer acquisition can be expensive and create a significant cost burden on a retail business – sometimes being almost as much as a retailer's net margin. These costs need to be recovered over the remaining customer base.

Arguably, retailers also engage in certain customer acquisition and retention practices that may not be in the best long-term interests of customers. A discussion of some of these practices, such as door-to-door sales and telemarketing and the use of third-party brokers is provided below.

Some retailers appear to compete primarily on price, with one retailer indicating it tries to offer lower prices than the cheapest Tier 1 retailer so that customers have a reason to switch. Other retailers referred to more service-oriented strategies for gaining and retaining customers, such as being Australian-owned and operated, and investing in customer relationship management systems to increase customer satisfaction.

In addition to more traditional customer acquisition methods such as door-to-door sales and telemarketing (discussed below), retailers generally also operate digital sales channels where they encourage customers to sign up online. Some Victorian retailers, such as Click Energy, even market themselves as being 100 per cent online. Retailers generally expressed they were trying to grow these digital channels, which are more cost-efficient to operate.

Other popular marketing tactics include offering sign-up credits, bonuses or credits to customers for behaviours such as for referring a friend, and specific customer acquisition campaigns offering deals such as paying zero fees or getting your first month of electricity for free. Some retailers also work with specific partners and/or clubs to offer their members particular deals.

## Brokerage services

Another common practice among energy retailers is to use third-party services, such as brokers and comparator sites to acquire customers. Comparator sites such as iSelect, Compare the Market and Make It Cheaper are used by many consumers to engage with the market and source information about market offers.

While energy retailers were reluctant to share much about their business practices with the review panel, they did indicate that comparator sites are expensive. For example, in its submission to the review, AGL said it had expected acquisition costs to reduce with greater use of digital channels, but this had not occurred because of unregulated commercial comparator websites.<sup>53</sup>

Some retailers indicated comparator sites charge a fixed fee per residential customer delivered, equivalent to roughly 10 per cent of the total annual customer bill. Commissions paid for these expensive services contribute to retailer costs, which are likely passed to customers.

Many retailers indicated that while they would prefer not to use these services, they were necessary for attracting new customers because so many used them. One retailer said approximately 20 per cent of their sales came from third-party channels.

Consumers may not be aware that not all retailers in the market are featured on 'free' comparator websites and therefore don't represent all market contracts on offer. The review searched 14 comparator websites operating in Victoria and found that all received commissions from participating retailers for each referred customer.

Most comparator websites also reveal (if you look carefully) that they have 'partnerships' with certain preferred retailers, with some stating they only compared products from these partners. Each site worked with a different number of 'partners' or 'preferred retailers', with the number varying from four to 16 retailers. Considering the significant number of retail competitors in the Victorian market, it is obvious that if a customer looks at just a single comparator website they are not seeing all the offers available in the market.

Comparator sites do not necessarily include all the offers from their retail partners either. For example, Energy Watch states on its website that it:

*...compares products from our partners whose logos appear above. Not all products available from our partners are compared by Energy Watch and due to commercial arrangements or service availability, not all products compared by Energy Watch will be available to all customers. Some products are available only from our call centre and others are available only from our website.<sup>54</sup>*

While the review panel did not have access to information that confirms this statement, many comparator sites also appear to promote 'sponsored offers', which are presented to customers in a more favourable manner because the site has a commercial relationship with the retailers (rather than an offer's intrinsic merits).<sup>55</sup> Fundamentally, these practices do not promote confidence in the market or empower customers to make informed decisions.

## Comparator websites are unregulated

Comparator sites are not currently regulated, though some are covered by the Energy Comparator Code of Conduct (ECCC), a voluntary, self-enforceable code.<sup>56</sup> The ECCC was launched by the predecessor of the Consumer Policy Research Centre (CPRC), the Consumer Utilities Advocacy Centre (CUAC).

To date, 12 ECCC signatories have agreed to a set of disclosure requirements to ensure information disclosed is accurate, presented in a consistent manner, and that the comparator discloses how the site works and its commercial relationships with retailers.

The ECCC has not been reviewed since it was introduced in August 2015, despite annual reviews being required to ensure signatories remain compliant. The CPRC is unable to continue as the administrator of the ECCC. The body is working with Sales Assured Limited (SAL) to become the new administrator, with the CPRC having an advisory role.

<sup>53</sup> AGL submission to the review, p. 6

<sup>54</sup> <http://www.energywatch.com.au/>

<sup>55</sup> [https://www.cuac.org.au/images/ECCC/Energy\\_Comparator\\_Code\\_of\\_Conduct\\_self-enforced\\_August\\_2015\\_Final.pdf](https://www.cuac.org.au/images/ECCC/Energy_Comparator_Code_of_Conduct_self-enforced_August_2015_Final.pdf)

<sup>56</sup> <https://www.cuac.org.au/consumer-and-community-resources/energy-comparator-code-of-conduct>

### Victorian Government comparator website

Many stakeholders, including retailers, noted during their discussions with the review panel and in their submissions that the Victorian Government's official comparison website, *Victorian Energy Compare* (VEC) was good, but cumbersome. They expressed support for improving the site to increase its visibility in search results, align it with the comparator site operated by the Australian Energy Regulator,<sup>57</sup> and make it a more user-friendly and understandable comparison tool.

It was suggested that if the VEC website was improved, perhaps fewer customers would use the commercial comparator sites, which are less accurate and not as unbiased. The Consumer Action Law Centre and Consumer Policy Research Centre (formerly known as the Consumer Utilities Advocacy Centre) also made recommendations to the review around the VEC site gaining access to smart meter usage data to allow customers to compare retail offers more easily and accurately.

## MINIMAL INNOVATION IN TARIFF STRUCTURE

Despite the deregulation of Victoria's energy markets, most consumers remain on old tariff structures that existed before deregulation.

Momentum Energy's submission to the review noted that:

*Until relatively recently, retail tariffs have largely reflected the structure of network tariffs as this approach best mitigates the risks that a retailer faces if the customer's consumption patterns do not align with expectations. (p. 5)*

Networks continue to offer traditional tariff structures to retailers, which are in turn informing the offers being made to consumers. New tariffs that have become available since the installation of smart meters enable flexible pricing based on the times that energy is consumed in each Victorian household.

The retail market has seen the emergence of bill smoothing and predictable pricing plans for consumers who wish to manage the cost of energy over the full year. These services usually come with a premium or incentivise pre-payments that place the consumer in credit with the retailer to avoid the retailer holding bad debt, which improves the retailer's credit position. Predictable plans are assessed each year to determine if the plan matches the consumption amount and patterns of the customer.

Momentum Energy's submission to the review also noted that:

*With the widespread rollout of smart metering technology retailers are now beginning to roll out new tariff structure and innovative products as greater insights exist into actual customer consumption patterns. (p. 5).*

There is support in the market from consumer groups, distributors and retailers for ongoing tariff reform and innovation to assist with demand management and better consumer outcomes. While this is a positive, it needs to be done in a way that maintains accessibility and understandability for all consumers.



# CONSUMER ENGAGEMENT IN ENERGY MARKETS

It is commonly argued that the more consumers understand and engage with the competitive energy market, the more likely they will get a better deal.

However, the CSIRO and Newgate research has shown that many Victorians are not actively participating in the energy market. They use energy continuously but make purchasing decisions infrequently.

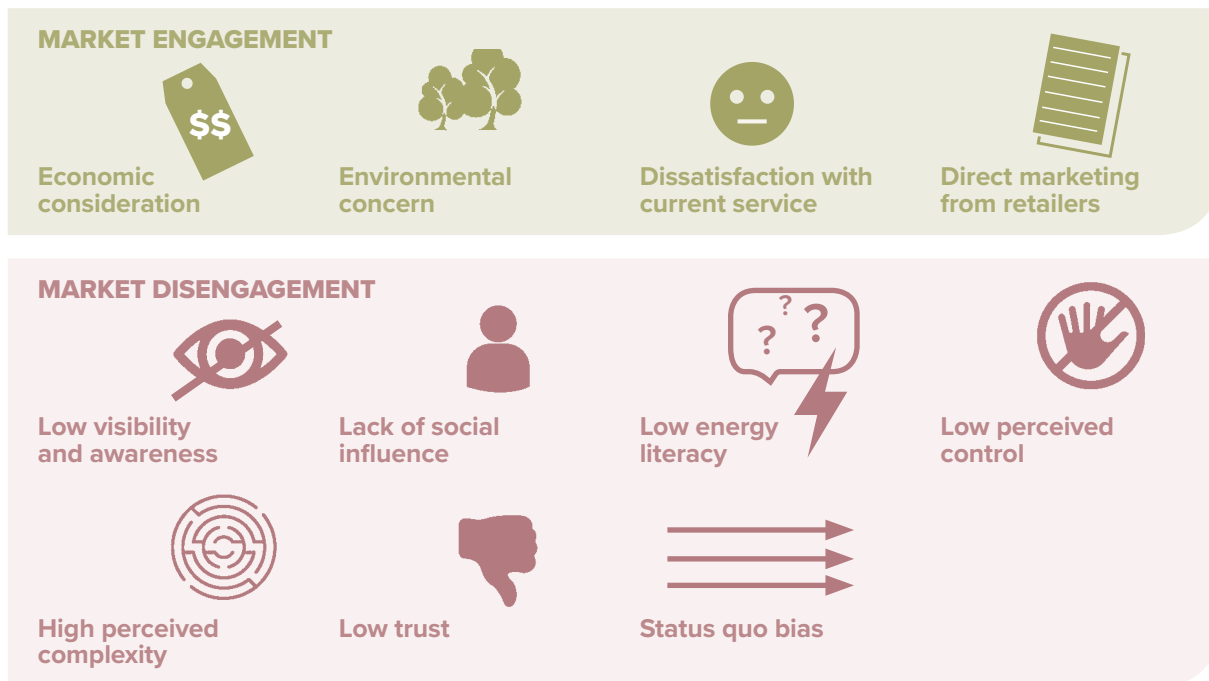
Energy retailers are all essentially selling the same thing. As the Grattan Institute has noted, there is no such thing as 'super electricity'.<sup>58</sup> Retailers cannot differentiate their electrons from the electrons of other retailers. They compete mainly on price and service.<sup>59</sup> So why aren't all consumers actively engaging in and getting the best deal from Victoria's energy market?

## BARRIERS AND DRIVERS OF CONSUMER ENGAGEMENT

Engagement in the energy market is a very specific set of behaviours that can be viewed through a behavioural science lens to help understand how, when and why these behaviours happen (and just as importantly, why they might not happen).

Consumer engagement in the energy market is influenced by drivers that encourage it and barriers that discourage it. These can be summarised into four key drivers and seven main barriers, as set out in Figure 27.

Figure 27 Drivers and barriers to consumer engagement in energy markets



Source: Based on CSIRO Research, Figure 1, p. 3

<sup>58</sup> Grattan Institute 2017, *Price shock, is the electricity market falling consumers?*, March 2017, p. 21

<sup>59</sup> Although some retailers differentiate their product by selling electricity from renewables rather than fossil fuels, this 'green' power is effectively the same product, but one that some consumers place a higher value on. Moreover, consumers pay a premium price to receive this product – it is not covered by the general increase in electricity prices Victoria has experienced. Source: Grattan Institute 2017, *Price shock, is the electricity market falling consumers?*, March 2017, p. 21

## Drivers

The CSIRO research<sup>60</sup> identified four broad drivers that can encourage consumers to engage in energy markets which can broadly be categorised as:

- » **Economic considerations** – consumers who consider switching tend to be responding to high energy bills, or are seeking to take advantage of financial incentives. However, consumers have a relatively high threshold for the size of saving they find sufficiently compelling to switch and they also give potential future savings less weight.<sup>61</sup>

Research conducted for the review<sup>62</sup> found that cheaper offers and discounts were the most important factors when residential and small business consumers decided to switch.

- » **Environmental concerns** – while consumers cite environmental concern as the second major consideration for trying to reduce their energy consumption (after saving money), it is not clear that this directly provokes engagement in the energy market except when consumers are explicitly pursuing a ‘green’ energy option.
- » **Dissatisfaction with their current service** – consumers who form a specific sense of dissatisfaction with their energy retailer might be prompted to investigate alternative providers.
- » **Direct marketing from retailers** – retailers have historically invested extensive effort and expense in door-to-door promotion of plans to residential customers, although this activity arguably drives switching rather than more general market engagement.

## Barriers

The discussion in the *Industry practices and regulation* section highlighted how the myriad of different electricity offers in the market makes it difficult for consumers. In most markets, there is a clear dollar amount advertised for the goods or services being purchased. However, in the energy market, many consumers do not understand the costs of different energy contracts – they have little knowledge of what actual ‘price’ they will pay. Further, they must consider the relative impact of fixed (supply) and variable (usage) charges on varying volumes of use.

Most retailers the review consulted with conceded that discounting practices were confusing for consumers. Many consumers want to save money on their bills, but find it complex and difficult to understand the different offers in the market. They conclude that it’s safer to stay with their current energy retailer – even if that means potentially missing out on a better deal.

### Switching behaviour and the cost to switch

The number of consumers who switch energy retailers and how often they switch is a key indicator of the engagement with the market.<sup>63</sup> While rates of switching behaviour are cited as evidence of a competitive energy market, these alone are not an adequate measure of market competition.

The 2017 consumer survey of the AEMC Retail Competition Review suggests that around half of the customers in the NEM have not switched providers or plans in the last 5 years. This is a cause for concern as most market offers include benefits that may expire after a limited period; usually after 12 to 24 months. This means consumers who do not switch regularly may not be benefitting and are paying higher energy costs than others.

<sup>60</sup> CSIRO Research, p. 3, 8-10.

<sup>61</sup> The AEMC 2016 Retail Competition Review reported that residential consumers across the NEM said they would need to save \$217 a year on average to ‘seriously consider’ switching their electricity retailer or plan and \$177 to consider switching their gas retailer or plan. Similarly, small business owners said they would need to save \$511 a year on average to consider switching their electricity retailer or plan. Source: Australian Energy Market Commission (AEMC) 2016, *2016 Retail Competition Review, Final report*, June 2016.

<sup>62</sup> Newgate Research, *Consumer research for the Victorian Government’s review of the state’s energy market*, May 2017.

<sup>63</sup> There are two key sources that report switching data: Essential Services Commission (ESC) 2016, *Victorian Energy Market Report 2015-16*; Australian Energy Market Commission (AEMC) 2016, *2016 Retail Competition Review, Final report*, June 2016. Both reports identified similar switching rates. Notably, the switching data reported captures only customers that switch from one retailer to another. It does not capture customers that switch from one offer to another with their existing retailer.

Also, while switching rate or ‘churn’ is often cited as an indicator of informed consumer engagement and participation in the market, rates of switching may mask barriers preventing more Victorian consumers from accessing the benefits of competition. Switching can be interpreted as meaning that consumers are engaging to take advantage of lower prices, or it may just mean they are unhappy with their retailer.<sup>64</sup> It would also appear that much of the switching is by a group of active customers who continue to switch between Tier 2 and Tier 3 retailers, whereas there is less switching by customers from Tier 1 retailers.<sup>65</sup>

Customer churn adds to retailer costs (customer acquisition and retention costs) which are eventually passed on to consumers. KPMG’s research into how international retail energy markets operate highlighted that international jurisdictions that support consumers to shop around typically have higher margins, greater price dispersion and more offer diversity<sup>66</sup>.

Of course, residential and small business consumers vary in their demographic, social and economic characteristics. This includes their age, income, energy literacy, size of household or business, and their desire, willingness and ability to engage in energy markets.

Some consumers cannot access competitive outcomes. These include consumers in embedded networks (such as apartment blocks, retirement villages, caravan parks and shopping centres where the site owner sells energy to residents or tenants) and regional gas consumers. In some regional areas of Victoria, particularly areas that have benefited from government funded natural gas extensions, just a single gas retailer is available, excluding these consumers from the market. “Take it or leave it” scenarios are unacceptable when accessing an essential service.

The lack of consumer engagement in energy markets can be viewed as consumers simply acting as if energy was still a monopoly product. It is possible the essential service nature of energy is responsible for this: consumers cannot exit the energy market, they need to use energy, and the amount of energy they purchase stays the same no matter which retailer they are with.

## Outcomes for vulnerable consumers

Vulnerable consumers are subject to the same drivers and barriers as other consumers, but some may be markedly less able to overcome these barriers or capitalise on the drivers.

This means they potentially face worse outcomes than the average consumer. For instance, vulnerable consumers are excluded from participating in the energy market if they cannot access products that require a certain level of income and access to technology and credit, such as direct debit deals, internet-only deals and pay-on-time discounts – particularly as these discounts bear little resemblance to the costs that retailers incur from late payment.

Consumers who are less engaged with the market may be more exposed to unexpected price rises. At the same time, there could be more opportunities for these groups to benefit, such as by using smart meter data.

## Limitations of behavioural interventions

Behavioural-based interventions can only achieve so much in a context which is so antithetical to active consumer engagement. While behavioural scientists are justifiably enthusiastic about their capacity to design interventions that achieve change, the large-scale and long-term contextual problems present in the current energy market require more than small-scale, short-term solutions.

KPMG’s research of international competitive energy markets suggests that a comprehensive suite of information and engagement policies and actions over the longer-term are usually required to achieve high levels of engagement and positive outcomes for consumers.<sup>67</sup>

A consumer information and engagement program is most effective when it is supported by other measures which make switching easier, such as an efficient consumer transfer process.<sup>68</sup>

64 KPMG Analysis, p. 4  
65 Morgan Stanley Research 2017, *Shocked by the Power Bill*, analysis of AEMO data, July 2017  
66 KPMG Analysis, p. 16  
67 Ibid, p. 19  
68 CSIRO Research, p. 15

# LOW INCOME AND VULNERABLE CONSUMERS

Low income and vulnerable consumers in Victoria's energy market have less capacity to engage in the retail energy market. This means they are less able to take advantage of competitive offers, and because their incomes are generally lower than the average consumer, the negative impact on their lives is greater.

## VULNERABLE AND AT-RISK CONSUMERS

The CSIRO research identified a range of groups classed as being vulnerable in the Victorian community, including:

- » Culturally and linguistically disadvantaged consumers
- » Aboriginal and Torres Strait Islander people
- » Low-income families, particularly those with a number of children
- » Households with low net worth
- » Single parent households
- » Single income households
- » Elderly people on aged pensions
- » People with medical and reduced cognitive capacity.<sup>69</sup>

Some consumers within these groups may also experience digital exclusion, which exacerbates their disadvantage.

These groups of consumers are subject to the same drivers and barriers as other consumers.<sup>70</sup> They experience the same confusion, complexity and lack of transparency of other consumers. However, due to income, capacity to engage or language, they may be markedly less able to overcome these barriers or capitalise on the drivers.

Vulnerable and at-risk consumers are often excluded from opportunities in the energy market if they are unable to take action that requires a certain level of income, such as installing solar technologies or replacing inefficient electrical equipment. Offers that are conditional, including

direct debit discounts, pay-on-time discounts or internet-only deals, may not be an option for vulnerable consumers.

Rising retail energy prices place vulnerable consumers under greater stress. Energy prices in Australia have increased markedly since 2005. While energy bills represent just 2.7 per cent of today's median household budget, the 20 per cent of households with the lowest income spend on average 5.6 per cent of their household budget on gas and electricity.<sup>71</sup> Some spend more. The barriers in the retail energy market that prevent them from reducing their energy costs has a more significant impact.

Given this, additional assistance is required to support vulnerable consumer groups to minimise their energy costs, including by ensuring they obtain the most affordable energy offer available.

Some retailers have recognised that vulnerable consumers should be helped to reduce their energy bills, including by providing concession card holders on standing offers an immediate discount or more appropriate tariffs. However, these discounts and tariffs may still be significantly more expensive than the retailer's best market offer.

Providing dedicated services for these consumers will help them to navigate the market and obtain the most affordable energy offer available.

## HARDSHIP CUSTOMERS

The group of consumers that is unable to, or is at risk of being unable to pay their bills in a timely manner are known as 'hardship' customers. Customers who are experiencing hardship are entitled to receive support from their retailers and the government.

<sup>69</sup> CSIRO, *Exploring the drivers and barriers of consumer engagement in the Victorian retail energy market*, April 2017, p. 11

<sup>70</sup> *Ibid.*, p. 11

<sup>71</sup> *Ibid.*, p. 9

In 2015, the ESC commenced a review into the support provided by retailers to hardship customers, in part responding to the high rates of disconnection in Victoria. It published its final draft report in February 2016.<sup>72</sup>

The ESC review found that

- » Customers in payment difficulty often use more energy than other customers
- » Existing hardship programs were generally ineffective at preventing customers from accumulating further debt, by the time help is offered
- » It is often too late to assist customers to manage their debt
- » Some retailers offer more help than others but customers cannot count on a consistent or minimum standard of assistance.

Following an extensive consultation process, the ESC subsequently released its new draft framework relating to hardship customers in May 2017.<sup>73</sup> Importantly, the draft framework is centred on customers and customer outcomes. If the framework is implemented, customers in payment difficulty would be entitled to receive assistance. Retailers would be required to offer assistance to customers.

For customers unable to pay the full cost of ongoing energy use, the retailer would need to offer:

- » The tariff that is most likely to minimise the customer's energy costs
- » A suite of practical assistance to help the customer reduce their use of energy
- » Information about how the customer is progressing towards lowering their energy costs.

These requirements would ensure that retailers would only pursue disconnection as a measure of last resort.

Those consumers most affected are not necessarily aged pensioners and the lowest income earners. Socio-economic drivers and individual circumstances (such as the loss of a job) often drive consumers into hardship. While older people have lower incomes and lower consumption on average, those in hardship are more likely to be aged 30–55 years and be supporting families.<sup>74</sup>

The Victorian Government's Utility Relief Grant (URG) is available to eligible cardholders unable to pay their electricity, gas or water bill due to a temporary financial crisis. Concession card holders need to apply to receive a grant through their energy retailer. The people in the family formation bracket are often not covered by concession schemes, although they can apply to receive a utility relief grant if they can demonstrate hardship.

Currently, the Victorian Government's URG scheme and the customer hardship programs of individual retailers represent the primary points of contact for people having trouble paying energy bills.

Submissions to the review raised concerns that the URG scheme was administratively difficult to access. ESC data shows that 62,000 hard copy URG scheme forms were provided to customers last year. However, only 33,000 completed forms were submitted to the Department of Health and Human Services (DHHS).<sup>75</sup>

The URG scheme was described as having a "slow and burdensome application process", and a review of retailer hardship programs concluded they were not effectively identifying and engaging with consumers facing hardship.<sup>76</sup>

Those in hardship are at risk of long-term harm and disconnection if costs are not managed and the Victorian Government should continue to enhance the framework that supports these consumers.

## VICTORIAN GOVERNMENT CONCESSIONS

The Victorian Government pays a range of rebates and grants to concession card holders including pensioner, seniors, veterans and health care card holders.

These rebates and grants provide support for paying energy costs. Some provide specific support for people with medical and life support requirements, and for low consumption households and those having trouble paying.

A concession card holder is entitled to a 17.5 per cent discount on their year-round electricity bill and the same discount on their winter gas bill. Additional rebates are available depending on their circumstances. Available energy concessions are outlined in Table 3.

72 Essential Services Commission (ESC) 2016, *Supporting customers, avoiding labels: Energy hardship inquiry final report, Final report*, February 2016.

73 Essential Services Commission (ESC) 2017, *Payment difficulty framework: New draft decision*, May 2017.

74 Simshauser, P and Nelson, T. 2012, *The Energy Market Death Spiral Rethinking Customer Hardship*, AGL Applied Economic and Policy Research, Working Paper No.31 – Death Spiral, June 2012.

75 Essential Services Commission (ESC) 2016: *Victorian Energy Market Report 2015-16*, November 2016, pp. 107-108

76 CSIRO Research, p. 2

**Table 3 Victorian Government energy concessions**

Victorian energy concessions	Description	Value
Annual Electricity Concession (AEC)	All year discount on electricity bills.	17.5% off electricity bills*
Winter Energy Concession (WEC)	Discount on gas bills during the 6 winter months (1 May–31 October).	17.5% off gas bills*
Controlled Load Electricity Concession	All year discount on off-peak (controlled load) electricity consumption.	13% off controlled load off-peak consumption
Service to Property Concession	Applied if the cost of electricity used is less than the supply charge.	Reduces the supply charge to the same amount as the cost of electricity over the billing period
Electricity Transfer Fee Waiver	The fee charged by electricity retailers when consumers move homes is waived.	The value of the fee
Life Support Concession	Provides a discount on electricity bills where a member of the household uses an eligible life support machine.	The discount is equal to the cost of using 1,880kWh per annum
Medical Cooling Concession	Additional discount on electricity summer bills (from 1 November to 30 April) where a member of the household has a medical condition that affects the body's ability to regulate temperature.	17.5% off electricity bills (in addition to the AEC)
Non-Mains Energy Concession	Discount for households who rely on liquefied petroleum gas (LPG), firewood or oil for heating, cooking or hot water. It also applies to households relying on a generator or those who access non-mains electricity through an embedded network.	Up to \$484 per year <sup>^</sup>
Utility Relief Grant Scheme	The Utility Relief Grant is available to eligible cardholders who are unable to pay their mains electricity, gas or water bill due to a temporary financial crisis.	Capped at 6 months worth of usage up to a maximum of \$500
Non-Mains Utility Relief Grant Scheme	The Utility Relief Grant is available to eligible cardholders who are unable to pay their mains electricity, gas or water bill due to a temporary financial crisis.	Capped at six months worth of usage up to a maximum of \$500

\* In July 2012, a threshold for the electricity and gas concessions was introduced to offset the Australian Government's carbon tax compensation. The AEC is not applied to the first \$171.60 of a household's annual electricity bill and the WEC is not applied to the first \$62.40 of a household's winter gas bill.

<sup>^</sup> As of July 2013

**Source:** Department of Health and Human Services: accessed at <http://www.dhs.vic.gov.au/for-individuals/financial-support/concessions/energy>, July 2017

Concession card holders automatically receive many of the concessions directly from their retailers once they inform the retailer they are a concession card holder. The retailer confirms eligibility and is reimbursed by DHHS.

Concession card holders represent a broad range of consumers, including aged pensioners, disabled, culturally and linguistically diverse and low-income families. They hold energy plans and conditions

similar to the broader population of Victoria, but their energy consumption is lower, particularly if they are older.<sup>77</sup> While many low income and vulnerable consumer groups are partially assisted through the Victorian Government's energy concession rebates, not all low income and vulnerable consumers are covered.

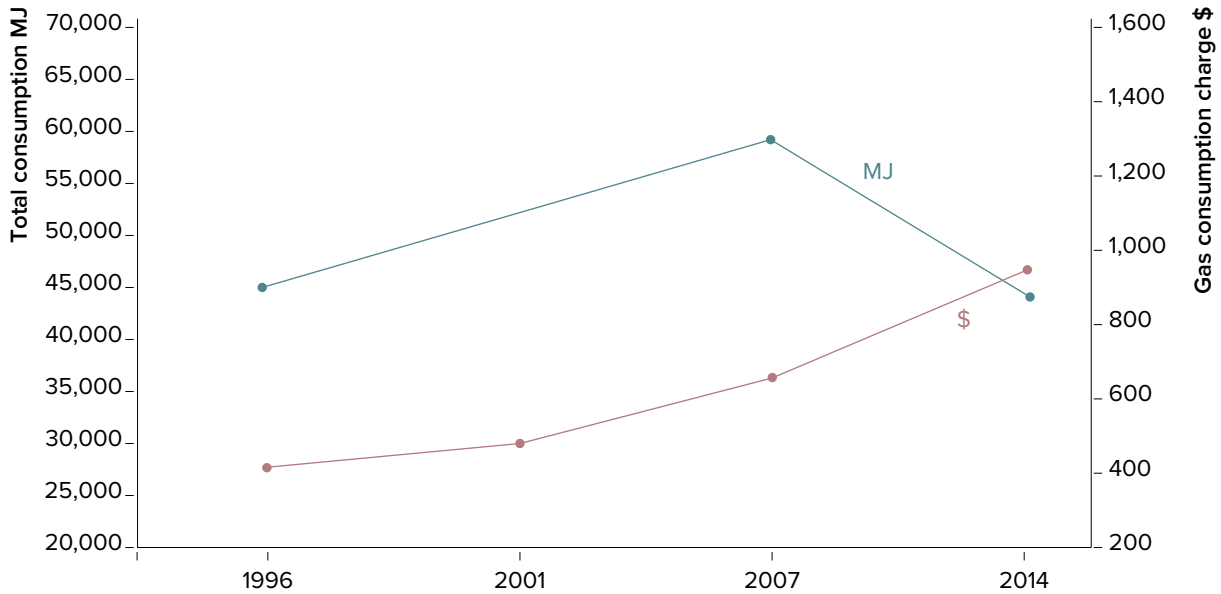
The DHHS 2015 Victorian Utility Concession Holder Survey<sup>78</sup> shows that while concession card holders (in line with the general population), are reducing their energy consumption, their energy costs are rising:

» Figure 28 (figure references to update) shows a similar pattern for annual gas consumption per concession household, with a 25.4 per cent decrease in consumption from 2007 to

2014 while the annual gas cost per household increased 45.5 per cent, from \$650 to \$946.

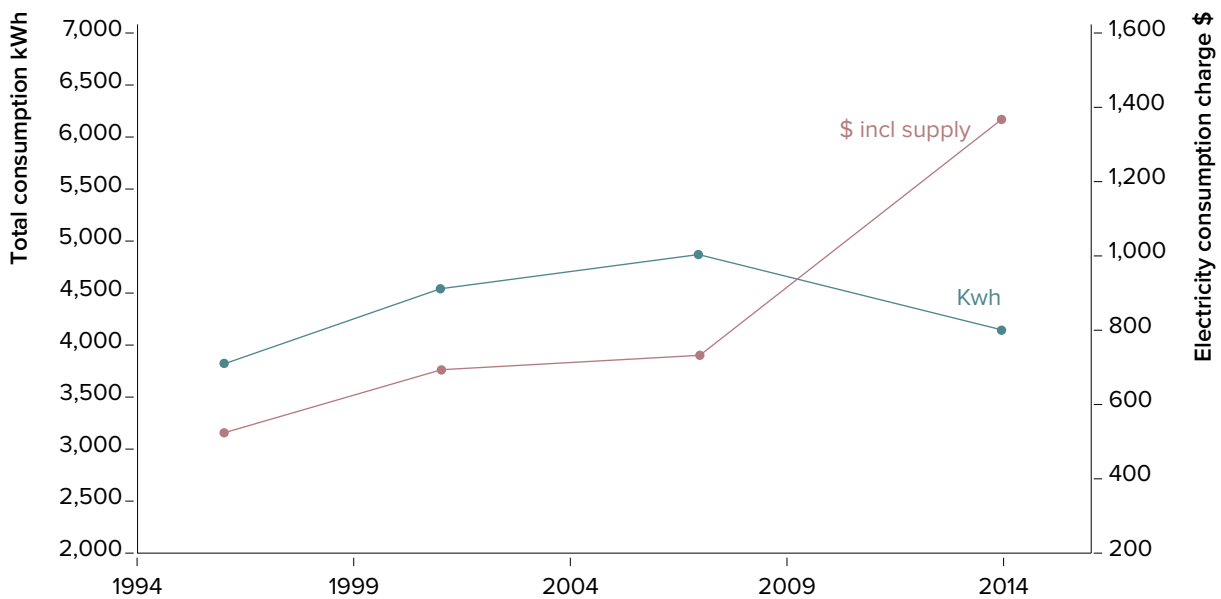
» Figure 29 shows that from 2007 to 2014, households receiving a concession reduced their energy consumption by 15 per cent, but their annual electricity costs increased 86.4 per cent, from \$733 to \$1,366. This is equivalent to a doubling of the cents per kWh rate paid by concession card holders since 2007.

**Figure 28** Concession household gas consumption and charges, 1996–2014



Source: Review analysis of DHHS, *Victorian Utility Household Consumption Survey 2015* (incorporating errata September 2016)

**Figure 29** Concession household electricity consumption and charges, 1996–2014



Source: Review analysis of DHHS, *Victorian Utility Household Consumption Survey 2015* (incorporating errata September 2016)

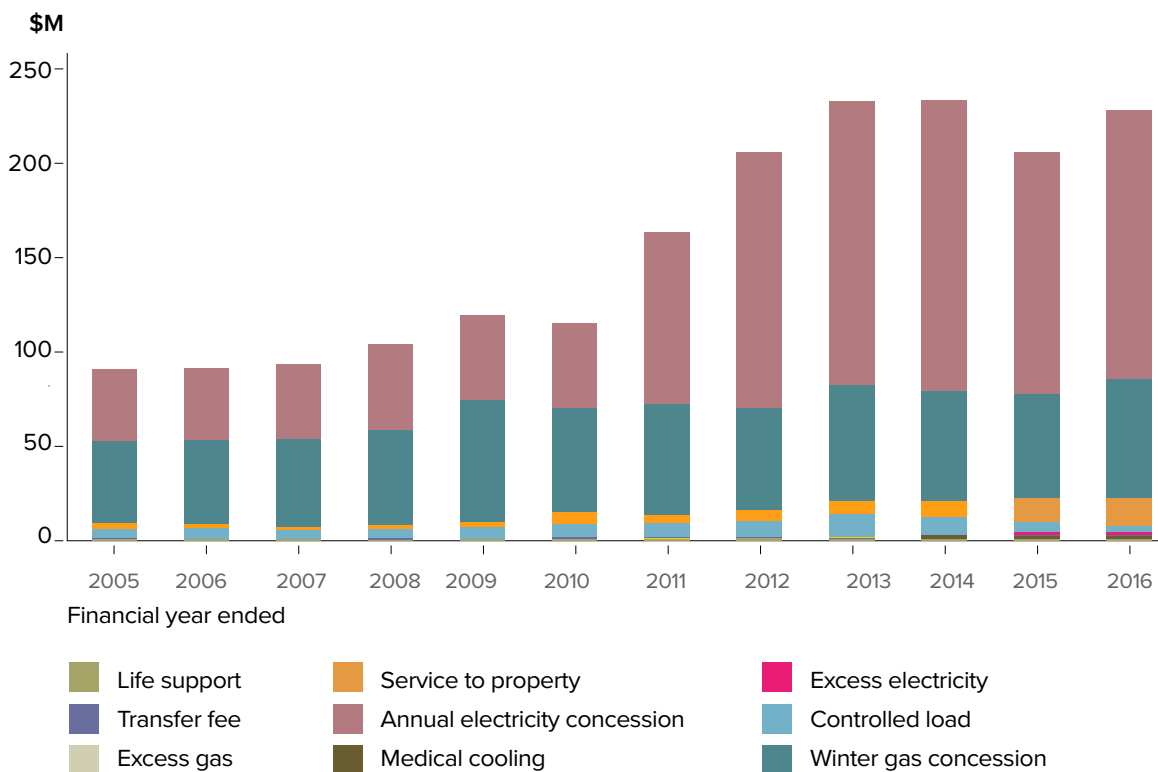
The cost to the Victorian Government for energy concession rebates and grants is now more than \$240 million a year. Figure 30 shows that from 2008/09 to 2015/16, the costs increased at a compound average rate of around 13 per cent.<sup>79</sup> This increase was due to more people receiving concessions, with almost 40 per cent of the population receiving concessions<sup>80</sup> as well as the greater amount that government is paying each concession card holder. The annual energy concession per person in 2015/16 was \$155.

The costs of electricity and gas concessions grew at a compound average growth rate of 15 per cent and 9 per cent respectively from 2008/09 to 2015/16.<sup>81</sup> Due to an ageing population and rising energy prices, costs are expected to continue to increase despite consumers reducing their energy consumption.

The increases in total energy concessions paid from 2011/12 to 2012/13 reflects the expansion of the electricity concession from a winter-only concession to an annual concession. The cost of concessions reduced in 2015 following the repeal of the Australian Government's carbon price in 2014. The Winter Gas Concession has shown a slight but steady increase each year, while the Service to Property concession which supports low energy consumption households, has increased significantly, from 2.6 million in 2005 to 14.5 million in 2015/16, in line with the increases in fixed charges as a component of energy bills.

The CME electricity analysis of customer bill data for the review showed that significant savings are available to consumers if they can be supported to find a better offer. If the Victorian Government supported concession card holders to save, on average, 10 per cent on their annual electricity and gas bill (or approximately \$150 based on a mean electricity bill), this would save the government \$20 million per year.<sup>82</sup>

**Figure 30** Total energy concessions paid, 2004–2016



Source: Review's analysis of DHHS Concessions data 2004–05 to 2015–16,

<sup>79</sup> Department of Health and Human Services (DHHS) state concessions and hardship programs - annual data 2008-09 to 2015-16, accessed at <http://www.dhs.vic.gov.au/about-the-department/documents-and-resources/reports-publications/state-concessions-and-hardship-programs-annual-reports> (accessed July 2017)

<sup>80</sup> Based on total number of Annual Electricity concession recipients in 2015-16 divided by total number of residential customers for electricity in Victoria. Source: Department of Health and Human Services (DHHS) state concessions and hardship programs - annual data 2015-16, accessed at <http://www.dhs.vic.gov.au/about-the-department/documents-and-resources/reports-publications/state-concessions-and-hardship-programs-annual-reports> (accessed July 2017); Essential Services Commission (ESC) 2016: *Victorian Energy Market Report 2015-16*, November 2016, p. 80

<sup>81</sup> Department of Health and Human Services (DHHS) state concessions and hardship programs - annual data 2008-09 to 2015-16, accessed at <http://www.dhs.vic.gov.au/about-the-department/documents-and-resources/reports-publications/state-concessions-and-hardship-programs-annual-reports> (accessed July 2017)

<sup>82</sup> A 10 per cent saving in retail bills would reduce the concessions payments for the Annual Electricity concession and Winter gas concessions by 10 percent, which is approximately \$20 million.



# MARKET RESPONSES TO INNOVATION

The energy sector is undergoing a major transition. New products and services are being released by new market entrants as well as existing retailers.

Technologies such as solar energy (distributed generation), electric vehicles, battery storage, and smart meters are changing the dynamic and structure of energy markets. These technologies will increasingly challenge traditional business models for established energy market operators.

The laws and rules governing energy markets must support and accommodate these changes. Regulatory frameworks must be flexible enough to respond to change and meet the challenges.

For example, consumers can now install more efficient and cost-effective solar panels, reducing the need to purchase energy historically generated from a centralised coal-based generation system.

There are more than 300,000 small-scale photovoltaic systems now installed in Victoria.<sup>83</sup> While consumers with solar systems must still currently interact with the retail market, products such as batteries that can store solar energy are being improved and are reducing in cost.

## NEW TECHNOLOGIES AND TARIFFS

The energy market is in transition as new technologies, environmental policies and higher energy prices drive changes across the sector. The impacts include:

- » Increasing deployment of solar and battery technologies, which alters the load profile on the grid and affects investment by generators and distributors
- » Consumers with solar panels who have lower consumption, putting upward pressure on fixed charges as retailers seek to cover costs
- » Retailers diversifying their operations, extending beyond a traditional billing and customer service agency
- » Energy consumers needing to interact with regulated and unregulated market participants to supply their energy.

*The traditional retailer was simply a billing engine and call centre. The new retailer offers you the most efficient way to manage your energy via a mix of technology, pricing choices and (possibly) finance options.<sup>84</sup>*

Tier 1 retailers in Victoria informed the review panel they are deploying and trialling products including solar power purchase agreements, electric vehicle offers, digital metering and personalised dashboards and peer-to-peer energy sales.<sup>85</sup>

The current regulatory licensing arrangements in the electricity market were built on a centralised energy model with consumers purchasing from a grid. The scope and approach of current regulations do not match a rapidly changing energy system.

New market players providing energy efficiency, demand management and distributed energy services, including providers of financial and trading mechanisms for energy, are not declared regulated industries under the current regulatory arrangements.<sup>86</sup> This limits the scope of the ESC to address market failures so the market operates in the best interests of the consumer.

*Consumers are no longer passive consumers of energy and are therefore a central pillar of the energy market.<sup>87</sup>*

Reform of energy regulations will be required so the consumer remains at the centre. Dr Ron Ben David, Commissioner at the ESC recommends reorienting the current Energy Retail Code to focus on consumer outcomes rather than controlling retailer behaviour.

The panel supports this approach and also recommends expanding the Code to include new products, services and business models to accommodate the future energy market. The existing classification and structure are increasingly obsolete and the regulatory framework must keep pace.

<sup>83</sup> Clean Energy Council (CEC) 2016, *Clean Energy Australia: Report 2016*, p. 42

<sup>84</sup> EnergyAustralia submission to the review, p. 19

<sup>85</sup> AGL, Origin and EnergyAustralia submissions to the review

<sup>86</sup> Alan Pears submission to the review, p. 5

<sup>87</sup> Victorian Electricity Distribution Businesses submission to the review, p. 8

Origin Energy supported the evolution of regulatory changes, highlighting that imposing the same conditions on the new market is not the focus; it's about rethinking the way the market is regulated.<sup>88</sup>

In designing a future energy code, the regulators should attend to vulnerable consumer, renters, low income home owners and those less able to navigate and access the new energy products. In its submission to the review, the Consumer Action Law Centre stated:

*The novel nature of many new energy products, and increasing complexity of the technology required to deliver them, may frustrate the efforts of less savvy consumers to engage with the energy market. Not only must consumers be able to understand these complex products in their own right, they need to be able to identify how the products alter the nature or source of their existing supply.<sup>89</sup>*

As the market evolves, equity must remain a core element of policy revision and regulatory reform so those less able to access off-the-grid and grid-based products are not disadvantaged.

### Access to data

Smart meters provide households, network operators and retailers access to time-of-use data. This allows for a greater range of tariff structure and demand management options, including:

1. Accurate real-time data, which could allow for retailers to develop more personalised offers to customers
2. Tools to be integrated that provide households real-time access to electricity consumption
3. The ability to make the data available to third parties to enhance competition.

The meter data currently available to users, retailers and networks is currently under-utilised.

Access to online data was a repeated concern in submissions to the review. Network operators noted they are taking steps to make their data available online, with some distributors working together. However, regulatory, legal and practical constraints remain that prevent consumers from obtaining the full benefits of the information.

Allowing consumers access to their energy information will support them to manage their

demand in real time. Enabling the data to be provided through authority to third-party retailers and energy brokers will enable retailers to develop cheaper and transparent offers. In its submission to the review, the Alternative Technology Association stated:

*The opportunity these businesses (energy brokers) provide is not only for middle income consumers who recognise the value of brokers and can afford an upfront outlay to find a better deal. Brokers can also be engaged by community service organisations who are assisting vulnerable households with their energy costs.<sup>90</sup>*

To support the competitive market, it is necessary to improve the framework and access to meter data.

### Consumer protections in the new energy market

The Energy and Water Ombudsman Victoria (EWOV) highlighted in its submission to the review that gaps have emerged in Victoria's regulatory arrangements and jurisdiction as the energy market has developed.

Products and services entering the market fall outside licence agreements or are given exemptions from licence agreements. The EWOV's submission to the review stated:

*Many new business models that have recently entered the Victorian energy market – including distributed energy generation and storage – are currently exempt under their derogated licence conditions from many of the licence conditions from many of the requirements place on 'traditional energy companies', including membership of EWOV.<sup>91</sup>*

The jurisdiction of the EWOV is directly linked to the licence conditions of the retailers. Where exemptions to licence conditions are granted or companies operating in areas where licences are not required, the jurisdiction of the EWOV is limited.

This leads to confusion for consumers about the jurisdiction of the EWOV. The EWOV has sought to clarify the jurisdictional limitation relating to new energy markets, but it remains a significant impediment to certainty for consumers who discover when they approach the EWOV that it is unable to support them in addressing their complaint.<sup>92</sup>

<sup>88</sup> Origin submission to the review, p. 21

<sup>89</sup> Consumer Action Law Centre submission to the review, p. 13

<sup>90</sup> Alternative Technology Association submission to the review, p. 3

<sup>91</sup> Energy and Water Ombudsman of Victoria submission to the review, p. 9

<sup>92</sup> Ibid, pp. 5-10



# HAZELWOOD

The Hazelwood Power Station was commissioned in 1971 and for the next 50 years supplied up to 25 per cent of Victoria's electricity. In November 2016, Hazelwood's French majority owner ENGIE confirmed it would decommission Hazelwood in March 2017.

## WHAT THE REVIEW HEARD

A number of retailers said they progressively purchase contracts for their future electricity needs, commencing purchases more than a year in advance. When the Hazelwood closure date was announced in November 2016, most retailers had already purchased most of their electricity contracts for 2017, although the prices had already increased significantly before the announcement.

Due to their forward contract purchasing strategies, many retailers expect the Hazelwood closure to have a greater impact on their wholesale costs from 2018.

Some retailers said they limited their price rises at the start of 2017 and did not pass the full increase of their wholesale costs to consumers.

## REVIEW ANALYSIS

The announcement of the Hazelwood closure has led to significant increases in forward contract prices for wholesale electricity.

Jacobs conducted modelling of the expected change in wholesale prices from the closure of Hazelwood.

The Jacobs analysis demonstrates that large increases in wholesale electricity prices in Victoria could be expected from the closure of Hazelwood. Since its closure, wholesale spot prices have increased significantly as anticipated (see Wholesale costs on page 20 for discussion on wholesale electricity prices).<sup>93</sup>

While many retailers are insulated against much of this increase through advanced purchases of electricity hedge contracts, it is likely that retailers have experienced some increase to wholesale costs for 2017. However, without the power to require retailers to disclose information on their purchased energy contracts, it was not possible for the review to determine how much the Hazelwood closure has impacted retailer costs for 2017.

Therefore, the review panel could not conclude if retailers have taken advantage of the closure of Hazelwood in terms of their price offerings to consumers.

# POLICIES AND PRACTICES IN OTHER JURISDICTIONS

The review commissioned research and analysis from KPMG on policy and regulatory frameworks in other national and international jurisdictions to identify options that could achieve better outcomes for consumers, and assess if these could be implemented in Victoria<sup>94</sup>. A cross section of markets were assessed to consider a range of options and approaches that have worked effectively to deliver strong benefits for consumers.

The KPMG analysis grouped the measures and reforms implemented in different jurisdictions into three categories: demand side measures such as targeted protections and collective bargaining to support consumers; measures to protect passive consumers by improving customer engagement and non-price tariff regulation; and supply side measures such as price regulation and price monitoring. Specific examples of how these approaches have been applied in various jurisdictions are provided in this section.

## Key insights

- » Many jurisdictions introduced retail contestability to drive efficient price outcomes, provide customers with greater choice and drive greater innovation. Most of these jurisdictions have now implemented further reforms to improve customer and market outcomes – either by regulating the behaviour of retailers, or to support greater customer engagement in the market and provide better protection for consumers.
- » All jurisdictions continue to have some degree of oversight of their energy retail markets. Even jurisdictions that are highly pro-competition and have very light-handed regulations periodically consider further refinements or reforms to address specific issues that arise that suggest outcomes for consumers could be improved.
- » Jurisdictions that have more prescriptive regulations on retailers typically have lower retail margins, lower levels of price dispersion, lower diversity in offers and lower levels of activity.

- » Different customer segments are affected in different ways by competition. There seems to be a trade-off between trying to ensure ‘all’ consumers benefit from price competition, and providing the right conditions for an innovative market that may exclude some customers from the market due to the level of complexity.

## DEMAND SIDE MEASURE 1 – IMPROVING CUSTOMER ENGAGEMENT

A number of jurisdictions have focused on making it easier for consumers to engage in the market to enhance the benefits of competition. Some of these measures include: providing a source of independent information on energy prices; price comparison tools; campaigns to encourage customers to switch or review their energy arrangements; making the process of transferring customers between retailers faster; and providing financial incentives to encourage switching. New Zealand, Texas, the Netherlands, Norway and South Australia are among the jurisdictions that have supported customers through these measures.

New Zealand’s electricity market introduced retail competition in 1999 and is one of the most competitive and progressive markets with limited regulation. The regulator has focused on fostering effective competition, intervening only when a clear market failure is identified. It established a Consumer Switching Fund in 2011 to promote the benefits of comparing and switching retailers to address lack of customer engagement. The Fund was used to establish a website that enabled

customers to estimate how much they could save by switching to a cheaper retailer, and to improve the functionality of an existing price comparison website. The Fund also paid for advertising and information campaigns.<sup>95</sup>

Texas has also focused on driving customer activity. It introduced an education program in 2001, which continues today and includes informative websites for customers and price comparison tools. Two other relevant approaches in Texas are the absence of a default supplier, which has meant that customers must make a positive decision to choose a supplier, and the development of a single data hub, which has allowed easy access to consumption data. While Texans are highly satisfied with their electricity retailers, and several innovative products and services are available, it is likely that relatively high retail margins in Texas have contributed to this outcome.<sup>96</sup>

In Great Britain, the 2-year Energy Markets Investigation by the Competition and Markets Authority recommended implementing a program of trials to test which measures will encourage customer engagement, and maintaining a database of 'disengaged customers' to allow other retailers to contact these customers.<sup>97</sup>

South Australia introduced an Electricity Transfer Rebate (ETR) as an incentive to encourage energy switching activity. Between November 2003 and August 2004, a one-off \$50 electricity rebate was provided to pensioners and self-funded retirees (with a valid concession card) for transferring their electricity accounts from standing or default contracts to market contracts with any retailer.<sup>98</sup> Subsequent to the ETR, the South Australian Government announced another one-off energy payment of \$150 to pensioners and self-funded retirees in its May 2005 State Budget.

## DEMAND SIDE MEASURE 2 – NON-PRICE TARIFF REGULATION

Some jurisdictions have regulated non-price characteristics of tariffs to achieve specific objectives. These can take various forms, such as by increasing standardisation between retailers or reducing the complexity of offers to make it easier for customers to compare tariffs, or ensuring certain tariff structures are available that may be more suited to certain customer types, such as low volume users.

In New Zealand, all retailers are required to offer and advertise a low fixed charge tariff option of no more than NZ\$0.30 per day to domestic consumers. Retailers must also inform domestic consumers at least once a year if it may be beneficial for them to switch to a low fixed charge tariff option. While it is difficult to isolate the impact of the low fixed charge tariff on the experience of customers, it appears this regulation is not harming the experience of New Zealand consumers or inhibiting innovation (and the number of offers) and could be enhancing the experience of low volume customers.<sup>99</sup>

Also, many jurisdictions, including Victoria, have introduced reforms to target specific marketing practices that are deemed to be unfair or misleading.

In Victoria, the regulatory and legislative framework offers flexibility for the ESC to specify non-price conditions for the sale of energy. The Energy Retail Code that retailers must adhere to could be expanded to include non-price elements of retail tariffs. These non-price conditions could include the methods or principles to be applied in determining prices or charges.

## PROTECTING PASSIVE CUSTOMERS MEASURE 1 – TARGETED PROTECTIONS

A range of policies has been adopted in other countries to assist vulnerable consumers such as subsidised energy tariffs, or restrictions on the circumstances in which customers can be disconnected.

In Portugal, vulnerable consumers can access energy at a social tariff or reduced prices, which together with additional discounts bring the total discounts to over 30 per cent off the regular price.<sup>100</sup>

In Germany, one supplier in each network is deemed to be the local default supplier. Customers receive a default supply if they do not choose a market contract or if their current supplier will no longer supply them.<sup>101</sup>

In Ireland, suppliers are required to follow a number of steps before disconnecting a customer for non-payment, including engaging with the customer and offering a payment plan that takes into account the customer's ability to pay. The final step is offering to install prepayment meters provided free of charge to those in financial difficulty.<sup>102</sup>

95 Ibid, p. 13

96 Ibid, pp. 107–111

97 Ibid, p. 20

98 Australian Energy Market Commission (AEMC) 2008, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia, First Final Report, September 2008*, p. 111.

99 KPMG analysis, p. 26

100 Ibid, p. 32

101 Ibid, p. 33

102 Ibid, p. 34

Other important lessons from international experience are that the availability of benefits for vulnerable customers is not sufficient and other mechanisms are required to ensure vulnerable consumers take up the benefits – such as obligations on suppliers to provide information to relevant customers or a widespread information campaign.<sup>103</sup>

## PROTECTING PASSIVE CUSTOMERS MEASURE 2 – GROUP PURCHASING

Some jurisdictions such as the state of Maine, in the United States, and Italy have adopted a single buyer or group purchasing approach to protect passive customers.

In Maine, the regulator continues to set a default price. The regulator auctions the right to supply energy to customers on the default service (applicable to customers who do not switch). This effectively provides customers on a default tariff with access to competitive prices, without the need to choose an offer.<sup>104</sup>

In Italy, consumers who do not choose a supplier remain with a default supplier – the local distribution system operator – which provides electricity according to a ‘standard offer’ and purchases it from a state-owned body. Eighty per cent of households in Italy are still on the standard offer.<sup>105</sup>

Unlike Maine and Italy, Victoria’s distribution and retail functions are separated. Hence, introducing this approach in Victoria will require substantial changes, such as requiring distributors to invest in necessary systems and resources to undertake the billing function.

Group purchasing, known as ‘municipal aggregation’, has also been authorised in the United States as a way to introduce the benefits of retail competition without requiring customers to make a choice of retailer or product.

In Australia, the South Australian Government announced plans in July 2017 for a bulk purchasing arrangement, whereby the government will directly negotiate electricity contracts on behalf of households that receive concessions. Competing energy retailers will be asked to deliver reduced prices and a range of flexible payment options. Households will not have their concession payments reduced as a result and will be able to stay on their remaining energy plan if they don’t opt-in for the contract negotiated by the government.<sup>106</sup>

## SUPPLY SIDE MEASURE 1 – PRICE REGULATION

While there are many jurisdictions with competitive markets that have continued to regulate energy prices, Ontario and the United Kingdom are two jurisdictions that have re-introduced regulation of prices after allowing retail prices to be set competitively.

In Ontario, a period of wholesale price volatility led to a price freeze and subsequent retail price re-regulation just seven months after lifting price controls. Price regulation was re-introduced with the objective of providing stable and predictable pricing. The regulated price applies to customers that obtain their electricity from their local utility (i.e. integrated distributor and retailer), which is the default supplier. Competitive electricity providers are not subject to the regulated rate.<sup>107</sup>

The energy sector in the United Kingdom has been subject to intense scrutiny in recent years including a 2-year investigation by the Competition and Markets Authority (CMA). Following this investigation, the UK introduced a price cap for prepayment customers in 2016. In July 2017, the government expressed its intention to introduce a price cap on retailers’ standard variable rates, which are paid by 70 per cent of customers (i.e. those not on fixed-rate deals).

However, the plan to legislate this is not part of the government’s announced plans for the next two years. The regulator has responded by outlining a number of proposals to help vulnerable customers, including extending the energy price cap (applicable for customers on prepayment meters) to vulnerable people on standard contracts. Other proposals include a trial scheme requiring suppliers to inform customers of cheaper deals with rival companies, scrapping charges by retailers for installing pre-payment meters and making it easier to find cheaper deals on price comparison websites.

While the regulator is considering various options for implementation, it has confirmed that the extension of the safeguard tariff cap to vulnerable consumers is a strong possibility. The regulator defines vulnerable customers as those who are “significantly less able than a typical consumer to protect or represent his or her interests in the energy market” or who are “significantly more likely than a typical consumer to suffer detriment, or that detriment is likely to be more substantial”.<sup>108</sup>

103 Ibid, p. 37

104 Ibid, p. 77

105 Ibid, p. 39

106 <https://www.premier.sa.gov.au/index.php/zoe-bettison-news-releases/7818-new-energy-discount-offer-for-low-income-south-australian-household>

107 KPMG analysis, p. 44

108 Office of Gas and Electricity Markets (OFGEM) 2013, *Consumer Vulnerability Strategy*, July 2013, p. 1

In Australia, all states within the NEM have introduced retail contestability in energy markets and prices are deregulated in major NEM jurisdictions. Gas prices have been deregulated for all NEM jurisdictions and electricity prices deregulated in Victoria, New South Wales and South Australia.

While practices and market approaches are similar, where price regulation remains (or remained until recently) there is a divergence in relation to the pricing of customer acquisition and retention costs in regulated prices. The New South Wales and Queensland governments chose to include customer acquisition and retention allowances in their regulated prices prior to recent deregulation, arguing the additional allowance in the short term will enable competition, which will return benefit to consumers with lower costs and innovation over the longer term.

This contrasts with a recent regulatory decision by the ACT Government which argued that there was insufficient evidence to demonstrate that allowing retailers to charge for customer acquisition and retention costs would realise net benefits to consumers and not just result in additional costs for the consumer.<sup>109</sup>

## SUPPLY SIDE MEASURE 2 – PRICE MONITORING

Some jurisdictions apply price monitoring as a less intrusive alternative to price regulation, protecting consumers by enhancing market transparency and fostering the competitive process. This may involve scrutiny of prices and market performance by requiring relevant businesses to publish, or submit to the regulator, key information. Price monitoring has been employed in the Netherlands and Belgium.

The Netherlands opened the energy markets to competition and removed price regulation in 2004.<sup>110</sup> The regulator continues to have the power to set a maximum price for individual electricity and natural gas retailers, although this power has not yet been exercised. The government has implemented tariff surveillance as a ‘safety net’ mechanism to prevent unreasonable prices and protect inactive customers.

This regulation requires that, while prices are set competitively, electricity and natural gas retailers must submit their tariffs for small-scale users to the regulator. The regulator assesses those tariffs for reasonableness. Each year, the regulator requires several retailers to provide an explanation about the level of their tariffs to determine if the contracting conditions and price are fair.

While the regulator has not published its assessment methodology, it does take into account whether a product or service of superior quality justifies a higher price. If the regulator considers a retailer’s tariff(s) to be unfair, it can set a maximum tariff for that retailer. To date, the regulator has not had to set a maximum tariff, although some suppliers have needed to adjust their tariffs to be considered fair.

Despite continued price monitoring, which in some markets could stifle competition, the Netherlands has continued to see strong competition and diverse offers. The regulator is also focused on encouraging customers to participate in the market by providing tools to make it easier for them to compare offers, ensuring transparency of information from retailers and conducting campaigns to encourage customers to review their services.

Similarly, in Belgium the retail energy markets have been subject to safety net regulation. The indexation of those retailer market offers which have a variable pricing formula is subject to the regulator’s supervision and is limited to four times a year. The safety net mechanism was supported by reforms to improve the transparency of energy market information available to customers.<sup>111</sup>

In Victoria, implementation would require legislative amendments to be made to confer a price monitoring function on the ESC and/or provide the ESC with the necessary information gathering powers.

<sup>109</sup> Independent Competition and Regulatory Commission (ICRC) 2017, *Standing offer prices for the supply of electricity to small consumers from 1 July 2017*, Report 6 of 2017, Final report, June 2017, p. 28

<sup>110</sup> KPMG analysis, pp. 85-88

<sup>111</sup> *Ibid.*, p. 51

# RECOMMENDATIONS

In considering its recommendations and potential policy interventions, the review panel first determined what represents a positive outcome for energy consumers. The overall objective of the competitive retail energy market is to provide long-term benefits to consumers. This should include lower prices and more innovative products and services. The review panel applied the framework below to determine how this objective of ‘a positive outcome for consumers’ is best achieved.

## The guiding principle – energy is an essential service

Energy is an essential service and underpins our health and wellbeing, and our social and economic participation. As an essential service, consumers must purchase energy and must participate in the retail market even if they are not interested in the product and regardless of continued price rises. Energy must be accessible, affordable, and reliable for all.

Consumers are entitled to obtain easily understandable energy offers and enter into energy contracts that provide value for money and don't contain negative surprises.

## Other policy principles

In line with the guiding principle, the review panel applied the following principles to guide its recommendations.

1. Competition is a means to deliver benefits to consumers, but not an end itself.
2. The retail energy market should deliver benefits to all consumers, not just to those who are capable, interested, and able to navigate its complexity.
3. An effective market should reduce the costs consumers pay.
4. Consumers should be able to control their energy costs through managing their energy use.
5. Passive consumers should not be blamed for not navigating the retail energy market.
6. Vulnerable and at-risk consumers must have access to affordable energy and should not cross subsidise other consumers.

7. A competitive market is likely better placed to respond to changes in the energy sector and new technologies.

8. Transparency is fundamental to an effective retail energy market.

## Identifying policy interventions

In assessing policy interventions, the review panel recognised that reforms have the potential to benefit some consumer groups more than others. Policy interventions may interact with each other and must be considered collectively. The impact on all groups must be considered and balanced.

The recommendations of the review panel can be separated into three broad categories:

1. Price regulation and monitoring the market – supply side (retailer) measures.
2. Customer empowerment and clearer marketing – demand side (consumer) measures to make the market work better.
3. Consumer protection – targeted protections and group purchasing.

## Regulation in the Victorian energy market

When competition was introduced into Victoria's retail energy market in 2002, it was expected to benefit consumers by reducing their energy costs and generating innovative products. It was assumed that low barriers to entry would see new competitors enter the market and reduce the commercial advantage of the incumbent market participants. Competition would be the most effective means for ‘regulating’ the retail energy market and delivering the best outcomes for energy consumers.



Two separate (but similar) codes for electricity and gas sales were introduced with competition. These codes largely reflected existing protections for customers from earlier instruments but sought to include provisions accounting for market competition. At the time, the view was that customers would be sufficiently 'protected' by the discipline of the competitive market. Therefore, the codes (and the preceding legislation) largely focused on preserving protections for customers who did not enter the new competitive market. These customers were deemed to be on standing offers (now known as standard retail contracts).

In 2005, the two codes were merged into a single instrument known as the Energy Retail Code (ERC). The Code adopted the provisions of the earlier codes while seeking to make the provisions consistent across electricity and gas. Some customer protections were clarified or strengthened.

The ESC has since amended the Code to reflect developments in the market or new provisions in legislation or Ministerial Orders.

The role of the ESC is to monitor and enforce the conditions on retail energy licences and publish reports which analyse the performance of energy businesses including their energy offers. The legislative objectives of the ESC are to promote the development of full retail competition and to promote protections for customers.<sup>112</sup>

The ESC exercises a degree of oversight over Victoria's retail energy market. Within this oversight model, the role of regulation (and the Energy Retail Code) is largely limited to:

- » A few minimum standards for regarding the provision of marketing material, bills, and contract formation, variation and termination
- » Enshrinement of customers' entitlement to a standing offer in particular circumstances (including if they have never 'entered the market' by accepting a market offer)
- » Assistance arrangements for customers experiencing payment difficulty
- » Retailer obligations regarding energy supply and delivery (most notably, when proceeding to de-energise (or disconnect) a customer from their energy supply).

The ESC remains the licensing authority for aspiring new entrants to Victoria's retail energy market. This involves assessing applications, granting licenses and monitoring compliance with relevant legislative and regulatory obligations. The ESC is also responsible for reporting publicly on the performance of the retail energy market.

Before all price regulation was removed in 2009, the Victorian Government played a role in determining standing offer prices. This effectively served as a cap on prices and retailers would 'undercut' each other by offering discounted market offers. From 2009, the retailers were free to set the prices of their own standing and market offers. In other words, Victoria fully deregulated prices in the retail electricity and gas markets.

In January 2016, new legislation came into effect providing the ESC a broad suite of enforcement powers and new regulations. Those legislative amendments also established a new objective for the ESC to promote protections for customers experiencing payment difficulty and require it to report publicly on compliance and performance issues.

A number of submissions to the review recommended that Victoria move to the national regulatory framework for retail energy markets and adopt the National Consumer Energy Framework (NECF), arguing that complying with a different regulatory framework in Victoria increases costs to retailers.

However, the review panel considers a number of market failures, which are highlighted throughout this report, warrant further regulatory action to protect the long-term interests of energy consumers. The recommended regulatory responses are outlined further throughout this section.

## PRICE REGULATION

Various previous studies, including from the ESC, found that surplus margins were evident in the Victorian electricity market and were trending upwards, not downwards as might be expected as the competitive market matured.<sup>113</sup> This review confirmed through actual bill data that the retail charge for a typical Victorian customer is approximately \$423, or around 30 per cent of the bill.

The recently released 2017 AEMC Retail Competition Review reported gross margins (referred to in this report as the retail charge) are the highest in Victoria compared to other jurisdictions, and gross margins for the Tier 1 retailers were larger across New South Wales and Victoria than the gross margins of the Tier 2 retailers in 2014/15, but similar in 2015/16.<sup>114</sup>

From the information and analysis obtained for the review, the review panel considers there is a fundamental market failure that requires intervention. Various constraints in the nature and design of the retail energy market make it unlikely the deregulated market will deliver the intended long term benefits to consumers.

The key reason is because energy is an essential service, so consumers cannot constrain the market by exiting. The market encourages retailers to continue to add costs, including marketing and other customer acquisition and retention costs to their business operations, which add little or no benefit to consumers but which they invariably pay for. Consumers are given a choice of offers at a high price. We expect that many consumers would prefer less choice, if it meant a lower price.

A second reason is that the operating costs of retailers that were passed on to consumers before the competitive market was introduced and then deregulated were relatively low. At the time, retailers were not significantly spending on customer acquisition and retention. There were not large operating costs, which could be brought down by efficiencies of competition.

As retailers have competed they have needed to invest more in acquiring and retaining customers. The only way to recover those costs is from the consumer and, as a result, prices for the consumer keep increasing. The Victorian retail charge is now the highest in the NEM.

It is interesting in this regard to compare the retail charge for energy with the retail charge for water. Melbourne's water retailers provide both distribution and retail services and are regulated through the Essential Services Commission. The retail charge for Melbourne's water retailers is in the range of 7–8 per cent of the total bill compared to the retail charge for electricity and gas which is around 30 per cent of the total bill.<sup>115</sup>

A third reason is due to the legacy of incumbent retailers. The three Tier 1 retailers are vertically integrated 'gentailers' that generate electricity as well as retail it. They have significant market advantages over their competitors, including large pre-existing customer bases, established systems and the ability to obtain lower cost wholesale energy and renewable energy certificates. The large retailers also have lower customer acquisition and retention costs as they have customers to lose rather than customers to gain. The cost difference between large and small retailers appears substantial. Our research has shown however, despite lower expected costs, the Tier 1 retailers are charging customers towards the top of the price range. The Tier 1 retailers do not appear to have been put under competitive pressure by the smaller retailers to lower their prices. If the competitive market was working we would not expect to see the low-cost supplier at the top of the price range and the high-cost supplier at the lower end.

A fourth reason the deregulated market isn't working effectively is because energy is not easy for people to track or visualise and so is hard to value. Combined with other barriers to consumer engagement and status quo bias, this means many consumers become 'sticky', staying with the same retailer, even when prices rise and lower priced offers are available.

Finally, retail energy is not a product that can be easily innovated. Under the current retail market structure, electricity generators and gas producers provide the energy, the network operators distribute it, and retailers sell it to consumers. There is limited product innovation available to retailers other than to improve their operations and billing and efficient purchasing of wholesale electricity. Innovation in the traditional marketplace is therefore generally limited to marketing, incentives and pricing.

113 SKM MMA (2013), *Analysis of Electricity Retail Prices and Retail Margins 2006 - 2012*, Report for the ESC, May 2013; Australian Energy Market Commission (AEMC) (2013), *2013 Residential Electricity Price Trends report*, December 2013; Carbon Market Economics (2015), *A critique of the Victorian retail electricity market*, June 2015; St Vincent de Paul Society (2016), *The NEM – A hazy retail maze*, December 2016; Carbon Market Economics (2016), *Australia's retail electricity markets: who is serving whom?*, August 2016

114 Australian Energy Market Commission (AEMC) 2017, *2017 Retail Energy Competition Review, Final report*, July 2017, p. vi

115 Yarra Valley Water (2017), *Yarra Valley Water Citizens' Jury Information Pack*, April 2017, p. 15

Any real innovation evident in the retail energy market today is not driven by competition between traditional retailers, but by other technology companies driving down the cost of renewable energy generation and battery storage, and by developing energy management systems and other new energy products and services. Innovation is occurring from outside and alongside the traditional energy retail markets.

The review panel concludes the market is unlikely to deliver benefits in its current form. The failure of the market to deliver efficient outcomes warrants intervention so that consumers receive better price outcomes.

The review panel recommends the introduction of a requirement for retailers to provide a 'no frills' offer, which is referred to as the Basic Service Offer in this report. The Basic Service Offer sets a clear and transparent regulated annual price. Retailers would be free to innovate and provide other offers to consumers with lower or higher prices, to give consumers the choice to pay for any additional value retailers may offer. However, consumers only interested in a basic 'no frills' service would have the option to select the Basic Service Offer and remain protected from the existing failures of the market.

The review panel recommends the ESC set a maximum regulated price for the Basic Service Offer for each consumption level. Retailers would be free to structure their Basic Service Offer how they see fit, so long as the price the customer pays remained below the price set by the ESC for any given consumption amount. It must be unconditional and must be provided if requested by a consumer. Figure 31 provides an example of a basic service offer price curve.

Key to the recommendation for a Basic Service Offer is the handling of customer acquisition and retention costs and headroom. In other regulated jurisdictions, regulators have faced pressure from retailers to allow these marketing costs. A significant failure of the competitive market has been to allow these costs to build up and increasingly be passed to consumers with little benefits to them to outweigh the costs. Based on the evidence, the review panel does not consider these costs should be included in the regulated price for the Basic Service Offer.

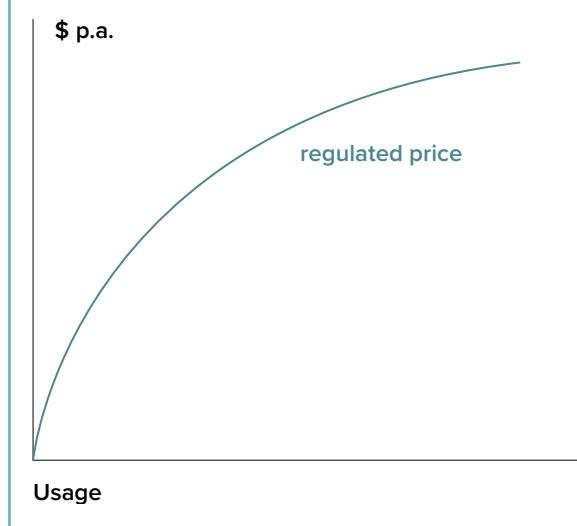
If retailers can find genuine cost savings they can undercut the Basic Service Offers.

Alternatively, they could offer innovation or services valued by the customer – allowing retailers to offer more costly plans.

The review panel shares the view of the Independent Competition and Regulatory Commission in its Standing offer process for the supply of electricity to small customers from 1 July 2017 report:

*In the Commission's view, inclusion of an additional CARC allowance will set regulated prices higher than the current price, and the arguments in favour of higher prices to facilitate competition in the ACT, fundamentally contradict the efficient pricing outcomes in competitive markets. The Commission believes that an increase in prices resulting from a CARC allowance or a competition allowance could only be justified if prices will reduce to efficient levels over time and longer-term benefits from competition would more than offset the cost burden faced by small customers from including a competition allowance. The Commission considers there is little evidence to indicate that a competition allowance would realise net benefits.*

**Figure 31** Example of price curve for basic service offer



The provision of a Basic Service Offer would provide a clear price signal to the market and allow consumers to transparently evaluate the value of other market offers.

The review panel acknowledges that regulation of prices may reduce competitors in the market. However, the counter point is that the expansion of market competitors in Victoria has not reduced energy retail prices.

The Basic Service Offer would be available to all consumers and would represent a reasonable price of energy in the market. It would provide an option for consumers who just want affordable energy without the fuss.

Some consumers are also unable to access the competitive market. These include consumers in embedded networks, such as caravan parks, retirement homes and some apartments, as well as gas consumers in some regional areas where just a single retailer operates. A Basic Service Offer would ensure these consumers have access to energy at a reasonable cost.

### Standing offers

Since prices were deregulated in 2009, the existence of standing offers has become increasingly irrelevant and may have contributed to some of the issues in the current market. For example, discounts offered by retailers are often from their standing offer rates, creating an incentive to continuously increase the price of standing offers to offer a higher headline discount to consumers.

The AEMC's 2017 Retail Competition Review highlighted that standing offer prices for some Tier 3 retailers increased between 3 and 43 per cent from 1 July 2017 in Victoria's CitiPower network region.<sup>116</sup>

A Basic Service Offer would reduce the need to maintain standing offers. Retaining standing offers and introducing a Basic Service Offer may increase confusion in the market. The review panel therefore recommends removing the requirement for retailers to offer standing offer tariffs.

The review panel recognises that standing offers have played an important role as a default offer and for the retailer of last resort. In abolishing the standing offer, consideration should be given to establishing a more appropriate default offer.

The following recommendations apply to residential and small business customers for both electricity and gas.

## Recommendation 1 – Basic Service Offer

- 1A Require all retailers to provide a Basic Service Offer that is not greater than a regulated price, based on annual usage, to be determined by the ESC.
  - i. In implementing the regulated price, the review panel recommends:
    - The regulated price to be based on the efficient cost to run a retail business
    - The regulated price includes an allowance for a maximum retail profit margin
    - The regulated price must not include customer acquisition and retention costs or headroom.
  - ii. In implementing the Basic Service Offer, the review panel recommends:
    - The retailer to determine the tariff type used in the Basic Service Offer, provided it stays below the regulated price for all usage levels
    - The Basic Service Offer is unconditional
    - The Basic Service Offer includes an obligation to supply
    - Retailers may make any other offers available to consumers, including offers priced above their Basic Service Offer
    - The Basic Service Offer to be made available to customers within embedded networks and where there is a single gas retailer.

## Recommendation 2 – Abolish standing offers

- 2A Abolish the requirement for retailers to offer standing offer contracts.

## CUSTOMER EMPOWERMENT AND CLEARER MARKETING

While recommendations 1 and 2 would address the fundamental market failures identified by the review, the review panel found that some retailer marketing practices, such as discounting, are not promoting the best outcomes for consumers. It believes that further intervention to protect consumers is required. The ESC could oversee these interventions applying its existing powers relating to the standards and conditions of service, licensing and market conduct through changes to the Energy Retail Code and Retail Energy Consumer Code.

The panel considered how a standardised mandatory comparison rate for home mortgage was introduced by banking regulators so that customers can better compare different mortgage products. The panel recommends a similar approach for energy contracts, where retailers are required to market prices in a standard approach that makes their offers easily comparable. Retailers should provide actual annual costs of offers rather than basing their marketing around tariffs or discounts.

Easily understandable and comparable information on marketing materials and energy bills should promote engagement with the market and consumer empowerment. Some customers may benefit from the Victorian Government's price comparison website, Victorian Energy Compare, but awareness of the site is not currently high and it is difficult to apply smart meter data on it.

Better access to and control of smart meter data could benefit consumers. It would help them understand their energy consumption patterns and enable retailers to develop tailored products and services for consumers.

Retail bills currently list GST-exclusive charges and add GST to the total bill. It would be simpler if all prices were GST-inclusive as per most industries.

The review panel believes the current ability of retailers to change energy prices without notice at any time during a contract must be addressed for fairness and to increase consumer confidence. The panel is aware that network costs may change and are outside the retailer's control, and therefore has recommended retailers may seek exemption from the regulator for unforeseen network price rises.

There is a high risk associated with conditional discounts such as pay on time discounts. Customers risk paying an extra 30 per cent

or even more if they are late in payment. Low income and vulnerable customers are particularly at risk. The amount at risk bears no relationship to the actual costs incurred by the retailer and is inconsistent with the Victorian Government's ban on late payment fees. The review panel recommends a capping of the costs incurred by consumers who fail to meet a condition of a benefit.

The following recommendations apply to residential and small business customers for both electricity and gas.

### Recommendation 3 – Marketing information on prices to be easily comparable

- 3A** Require retailers to market their offers in dollar terms, rather than as percentages or unanchored discounts.
- 3B** Where the retailer knows the actual usage profile for a specific customer, the marketing to that customer to be based on the estimated annual costs of the offer for that customer, and the \$ costs if conditions attached are not met.
- 3C** The ESC to develop a small number of typical customer usage profiles (3–4) for use in standardised marketing material (e.g. for 2,000 kWh, 4,000 kWh, 6,000 kWh per year).
- 3D** Marketing of prices to appear in a standardised format and display the actual annual cost for the 3–4 standardised customer usage profiles. Annual energy costs for the standardised customer usage profiles to be the comparison rates in marketing materials.
- 3E** The ESC to develop a standardised format for retailer information disclosure and marketing material.
- 3F** Require retailers to notify a customer of the best offer available by that retailer, and reference the Victorian Energy Compare website, in advance of any price or benefits change.

**3G** Require retailers to include the following information on customer bills:

- How the customer can access the Victorian Energy Compare website
- How the customer can access the Basic Services Offer (see Recommendation 1)
- The retailer's best offer for that customer based on their usage patterns
- The total annual bill for that customer based on the customer's current offer and usage patterns.

**3H** Require marketing material and bills to provide GST-inclusive pricing.

**3I** The Victorian Government's customer engagement program to continue to focus on improving consumer awareness of the competitive market.

**3J** The Victorian Government's program to continue to enhance and promote the Victorian Energy Compare website and use of smart meter data.

#### **Recommendation 4 – Contract periods, practices and variations to be clear and fair**

**4A** Require retailers to commit to fix any prices they are offering for a minimum of 12 months. During this period, the market contract prices cannot change. Retailers may request an exemption from the ESC to address unforeseen changes in network costs.

**4B** Require retailers to clearly disclose to customers the length of time any offered prices will be available without change.

**4C** Require retailers to roll customers onto the nearest matching, generally available offer at the end of a contract or benefit period, unless the customer opts for another offer.

**4D** Any conditional discount or other benefit offered for paying on-time or on-line billing should be evergreen. Customers should not lose the discount or other benefit when the contract ends.

**4E** Costs incurred by customers for failing to meet offer conditions are to be capped and not be higher than the reasonable cost to the retailer.

#### **Recommendation 5 – Promoting access to smart meter data to assist customers to manage bills and increase energy efficiency**

**5A** The Victorian Government should eliminate barriers to the use of smart meter data to encourage innovation from retailers, and energy efficiency and enable consumers to compare offers.

## CONSUMER PROTECTION

Energy is an essential service and low income and vulnerable customers must have access to affordable energy. Low income and vulnerable households may find navigating the complexities of the retail energy markets difficult, and the review panel believes that some targeted assistance is appropriate.

Low income households generally spend a higher proportion of their income on energy bills. One way to reduce this is by supporting households to become more energy efficient. The panel believes that government has a role in ensuring access to energy efficiency programs to support these households.

While there are better deals available in the market for most vulnerable consumers, they are difficult for them to identify. Supporting concession card holders to find the best offers will reduce their costs and as well as the cost to the government for its energy concessions rebates.

Assistance provided to concession card holders needs to be independent, accurate and accessible. Funding an independent not-for-profit brokerage service will enable consumers to receive advice about the best offer and support them to switch to the most affordable contract. Linking the service with access to household smart meter data will enhance the benefits.

The costs of concession schemes to government are increasing and this is set to continue as energy prices rise and the population ages. Empowering concession card holders to reduce energy costs provides dual benefits. A group purchasing process will allow concession card holders to exercise greater purchasing power and incentivise retailers to offer better prices. Group purchasing can be operated in a range of ways. The Victorian government should explore how it could conduct a group purchasing arrangement on behalf of concession card holders.

The following recommendations apply to residential customers for both electricity and gas.

### Recommendation 6 – Protecting low income and vulnerable customers

**6A** The Victorian Government to provide assistance to vulnerable and disadvantaged consumers to help raise their awareness and understanding of the energy market and with managing their bills.

**6B** The Victorian Government to support programs that help low income and vulnerable households reduce their energy consumption.

**6C** The Victorian Government conduct an extensive investigation into the energy support scheme for concession card holders and adjust accordingly so consumers gain the best possible outcome from the competitive market.

**6D** The Victorian Government review the administration of the Utility Relief Grants Scheme to ensure it is serving consumers who are most in need.

**6E** The ESC to implement the outcomes of its review into improving outcomes for hardship customers.

### Recommendation 7 – Brokerage and group purchasing on behalf of low income and vulnerable customers

**7A** The Victorian Government support the pilot of a not-for-profit brokerage service for concession card holders.

**7B** The Victorian Government should consider ways to negotiate a better deal for concession card holders including a 'group purchasing' or single buyer scheme on their behalf.

## MONITORING AND OVERSEEING THE MARKET

The review panel recognises that a monitoring regime is vital for efficient and effective market outcomes.

The review panel observed that it is currently difficult for regulators to fully understand the retail energy market due to hidden offers, legacy offers and costs and margins not being visible. Transparency is vital to effective and efficient regulation and reform processes and outcomes.

The review, as per previous reviews of Victoria's retail energy market by others, was limited to an analysis based on publicly-available information, although this review also obtained and analysed a sample of actual customer bills to help identify the dynamics of the retail market.

In international jurisdictions, regulators are empowered to collect information directly from retailers to conduct assessments of the competitiveness and efficiency of the markets. For example, the UK energy regulator has these powers and produces regular public reports on retail margins based on information it asks energy suppliers to provide. The Netherlands regulator is able to obtain information from retailers relating to tariffs and pricing. These mechanisms have helped regulators better understand the market and to control retail prices.

The ESC currently reports on its compliance activities and on various performance measures (based on data it collects from retailers and other sources). While the analysis is helpful, it does not extend to the hidden market and pricing practices in the Victorian retail energy market. Extending the ESC's remit to analyse and report on these underlying dynamics (including the exercise of market power and retail margins) will enhance community confidence in the efficiency of the market and the benefits of competition. This may require legislative change.

The review panel recommends the regulatory framework contain an overarching objective that focuses on delivering benefits to consumers. This higher standard for energy compared with other markets is important because energy is an essential service. This would also assist with future proofing consumer benefits in a market where business models are experiencing profound change.

That change also requires additional protections through the Energy and Water Ombudsman Victoria (EWOV). The EWOV's submission to the review highlighted the confusion and limitation of the current powers of the Ombudsman, which does not best serve consumers. The power of the Ombudsman should be expanded and clarified so that consumers are clear where to turn to for representation and resolution of complaints in the new energy market.

The review panel also found structural issues in Victoria's overall energy market due to the role of distributors, new energy service providers and vertical integration which all impact retail pricings and the market's efficient operation. The interaction of these different market elements was beyond the scope of the review but they are no less important. The review panel recommends that further work is required by the Council of Australia Governments (COAG) with the priority being to support the best outcomes for energy consumers.

The following recommendations apply to residential and small business customers for both electricity and gas

### Recommendation 8 – Monitoring the market

- 8A** Require the ESC to monitor and report on the competitiveness and efficiency of the Victorian retail energy market. The ESC should have the power to compel the provision of any information required to fulfil its functions including:
- Information on costs and margins
  - Information on customer numbers and types, the contracts they are on, the prices they are paying and whether they are meeting contract conditions
  - Offers that are made including 'not generally available' offers
  - Costs and practices of brokerage services and comparator sites.

### Recommendation 9 – An energy market code based around the consumer

- 9A** Require the ESC to review its regulatory codes to ensure they focus on customer outcomes and can account for new business models of service provision.

### Recommendation 10 – Full coverage of new energy services

- 10A** Expand the powers of the Energy Water Ombudsman Victoria (EWOV) to cover emerging energy businesses, products and services

### Recommendation 11 – Energy market structure

- 11A** Request the COAG Energy Council to review the structure of the energy market, so that it is structured to deliver long-term interests of consumers.



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Environment Victoria
Jemena, CitiPower, Powercor, Ausnet and United Energy (joint submission)
Lumo
Momentum Energy
Online Power and Gas
Origin Energy
Powershop
Queensland Consumers Association
Victorian Council of Social Services

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# GLOSSARY

**Advanced Metering Infrastructure (AMI)** – an integrated system of smart meters, communications networks, and data management systems that enables two-way communication between utilities and customers.

**Benefit/benefit period** – the defined (set) time that a customer receives a particular benefit under their energy contract. For example, they may receive a 10 per cent discount for the first 12 months of a 2-year contract.

**Conditional discount** – a discount off an energy bill if the customer abides by a certain condition in their contract, such as paying their bill on time, or by direct debit.

**Consumer/Customer** – For the purposes of this review, these terms are interchangeable and encompass both residential and small business.

**Contract period** – the length of time a consumer signs up with an energy retail company for an energy offer. The contract period may include a shorter benefit period. A retailer must alert a customer their contract period is ending. If the customer takes no action the retailer may roll them on to a standing contract or another contract. Contract may be ‘evergreen’ – see definition below.

**Controlled load** – A tariff used for some appliances, like slab or underfloor heating, or electric hot water systems. The retailer charges a rate just for that appliance and the energy it uses. Controlled rates are usually lower.

**Distributor, or network operator** – the company which owns the infrastructure (power lines, poles and gas pipes) that supply electricity and gas to homes and businesses. There are five electricity and three gas distribution zones in Victoria, each covering a specific geographic region. The electricity distributors are CitiPower, Jemena, Powercor Australia, AusNet Services and United Energy. The gas distributors are Australian Gas, Multinet Gas and AustNet Services.

**Dual fuel contract** – an energy contract for the sale of electricity and for the sale of gas by a retailer to a customer.

**Energy Price Fact Sheet** – a short document that sets out the prices and key terms and conditions for the energy offer. Energy retailers must give customers an Energy Price Fact Sheet for all generally available offers.

**Evergreen contract or ‘ongoing contract’** – a contract that does not have a specified end date. An evergreen may or may not have an initial benefit period.

**Fixed charge** – Also called a service charge (and sometimes called a service to property charge) or daily supply charge. A flat, daily fixed rate, charged in c/per day, that is not based on how much energy a consumer uses.

**Generator** – A company that produces electricity or gas. Electricity is produced in power stations, using either fossil fuels (such as coal or gas), or with renewable energy sources (such as wind, water or the sun).

**Gigajoules (GJ)** – a measure of gas used on gas bills, equals 1 billion energy Joules (J).

**Headroom** – is an allowance that is often added to regulated retail energy prices so that regulated retail prices do not act as a barrier to entry for new retailers.

**Kilowatt (kW)** – a measure of electricity equal to 1,000 watts.

**Kilowatt per hour (kWh)** – a measure of electricity equal to 1,000 watt hours. It is the unit measure used on electricity bills.

**Market offer/Market contract** – these are offers that energy retailers set – their competitive offers. They may offer you a discount (or some other benefit) and can vary in length or be ongoing. Prices under most market contracts can change at any time, even just after the customer has signed up. Some retailers offer market contracts where the price is fixed for a certain period.

**Megawatt** – a measure of electricity equal to 1 million watts.

**Megawatt per hour** – a measure of electricity equal to 1 million watt hours.

**National Electricity Market (NEM)** – the wholesale spot electricity market that interconnects all states and territories except Western Australian and the Northern Territory. The NEM involves wholesale generation that is transported via high voltage transmission lines from generators to large industrial energy users and five local electricity distributors in Victoria, which deliver it to homes and businesses.

**Network costs** – costs of the transmission and distribution networks. These are regulated by the Australian Energy Regulator.

**Retail profit or net retail margin** – the difference between the total revenue and the total cost of for retailing energy.

**Retail charge** – includes the retailer's operating costs and a retailer's profit margin. The retailer's operating costs include billing customers, customer acquisition and retention, marketing and financing, and the smaller costs of complying with government energy efficiency programs and environmental schemes.

**Retailer** – the company that sells gas and/or electricity to consumers. It can be the same company. They purchase electricity from an electricity generator or gas provider, and they pay a distributor for transporting the energy, and then sell it to you at a profit.

**Smart meter** – an electronic device that records consumption of electric energy in intervals of an hour or less and communicates that information at least daily back to the utility for monitoring and billing.

**Standard offer/Standard contract/Standing offer/Standing contract** – an offer that retailers are required to make available and publish as per the *Electricity Industry Act 2000* the *Gas Industry Act 2001*. The terms and conditions are written and specified by the retailers, but subject to s. 36, the ESC may regulate the terms and conditions of these contracts.

**Switching** – when a customer signs up to a new offer for their electricity and/or gas supply, usually with a different energy retailer.

**Tariff** – the total price charged for electricity or gas, the tariff includes at least two parts:

- » Fixed charge – also called the daily supply charge, or the service charge (see fixed charge above)
- » Variable charge – for the amount of energy you use, also called the consumption charge (see variable charge)

**Tariff blocks** – Some energy offers split a customer’s energy usage into different tariff blocks. This means the customer pays one rate or cost for the first part of your usage, then a different rate or cost for the next part of your usage. Tariffs can contain multiple block. Blocks can apply to daily, monthly, or quarterly usage.

**Unconditional discount** – or non-conditional discount, it is a discount a customer receives automatically on a market contract without conditions attached.

**Variable charge** – also called a consumption or usage charge, this is the cost of the actual amount of electricity or gas used.

**Wholesale cost** – the cost that retailers incur in purchasing energy from generators using a combination of ‘hedging contracts’ or futures (where they negotiate the price they will pay for energy in future) as well as from the ‘spot’ market (where they purchase a portion of energy for immediate supply).

**Spot market** – where a retailer purchases energy ‘on the spot’ as opposed to in advance.



# ACRONYMS

**ACCC** – Australian Competition and Consumer Commission – the ACCC promotes competition and fair trade in markets and regulates national infrastructure services, ensuring that businesses (and individuals) comply with Australian competition, fair trading, and consumer protection laws.

**AEMC** – Australian Energy Market Commission – established in 2005 by the Council of Australian Governments to promote efficient, reliable and secure energy markets that serve the long-term interests of consumers, including effective competition at wholesale and retail levels and appropriate regulation. The AEMC makes the rules that govern the electricity and gas markets, including the retail elements of those markets. It also supports development of these markets by providing advice to the Standing Council on Energy and Resources.

**AEMO** – Australian Energy Market Operator – the national independent operator of Australia’s energy markets and power systems. It provides planning, forecasting and power systems information and has responsibility for operating the National Electricity Market (NEM). The AEMO also operates Victoria’s gas wholesale market and transmission network and retail gas markets in Victoria.

**AER** – Australian Energy Regulator – regulates energy markets and networks under national energy market legislation and rules. The AER assumed responsibility for the economic regulation of Victorian electricity distributors on 1 January 2009. This function was previously the responsibility of the Essential Services Commission of Victoria (ESC) – see below. The AER does not regulate retail energy markets in Victoria.

**COAG** – Council of Australian Governments – the peak intergovernmental forum in Australia consisting of the Prime Minister, First Ministers for each state and territory and the President of the Australian Local Government Association. COAG is supported by specialist Ministerial councils including the COAG Energy Council which has overarching policy and leadership responsibility for Australia’s energy markets.

**DHHS** – Department of Health and Human Services is a government department responsible for health, ambulance services, families and children, youth affairs, public housing, disability, ageing, mental health and sport policy in the state of Victoria

**ESC** – Essential Services Commission, Victoria’s independent economic regulator of the electricity, gas, water and sewerage, ports, taxis and rail freight industries. The ESC is responsible for the regulation of retail energy markets in Victoria.

**EWOV** – Energy and Water Ombudsman Victoria is a not-for-profit, independent and impartial dispute resolution service. It provides Victorian energy and water customers with free, accessible, informal and fast dispute resolution.

**NEM** – National Electricity Market, see Glossary.

