Submission to the

Review of electricity and gas retail markets in Victoria

Department of Environment, Land, Water and Planning (DELWP)

Brotherhood of St Laurence

March 2017
About the Brotherhood of St Laurence

The Brotherhood of St Laurence (BSL) is an independent non-government organisation with strong community links that has been working to reduce poverty in Australia since the 1930s. Based in Melbourne, but with a national profile, the BSL continues to fight for an Australia free of poverty. We undertake research, service development and delivery, and advocacy with the objective of addressing unmet needs and translating the understandings gained into new policies, new programs and practices for implementation by government and others.

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Introduction

The Brotherhood of St Laurence commends the Victorian Government for undertaking the *Review of electricity and gas retail markets in Victoria* and we welcome the opportunity to provide a submission.

Central to our approach is – energy is an essential service. Without the services energy enables – heating, cooling, lighting, entertainment – households’ health, wellbeing, social and economic participation are all put at risk. Such concerns are not merely academic. We know the numbers of disconnections have increased – forcing some households to go without energy, at the same time we know other households trade off paying their energy bills with other needs such as buying food or participation in school excursions (see for example Chesters 2013).

Affordable, accessible energy is therefore extremely important. Low income households who spend a higher proportion of their income on energy than other households on energy are particularly vulnerable to price rises. As are households who have medical special needs, those who have a person living with a disability and renters (see Azpitarte et al 2015). Similarly households facing difficulties paying their energy bills are particularly vulnerable to high prices.

For these reasons it is critical that energy costs are kept as affordable as possible. Across the energy supply chain attention continues to be given to network, wholesale and policy costs. The retail charges component of energy bills have largely escaped detailed attention. We can only surmise this is because as retail markets have been deregulated and market indicators have suggested competition is working the assumption has been made that the outcomes will be better for consumers.

We are concerned that the market has failed to deliver on its full potential. Energy retailers rather than consumers are capturing too much of the value in the market. Changes are needed.

Key issues with the operation of the market include:

- A lack of evidence of the actual prices consumers are paying for their retail energy
- Outcome measures based on satisfaction, rather than the prices consumers are paying
- A lack of transparency in retail charges
- Rising retail charges and high fixed charges that cost low income households
- Undermining the effectiveness of the Victorian government energy concession at the expense of low income household and the state.

Rather than having the answer the BSL is keen to participate in dialogue with the government, other community sector organisation and key stakeholders to develop workable solutions that improve the function of the market and can be shown to lower energy bills for low income and vulnerable consumers.
1 Response to selected review questions

1. (a) Has the introduction of competition to electricity and gas retail markets in Victoria delivered improved efficiency and benefits in the long term interests of consumers? Please explain the reasons for your response
(b) If not, what measures or alternative model(s) would you suggest for the efficient and effective delivery of electricity and gas in the long term interests of Victorian consumers? Please explain the reasons for your response.

The introduction of competition into the electricity and gas retail markets has failed to deliver the full potential benefits to consumers. As a result consumers have been paying more for electricity than they would, if the market were delivering the optimal outcomes to consumers.

There are, however, two inter-related and over-riding issues, which undermine the ability to assess the impact of competition on Victorian consumers:
1. A lack of information on the actual prices consumers are paying for energy
2. Outcome measures that are used to assess retail market competition fail to account for the actual prices consumers are paying for energy, rather focussing on self-reported measures such as satisfaction.

There is limited, or no information, on the prices households are actually paying for energy

Numerous studies ask consumers about their level of satisfaction in the energy market (see for example the survey by Newgate (2016) for the AEMC and ECA (2016)). Similarly, numerous studies have identified the spread of available offers in the market (See for example the Vinnies Tariff Tracking Project, ESC (2016), AER (2016)).

It is striking that there are no large scale, publically available studies, which provide detail on the retail market offers people are actually on.

Such studies need to provide reliable data on the price households are actually paying for energy including the contribution of different components of the bill (eg. fixed and variable), and information on consumption levels for the households in the study. Ideally there would be sufficient detail to understand the prices paid by different segments of the population who may be less engaged in the market and therefore paying more than they need to for energy.

At the Brotherhood of St Laurence, we are acutely aware that the price of energy is extremely important for low income and vulnerable Victorian consumers, we remain perplexed that energy market institutions haven’t sought to identify the actual costs energy consumers are paying and whether they are truly benefiting from the competitive market. The Victorian Department of Human Services Utility Expenditure Consumption survey comes the closest to providing the information needed.
Such studies are essential if we are to understand the real hip pocket impact of the retail energy market and to identify if there is a significant gap between what is promised by cheap retail energy offers and the lived experience of Victorian consumers.

**Outcome measures that rely on satisfaction are inadequate on their own**

Consumer satisfaction in the market is a useful indicator in the market if it is used with caution and in conjunction with other indicators. In particular, the prices households are actually paying for energy. Ben-David (2015) has highlighted a fundamental failing in satisfaction measures – many of those surveyed make contradictory responses and are being asked about something they don’t fully understand.

**The actual prices people pay for energy, and the retail contribution should be the primary outcome measure**

The primary and most important outcome measure should be an assessment of the actual price consumers are paying per unit of energy consumed, and the contribution of retail costs to that price.

We would expect in a competitive market (that is working in the interests of consumers) that the retail component of the price would reduce over time, with consumers benefiting from lower prices (relative to what they might have been). Or alternatively, consumers may continue to pay the same or more, but they benefit from improvements in service.

There is, however, limited evidence of substantial ongoing improvements to consumers across the retail energy market that would sustain the increases in retail margins.

The BSL is concerned by retail costs because of the impact on low income households.

**Households on low incomes are among the hardest hit by rising energy prices**

Low income households spend more of their weekly income on energy than other households, even though they tend to consume less overall. On average, households in the lowest 20% of income distribution spend close to 6% of their weekly income on energy, whereas the highest 20% spend around 1% of their income on energy. Energy price rises are therefore much harder to accommodate in their smaller household budgets.

**High bills also cost the Victorian Government**

With a 17.5% energy concession offered to low-income Victorian households, excessive energy costs hit the government bottom line as well as bigger bills mean the cost of the concession rises.

2. How much have retail charges paid by consumers increased? What are the reasons for retail charge increases and does this demonstrate that the markets are not operating in the interests of consumers? Please provide detailed evidence to support your response
While we recognise the difficulties in disentangling retail charges from other charges in the energy price stack we note a number of studies have provided estimates of the retail contribution to the total energy bill.

The variability in these studies highlights the need for greater transparency in retail energy charges. The review should consider options to mandate the provision of data that enables regulators to monitor and report on retail charges.

**Retail charges appear to have increased significantly over recent years.**

In 2015, the Brotherhood of St Laurence commissioned CME’s to undertake *A critique of the Victorian retail electricity market*. **CME’s analysis found that that the retailer component of electricity bills, more than doubled between 2008 and 2014, and is far higher than in other states.** CME’s analysis is based on Australian Bureau of Statistics (ABS) data for total household electricity bills, from which network charges, environmental and metering charges and wholesale supply charges were deducted, to estimate the amount retailers are charging for their services.

The analysis demonstrates that retailer charges rose from a range of $86 to $183 for the average energy bill in 2008 to a range of $371 to $471 in 2014\(^1\). This represents an average increase of approximately 212% over the six years. Reducing these retailer charges would reduce Victorian households’ electricity bills.

**Figure 1 Average annual retail charge in Victoria over time – derived (upper and lower bounds)**

![Graph showing the average annual retail charge in Victoria over time](source: CME 2015)

OGW (2014) using a different methodology identified a total average bill increase of $476 in real terms between 1995 and 2014 (based on 4,000 kWh consumption in a household without electric off-peak hot water in 2014 dollars). They identified an increase of $141 or 39% in retail services charges in real terms between 2002 and 2014 (see Table 1). OGW’s analysis showed a fluctuation

\(^1\) This is an increase of between 331% and 157%. 
in the retail component of the bill, with largest being 20% in 2014. Wholesale charges, advanced metering infrastructure, and policy costs were accounted for separately in the OGW analysis.

**Table 1: Retail services and total annual bill of a residential electricity customer in Victoria using 4,000 kWh (without electric off-peak hot water) FY02 to FY14 (2014 dollars)**

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<tbody>
<tr>
<td>RETAIL SERVICES</td>
<td>$358</td>
<td>$325</td>
<td>$261</td>
<td>$301</td>
<td>$406</td>
<td>$341</td>
<td>$499</td>
</tr>
<tr>
<td>ANNUAL BILL (EX GST)</td>
<td>$2,360</td>
<td>$2,329</td>
<td>$2,267</td>
<td>$2,309</td>
<td>$2,416</td>
<td>$2,353</td>
<td>$2,513</td>
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<tr>
<td>RETAIL AS % OF BILL</td>
<td>15%</td>
<td>14%</td>
<td>12%</td>
<td>13%</td>
<td>17%</td>
<td>14%</td>
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Authors calculations based on data from OGW 2014, p 14

The different estimates highlight different data and approaches to calculating the retail margin. They also point to a significant problem in the retail energy market.

**There is a lack of transparency on the retail component of energy bills.**

The difficulty in separating retail charges from wholesale charges presents a real challenge for anyone seeking to understand the change in retail charges. This applies to policy makers and analysts but also to consumers.

2. Are there any features of market structure or regulation that inhibit the market from delivering outcomes in the best interests of consumers?

We are unsure if any particular features of the market structure or regulation inhibit the market delivering the full benefit to consumers.

There are some features of the offers available in the market that increase prices for low income and vulnerable consumers and undermine consumers’ ability to realise the full benefits from the market. These include:

- High retail fixed charges, which result in low consumption households paying more per unit of energy consumed
- Residualisation of customers who do not regularly switch. At the end of contract benefit periods customers who do not switch again will lose any discounts and face the likelihood that their terms will deteriorate further over time. The AEMC (2016) has identified that 50% of consumers have not switched in the past 5 years.
- Lack of clarity on the starting point for discounts, which makes it difficult for consumers to assess the real value of a discounted energy bill
- Price discrimination against customers who are unable to access discounts due to difficulty paying on time or limited access to the internet.
- Lack of simple easy to compare prices. Unit prices in supermarkets have provided consumers with a simple way to compare products that are sold in different quantities or weights. While difficult in the energy market, easily comparable unit prices would make it much simpler for consumers to compare offers.
5. To the extent that analyses of retail pricing and/or margins indicate a trend of increasing retail charges and/or margins, what are the explanations for this? Please provide evidence to support your claims.

CME (2015) identified the impact of mergers and acquisitions on retail charges or margins. Essentially low price, innovative retailers enter the market, capture a share of the market and are bought out by bigger players. With the result that there is limited sustained downward pressure on retail margins from new entrants.

Beyond mergers and acquisition, the following factors are likely to enable retail charges to increase more than they would in a well-functioning market:

1. The market is not adequately structured to facilitate simple comparison of costs and benefits of different offers. As a result consumers find it difficult to assess the cheapest price.

2. The transaction costs (/hassle) involved in searching for a new offer are too high, relative to the benefits.

3. The perceived risk involved in switching is putting some households off (evidenced by risk averse households lower levels of intended switching).

4. Many consumers who may have switched in the past have remained dormant for over five years. As noted previously, the AEMC (2016) identified that over 50% of consumers report they haven’t switched for over five years. These consumers may have disengaged because they are unaware of the potential benefits of switching, are uninterested in realising the benefits, turned off by perceived hassle of switching, unable to identify the level of benefit with sufficient confidence to warrant switching.

5. Specific customer segments may face barriers to participation, which undermines the competitive markets function. Newgate (2016) for example identified older people, people on low incomes and the less internet proficient as being more likely to say they would need switch in the next twelve months.

6. Please provide any other information or evidence you consider may help the review to accurately assess retail charges and margins or pricing outcomes for consumers.

In general there is a paucity of publically available information to assess this issue. We refer you to the analysis by CME (2015) for the Brotherhood of St Laurence. We also note the report by SKM MMA (2013) for the Essential Services Commission.

As a general point, the lack of transparency on retail charges and margins undermines confidence in the outcomes of the retail market.

We would strongly support measures designed to monitor and report on retail margins.
7. Which costs have been introduced or significantly increased as a result of the introduction of retail competition? How much cost has retail competition added to the electricity and gas supply chains?

There are a number of costs that would have increased as a result of competition including the costs of acquiring customer. Others are better placed to comment on the specifics of the various costs.

The key point for the BSL is: competition should not lead to more expensive energy for low income and vulnerable consumers.

If the current design of the competitive retail market makes energy more expensive for consumers then remedies need to be taken to address issue. One obvious exception to this argument is if there are substantive improvements in services realisable by all customers including those on low incomes.

8. What cost reductions and other benefits to consumers have resulted from the introduction of retail competition? Are there characteristics of the electricity and gas retail markets or supply chains that inhibit retail competition from delivering cost reductions or significant other benefits to consumers?

We know consumers on the best retail market offers can get very cheap energy deals relative to other consumers in the market. The significant expansion of discounted offers also benefits those who are in a position to access them.

It is, however, difficult to identify the counter-factual – What would prices be without retail competition?

The BSL is concerned that many of the benefits from competition – for example low prices for the best market offers and discounts – are only available to specific customer segments.

In particular the following customers are likely to be effectively excluded:

- Customers who have difficulty paying their bills on time
- Customers with low internet proficiency
- Risk averse customers

Other customer segments may also be excluded from the benefits of the market, however, with limited or no data available it is difficult to understand the extent to which this is the case.
9. Why do prices remain so dispersed in Victorian electricity and gas markets? Does price dispersion indicate that some consumers are not obtaining the price benefits of competition? Why or why not?

One explanation for price dispersion is that higher prices correspond with a higher level of service. There may be examples of this, however, we would contend that they are limited in the Victorian market.

The wide dispersion of prices available at any one time suggests a substantial proportion of customers either:

- do not know that there are cheaper offers available,
- do not understand the price differential,
- are unaware of how to switch, or
- do not care enough that they are paying a higher price (relative to the effort of switching).

**Actual prices dispersion is in all likelihood greater than recent analysis suggests**

Recent studies of prices dispersion are based on publically available offers within the market (see for example Vinnies 2015, ESC 2016). However, we know that customers whose contracts are over 1 or 2 years old are likely to be outside the benefit period. This is a very large group, the AEMC (2016) for example reports 50% of consumers haven’t been active in the market for more than five years.

No information is publically available on how much these in-active households are paying for energy.

In-active households are likely to be paying a dis-engagement penalty. Their contracts may be worse than the worst contracts on offer today.

Once again, it remains alarming that limited reliable data is collected on the actual prices people are paying, despite numerous customer surveys by energy market institutions.

10. When do consumers end up on standing offers or higher priced (typically undiscounted) market offers? What happens to consumers at the end of their contract period?

An additional important question is – Which customers are more likely to end up on standing offers who higher priced market offers?

We remain concerned that low income and vulnerable consumers are likely to be some of those who remain on standing offers and who are on higher priced market offers.

It is our understanding that many customers lose their benefits at the end of either the contract or benefit period (which is often 1 or 2 years). At this point the customers revert to the original pre-discount terms of conditions. The original pricing will also deteriorate over time. The extent to which customers on residualised offers may be paying more than the standing offer is unknown.
Negate (2016) for AEMC identified the following groups who were more likely to say they were NOT interested in switching. In Victoria:

- Lower income households – 42% earning less than $50,000 annually vs. 26% of those earning $50,000 or more;
- People who hadn’t switched in the past five years – 44% vs. 22% among those who had not
- Technology Laggards – self-assessed technology laggards or part of the late majority (nett 47% vs. 31% of those who are part of the early majority and 17% of those who are innovators or early adopters);
- Have a low quarterly electricity bill - 43% of those with a bill less than $300 vs. 24% of those with a bill of $300 or more

Nationally they identified the following additional groups:

- Older people – Aged 55+ (40% vs. 29% of those aged under 55 years);
- Less internet-proficient – 44% of those who rated their comfort with using the internet as 0-6 out of 10 vs. 32% of those who rated their comfort levels as 7 or higher;
- More risk-averse – 37% of those who self-rated their willingness to take risks as 0-6 out of 10 vs. 24% who self-rated their risk willingness as 7-10;

11. What factors influence the level of fixed charges imposed by retailers? What are the implications of fixed charges for consumer outcomes?

CME’s (2015) analysis for the BSL identified the following on fixed retail charges:

1. Victorian consumers pay a higher fixed charge as part of their energy bills than people in other states (with the exception of the NSW Essential Energy network).

2. The high fixed retail charges Victorian consumers face is much higher than the fixed network charges that underlie the retail tariff.
High retailer fixed charges mean that the average price per kilowatt hour of energy paid by low consumption (typically low income) households in Victoria is far higher than the average paid by higher consumption (typically higher income) households.\(^2\)

We remain surprised that there has not been more innovation in low or no fixed price offers in the Victorian retail market, such offers would be simpler for many consumers to understand. We note the ESC’s (now abandoned) proposal for a 100% variable tariff for certain customers in debt.

The BSL strongly supports moves to address the high fixed component of retail bills in Victoria.

Due consideration needs to be given to the implications of various options to address high fixed charges. Options that should be investigated include:

- Capping fixed charges
- Restricting fixed charges to a ratio of the underlying network fixed charge

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\(^2\) High retailer fixed charges mean that the average price per kilowatt hour of energy paid by low consumption (typically low income) households in Victoria is far higher than the average paid by higher consumption (typically higher income) households.
12. What product or service innovation has been introduced by Victorian electricity retailers?

Are there any barriers preventing the entry of new, innovative energy business models or products and services in Victoria?

**Portals**

The development of energy retailer and distributor portals as a relatively recent innovation. Such portals are a welcome development. Of particular interest for customers wishing to compare offers is the recent Citipower / Victorian Energy Compare initiative that provides a direct link between consumption data and the best retailer offer for the household usage profile.

We do note such initiatives, well welcome, are unlikely to be taken up customers with limited access to or capability in online services.

**Development of service quality indicators**

In this submission we have highlighted the fundamental importance of price to the low income and vulnerable consumers we work with. We also note the importance of service quality and innovation.

To this end we would encourage any attempts to introduce a reliable, empirically based measure of retailer service quality into Victorian Energy Compare. Such a measure would provide consumers with an additional trusted indicator, to assess the performance of a given retailer. Data already reported to the ESC could be used to develop the indicator.

**Access to data**

Individual and third party access to smart meter data remains a barrier to product and service innovation. We have found most retailers and distributors to be helpful in accessing data. However, there are material transaction costs involved in going to more than one retailer/distributor that result from:

- No common data format for providing data to third parties
- No common, legally recognised consent forms
- (In most cases) no easily identifiable contact point for accessing data
- Differences between and within firms on the conditions attached to the provision of data vis a vis consent, understanding of costs and timeframes for the provision of data.

We note the green button protocol in the United States ([http://www.greenbuttondata.org/](http://www.greenbuttondata.org/)). Such an approach is essential if consumers are to be able to realise more benefits from Victoria’s smart meters.

**The BSL supports the development of consistent data sharing protocol in Victoria.**
We note a number of organisations have looked in detail at issues with discounting including the Consumer Action Law Centre (CALC).

We have the following concerns with discounting:

1. Discrimination against consumers with poor payment records or low internet connectivity who can’t access many of the discounts. This becomes more important as low cost non-discounted offers reduce in the market.

2. Lack of clarity and uniformity about the base level from which discounts are offered. As a result it is difficult for consumers to compare different offers within a given retailer and between retailers.

3. Default late payment penalty. Discounts essentially become a penalty for those who cannot pay on time.

17. Are there any issues that have not been considered in this discussion paper that you consider should be considered during the review?

The impact of sub-optimal retail energy contracts on concession spending

Every year the Victoria Department of Health and Human Services provides millions of dollars in electricity and gas concessions to eligible low income households to assist them paying their energy bills. The BSL supports the provision of energy concessions as a valuable measure to reduce energy cost pressure on households.

The largest energy concessions are:

1. **Mains electricity concession**, claimed by 910,865 households in 2015/16, at a cost of $141,999,913 for the year. The concession provides a 17.5% reduction on bills (it does not apply to the first $171.60 and only applies up until the bill reaches $2,672; once it exceeds this amount the household needs to apply for a excess energy concession to receive a discount on the additional expenditure.)


Also of interest is the **excess energy concession**. Households with a bill over $2,672 must apply for this concession if they are to get the additional amount covered. In 2015/16, 8271 households received this concession, at a cost of 1,640,007. The average amount per claimant is $198, which would be applied in addition to the Mains electricity concession.
We are concerned that the benefits of the concession will be eroded if the concession households are on expensive retail contracts.

Further analysis needs to be undertaken to identify the contracts concession households are actually on. However, it is reasonable to assume some proportion of these households will be on more expensive contracts. In such circumstances the concession essentially acts as an over-inflated subsidy to the energy retailer.

The Victorian Government should play a role in ensuring concession households are on better contracts. Given the Victorian government is footing a proportion of the concession card holders’ bill the state has a responsibility to ensure the householders bill is not unnecessarily high.

There are however barriers to the Victorian government addressing this issue.

The Victorian government provides the energy concession, however, it does not issue the cards that define eligibility. As a result it does not automatically have the contact details of those who receive the concession.

The parties who have the contact details of concession households are:

- the Commonwealth Departments who issue the relevant concession cards (these include Department of Human Services and the Department of Veteran Affairs)
- the energy retailers whose customers sign up for the concessions

A number of possible remedies should be pursued. These may include:

1. Energy retailers be required to report to the State Government de-identified billing information for each concession customers once per year.

   The information could be provided in a common, pre-agreed format. It should include the amount consumed (at each price), supply charge, price (for each consumption period eg. peak, shoulder, off-peak), total price, discount pre-concession, concession amount. Other information should include some geographic identifiers (eg. postcode, but preferably an abs locational identifier at a smaller scale).

   Clearly, this will be a lot of data. However, it will enable a government agency to contract out analysis of the data in order to identify any c

2. Victorian Government accessing contact information in order to communicate directly with concession customers

   Given that the Victorian government provides over $200 million dollars per year in support for the mains electricity and mains gas concessions alone, the Victorian government should develop means to have access to the contact details of concession card holders.

   Options to consider include:
Commonwealth sharing data with Victoria
Consideration should be given to the consent process involved in issuing a health care, pension or dva gold card including either an opt out or opt in process to share contact information with named state government departments for the specified purpose of providing information to households receiving state based concessions. (Safeguards would need to be built in to ensure appropriate use of the data)

State communicating with concession households via the retailer or the Commonwealth

3. Obligation to place concession customers on the best / near to best contract

At the completion of contract benefit periods, concession customers could be placed on terms equivalent to the best available tariff (or a tariff within 10% of the best available tariff). This would ensure concession customers are on a tariff within the best 10% offered by a given retailer.

4. Simple, low cost tariff for concession customers

Requirement to have a simple low cost default tariff for concession customers who do not re-engage in the market.

In addition to these options the Victorian Government could consider a variety of programmatic interventions including:

1. Sponsoring the establishment of a not for profit retailer
2. Supporting a dramatic increase in outreach for Victorian energy compare
3. Development of tailored switching support for vulnerable customers.

21. What potential policy options and measures exist to address any issues with the operation of retail electricity and gas markets? Please explain how these policy options and measures would improve outcomes for consumers and identify any potential risks arising from these options and measures.

The BSL is keen to engage in dialogue on the best mix of reforms to ensure better outcomes for low income and vulnerable consumers from Victoria’s retail energy market. We have identified a number of options to consider in this submission. They include:

1. Regular collection and reporting of data on the prices consumers are actually paying for energy, broken down into customer segments.
2. Use of retail market outcome measures based on the price consumers are paying for energy, and their satisfaction in the market
3. Development of metrics and a process for retailers to report on retail charges
4. Introduction of measures to control the high fixed component of retail bills in Victoria, these may include capping fixed charges or restricting fixed charges to a ratio of the underlying network fixed charge.

5. Development of consistent protocol for sharing data from retailers and distributors with consumers and third parties.

**Households receiving energy concessions**

6. Requirement on energy retailers to report to de-identified billing information for each concession customer once per year.

7. Development of Victorian Government processes to be able to communicate directly with Victorian concession customers.

8. Obligation on retailers to:
   - place concession customers on the best / near to best contract at the end of benefit period or
   - introduce a simple, low cost tariff for concession customers.

9. Investigation of programmatic interventions including:
   - sponsoring the establishment of a not for profit retailer
   - supporting a dramatic increase in outreach for Victorian energy compare
   - development of tailored switching support for vulnerable customers.

We also note the proposals floated by Ben-David (2016). The following proposals appear relatively straightforward and should be considered immediately:

1. Universal obligation to publish – require retailers to publish any contract offered to one or more customers (not simply the publicly available offers).

2. Genuinely fixed prices – require all contracts of fixed length to offer fixed terms for the duration of the contract.

3. Recommended Retail Price requirements – retailers would be able to set their own recommended retail price, but they would only be able to discount from their RRP.

Further consideration should be given to the other proposals, which include:

4. Separated billing – billing the network component of energy bills separately from the retail related charges, providing a comparable anchor for discounts.

5. Regulatory approval, review or veto of offers – “regulators be given the authority to approve, review or veto products offered by energy retailers?”

6. Contract moratorium – void all existing contracts from a given time and effectively reset the market.
7. End of contract termination – ban retailers from automatically rolling over from one contract to another, or ultimately face disconnection

8. Market segmentation – structurally segment retailers who supply small customers from those who supply large customers

9. Limits on market share

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A critique of the Victorian retail electricity market

A report for the Brotherhood of St Laurence

June 2015
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Executive summary

This document is a report to the Brotherhood of St Laurence. We have been commissioned to critique the Victorian retail electricity market in its provision of electricity to households.

Retailers consider that the Victorian electricity market is fiercely competitive. The Australian Energy Markets Commission (AEMC) agrees with this and says that competition is effective. The Australian Energy Regulator does not comment on the market. The Essential Services Commission of Victoria (ESC) has expressed concerns about retail costs and margins and is seeking to encourage debate about this.

Energy consumer advocates are highly critical of the Victorian retail market. Consumer surveys commissioned by the ESC and AEMC are also not encouraging. The ESC’s survey finds consumer dissatisfaction with many aspects of the retail market. The AEMC’s survey finds Victorian consumers are less satisfied than those elsewhere in the National Electricity Market (NEM).

Our quantitative analysis focuses on retail charges, starting with data on household electricity charges and prices supplied by the Australian Bureau of Statistics. We find that retailer charges (in respect of the costs that retailers control) have increased since the market was fully deregulated. Our calculation of retailer charges is broadly consistent with (if not towards the lower end) of the range estimated by others. We also find that the fixed charges in retail tariffs are, relative to the fixed network charges, far higher in Victoria than elsewhere in the NEM. This means that the average prices paid by low consumption (typically low income) households in Victoria are far higher than for higher consumption (typically higher income) households.

The evidence on the effectiveness of competition seems to be contradictory. Retailers say the market is highly competitive and it is true that switching rates in Victoria are high by Australian and international standards. Also there do not seem to be significant barriers to retailer entry or customer switching.

Why then are retail charges, on average, so high and why is there apparently so little evidence of product and service innovation? New entrant retailers have been able to build market share, but have typically been acquired by one of the major retailers once they have reached critical mass. The characterisation of the retail market, by the Chief Executive of a retailer that was acquired by one of the major incumbent generators, as an oligopoly selling a commodity product seems to be a reasonable characterisation of the current state of a market that has been open to competition for 13 years. If this characterisation is correct, then households seem to be paying retailers a lot but only getting a little in return. If there is indeed fierce competition, consumers don’t seem to be the beneficiaries of it.

Markets are complex. More needs to be done to properly understand what is really going on. In addition to strategic analysis, quantitative work to understand retailer margins and return on investment, and cost structures would be very valuable. Consistent definitions and approaches will allow international and national
comparison. In this regard the quantitative analysis of retail markets being undertaken by the Competition and Markets Authority in Great Britain might form part of an analytical template.

We also suggest analysis of possible interventions including the regulation of fixed charges. Is it possible to find interventions that improve the market for all consumers and not just for some at the expense of others?
1 Introduction

This document is a report to the Brotherhood of St Laurence. The Brotherhood of St Laurence is a non-government, community-based organisation concerned with social justice.

We have been commissioned to critique the Victorian retail electricity market specifically as it relates to the provision of electricity to households. This report does not focus specifically on any particular segment of the residential electricity market. However the concerns raised in this report – apparently unhappy consumers, high retail costs and very high fixed elements of retail tariffs - affect the lower income households and individuals whose interests the Brotherhood of St Laurence promotes, most adversely. This means that low-income households and individuals have a particular interest in the issues that are the focus of this report.

There are two main sections to this report. The first section summarises others' views of the Victorian retail market. It then analyses those views and provides our own quantitative and strategic assessment. The second section describes possible actions that regulators and the Government might consider.

It is intended that this report is a constructive contribution to the contemporary debate about the Victorian retail market, in the context of widespread concern about the market.
2 Evidence and views

This section summarises what regulators, consumer advocates and the industry have said about the retail electricity market in Victoria. We then present our own analysis and finally conclude.

2.1 Background to the Victorian retail electricity market

The Victorian retail electricity market is a market of around 2.3 million connections about 98% of whom are classified as small consumers – typically households and small businesses.

Victoria is one of five states served by the National Electricity Market (NEM). This involves a mandatory market for the provision of electricity by large scale generators. A single transmission network service provider and then five distribution network service providers convey the electricity from these large scale generators to end users. Many end users also produce electricity through distributed generation to meet part of their own needs and at times export production surpluses to the grid.

The retailing of electricity – which is the businesses of selling electricity to end users – is contestable and has been since 2002. From 2002 to 2008 the Essential Services Commission of Victoria (ESC) set the terms of some tariffs (known as reference tariffs or standing tariffs) which were intended to be fall-back tariffs for consumers who chose not accept tariffs offered in the market (known as market offers). Since 2009 the ESC does not regulate any retail tariffs. However some retailers are obliged to still offer reference/standing tariffs but they are free to set the terms of these tariffs.

Retail tariffs in the other four states covered by the NEM are becoming deregulated, embarking on the path that the Victorian retail electricity market has been on since 2009.

2.2 Regulators

Three regulatory commissions are involved in oversight of the Victorian electricity retail market in various ways.

Australian Competition and Consumer Commission (ACCC)

The ACCC enforces compliance with Australian Consumer Law which covers activities such as door to door sales and deceptive conduct. The ACCC has not commented on the competitiveness of the Victorian retail market but has issued fines to various retailers operating in Victoria for false, misleading and deceptive conduct.

Essential Services Commission of Victoria (ESC)

The ESC is responsible for regulating energy retailing in Victoria. All energy retailers are required to hold a licence granted by the Commission. Energy licences place a range of obligations on energy companies, including compliance with the Energy Retail
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Code (ERC). The Commission has recently harmonised the ERC with the National Energy Consumer Framework (NECF) administered by the Australian Energy Regulator (AER), to enable national energy retailers to achieve regulatory efficiencies, whilst retaining a number of consumer protections that are unique to Victoria. However, these protections do not extend to the regulation of energy prices.

Since 2009 the ESC has not regulated retail tariffs in Victoria. The ESC may regulate retail tariffs but only if a review by the Australian Energy Markets Commission (AEMC) finds retail competition to be ineffective and recommends that price controls be reintroduced. The ESC has produced studies of the Victorian electricity retail market in 2002, 2004 and 2013.

The ESC’s first (2002) study was completed shortly after the retail market was opened to competition. It noted that little could be said about the competitiveness of that market at such an early stage. However, it said that its price caps discouraged participation by suppressing margins and creating uncertainty about future levels of those caps. The net churn rate at the time of the review was 4%, and although there was evidence of innovation, the ESC expressed concern about the complexity of retailers’ offers and the ability to compare market offers across retailers.

The ESC’s 2004 study pointed to seven new retailer entrants in the previous two years that had attracted 50,000 customers, that 13% of customers had switched retailer and that 17% of customers had chosen market rather than regulated contracts. It concluded that the market had been less than fully effective for the smaller retail customers.

The ESC’s 2013 review included a research paper and a quantitative paper on retailer margins. The research paper suggested that Victorian retail electricity market could no longer be classified as highly concentrated (the market share of new entrants in 2012 was close to 30%). It calculated customer churn rates in 2011 and 2012 of 17% (about 40% below those reported by the AER, AEMC and the Energy Retailers Association which include new dwellings and customers moving between dwellings as churn).

The quantitative paper commented on the findings of the ESC’s consultant’s reports on electricity prices and retailer margins in Victoria from 2006 to 2012. The consultant’s report focused on gross margins (i.e. the retail charge as a percentage of non-retail charges) and net margin. This was calculated for various tariffs and in each of five areas defined by the boundaries of the distribution network service providers. The report found that gross and net retail margin had been increasing since regulated reference tariffs had been withdrawn. It also found higher margins for customers that were still supplied on reference tariffs. It speculated that such customers were more “sticky” and that this might reflect complacency or a more fundamental inability to interact with a competitive market.

The ESC suggested that its reports were not intended to definitively answer questions about the progress of retail competition, but rather to shed light on the reason for price rises in Victoria which would inform discussions about the effectiveness and extent of competition in the Victorian retail electricity market.
In 2013 the ESC commissioned market research to understand aspects of the Victorian retail market\(^1\). This report found that Victorians rate the electricity offers they are presented with very poorly, and generally lower than they have in the past. It found that older people and lower income households are less likely to switch retailer than younger people and higher income households. It found that price was by far the biggest reason for switching retailer and that those who remain on standing offers do so because they see no benefit in changing.

**Australian Energy and Markets Commission**

The AEMC reviewed the Victorian retail market in 2008, as a precursor to the withdrawal of regulated reference prices. It concluded that the Victorian retail electricity market was workably competitive. It concluded in particular that there were low barriers to entry, that Victoria had one of the highest switching rates in the world and that although half of all residential customers had by then not switched off regulated tariffs it could not be assumed that such non-switchers were not getting the benefits from competition.

The AEMC periodically produces information relevant to the assessment of retail costs, as part of its annual small consumer price reports. Its 2011 report\(^2\) said that retailers’ charges per kWh sold to households in 2013/14 in Victoria (based on regulated reference tariffs) were expected to be between 2.2 and 3.4 times higher than those in New South Wales, Queensland and South Australia.

Its 2013 report\(^3\) did not express retail charges in the same way but instead stated the retail charges per kWh, giving a wide range in each state: 0 to 3 cents/kWh in South Australia, between 1.7 and 2.6 cents/kWh in Queensland and New South Wales. Again Victoria led the pack by a wide margin (between 3.3 and 7.6 cents per kWh).

In August 2014 the AEMC completed its first annual retail competition review in the National Electricity Market\(^4\). It concluded that “a range of competitive market indicators suggest the Victorian market has the right conditions in place to promote rivalry between retailers and we have not found a systemic issue on the retailer-side of the market that suggests competition is not working”. In relation to its finding from previous work that retail margins in Victoria were higher than elsewhere in the National Electricity Market, the AEMC suggested that “Competition is a process and retailer margins can be expected to fluctuate over time. Estimates of retailer margins should therefore be interpreted with caution.”

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Australian Energy Regulator (AER)

The AER administers the National Energy Consumer Framework (NECF) but has no role in regulating the retailing of energy in Victoria. It is Victorian Government policy not to transfer retail regulation to the NECF. The AER nonetheless includes information on the Victorian market in its Annual Reports. In its 2014 annual report the AER provides data on retailer market shares and customer switching data. In its latest report (and in all previous reports) it made no adverse (or complimentary) comment on the competitiveness of the Victorian electricity retail market or whether the outcomes it is delivering are acceptable.

2.3 Consumer advocates

St Vincent de Paul

The Society of St Vincent de Paul produce very useful bi-annual reports on retail electricity prices in Victoria, analysing both reference and market tariffs. An enduring theme of their reports is that some retailers offer significantly lower prices than others.

Their July 2014 report\(^5\) produces an interesting analysis of retail costs based on market offers to customers connected to Jemena’s distribution network. From this they estimate retail charges of $380 per household, which is 25% more than their estimate of the wholesale charge. They comment “if the retail component of households’ energy bills in a competitive market is greater than the cost of wholesale energy it must be time to examine where the market design went wrong”.

Consumer Utilities Advocacy Centre (CUAC)

CUAC undertook a study of the Victorian electricity retail market cover the period 2009 to 2012. The examined market concentration using the Herfindahl–Hirschman Index (HHI) and the Four Firm Concentration Ratio (CR\(_4\)) and noted that in the three years since market deregulation there was no evidence of a significant reduction in market concentration or evidence of strong new entrant retailers. They concluded that the three first tier retailers offered similar prices to each other (this is also seems to be generally consistent with St Vincent de Paul’s reports). They also suggested that in January and July 2012, new entrant retailers increased their prices as much as the first tier retailers. From this they speculated that marketing expenditure rather than price innovation and price differentiation is a significant factor affecting market share.

2.4 The industry

Energy Retailers Association of Australia (ERAA)

The ERAA contends\(^6\) that the Victorian electricity market is a fiercely competitive market. It says that since price caps were removed in Victoria on 1 January 2009 competition has developed strongly, offering customers more diverse and innovative energy products, and enabling consumers to save on their power bills by shopping around. Since this date there has been a growth in the number of smaller retailers. The Victorian market is the least concentrated in the country with the three incumbent retailers having about 70-75 per cent of the market while a range of new entrant retailers have secured about 25-30 per cent of overall customers. They draw attention to a 2012 study by consultancy vasaaETT\(^7\) that concluded that the Victorian electricity market had the highest rate of switching in the world.\(^8\) The ERAA also strongly rejected the ESC’s 2013 findings on retail margins in Victoria.

Retailers

The retailers that operate in the Victorian electricity market seldom comment on the market, although when they do – in their annual reports or investor presentations - they usually describe it as one characterised by vigorous or intense competition. Interestingly, both Origin Energy and AGL Energy, two of the largest retailers both consistently report much lower switching rates for their customer base than for the market as a whole.


\(^8\) It is not clear that their comparison accounts for all the difference. For example the Victorian switching rates include retailer contracts with new dwellings, and when an existing consumer relocates is counted as a switch. In Victoria small non-residential customers are also included. In Britain for example switch rates do not include non-residential customers, and the ESC’s analysis is that 2012 switch rates excluding new dwellings and relocations were about 40% below the rate claimed by vasaaETT.
2.5 Our analysis

This subsection sets out our analysis of retail charges in Victoria. Figure 1 below, compares the network and non-network charges in Victoria to those in other states in the NEM. The analysis is based on standing offers/regulated reference tariffs and published network tariffs in the year ending 30 June 2014. Market offers are typically lower than standing tariffs. However we have crossed checked these prices with the prices obtained from the ABS’s authoritative 2012 survey\(^9\) (discussed in further detail in this section) and indexed to 2014 using the ABS’s indices and from this we conclude that the information contained in Figure 1 can be relied upon as a reasonable indication of network and non-network charges to average usage households in various parts of the NEM\(^{10}\). The figure shows a remarkable difference between average retail charges to households in Victoria compared to those charges in other states.

Figure 1. Breakdown of average price for average consumption household

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\(^{10}\) We refer those readers wishing to explore this in further detail to Mountain, B. 2015. “Network tariffs applicable to households in Australia: empirical evidence”. A report for UnitingCare Australia. Available from www.cmeaustralia.com.au. It should also be noted that there are various details that need to be taken into account in a more precise understanding of the relative size of the red and green bars. For example the green bar for Victoria, includes the smart meter costs, which account for about 1.5 cents per kWh in that year. And in South Australia and Queensland in particular solar feed-in tariffs mean that the red bars in those states should be reduced by about 1.5 cents per kWh to ensure comparison with those in other states.
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In the rest of this sub-section we estimate the retail charges to households in Victoria and then comment on market concentration, barriers to entry, barriers to switching, product innovation and consumers’ views.

Retail charges

Our analysis examines the charges that retailers present to households for the sale of electricity. This amount is not presented on electricity bills separately from other charges and so needs to be estimated. Our analysis starts with data provided by the Australian Bureau of Statistics (ABS) of household electricity bills in 2012 and household electricity price indices before and after that. From this we deduct network charges (which can be reasonably accurately calculated based on known network tariffs), various non-network charges (covering environmental and metering charges) and then wholesale supply charges (which we estimate within a range). The residual from this calculation is the charge by retailers for the services they provide. The text that follows explains our calculations in detail.

Figure 2 below shows the change in the average annual household electricity bill in Victoria from 2008 to 2014 (the blue line). This is based on the Bureau’s 2013 report11 of average household electricity bills in Victoria in 2012. The values for the other years in this chart are calculated by adjusting the 2012 value for the change in the ABS’s Melbourne household electricity price.

Figure 2. Total charge, network charge and derived non-network charge

The red line in the chart is the average household network services charge which we have calculated based on the known network tariffs for each of the five distribution network service providers (and using the average consumption used in the ABS study). To obtain a Victoria-wide average we have weighted the number of connections of each network service providers as a proportion of the Victorian total.

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The difference between the blue line and the red line is the green line. This is the derived non-network charge. This non-network charge represents the charges for wholesale energy plus retailing plus a variety of environmental and metering charges which retailers incur and pass on to households.

We now proceed to strip out what we call “other exogenous charges” from the derived non-network charge. These “other exogenous charges” include payments for metering, environmental charges (feed-in tariffs, the Victorian Energy Efficient Target and the federal Renewable Energy Target). To do this we have used the analysis of other exogenous charges presented in Oakley Greenwood 2015\textsuperscript{12,13}. The result of this analysis gives the derived wholesale plus retail charge in Figure 3 below.

Figure 3. Derived non-network, other exogenous charges and derived wholesale + retail charge

We recognise nonetheless that the black line in Figure 3 may be slightly understated and so the resulting implied wholesale + retail charge (the orange line) may be slightly overstated, but the difference will not be large. We therefore suggest that the orange line is a reasonable estimate of the wholesale electricity plus retailer charges for the average Victorian household. The orange line shows that the inferred wholesale plus retail charge has roughly doubled between 2008 and 2014.

The next step in our analysis is to separate the wholesale electricity charge from the retail charge. This is impossible to do with certainty since the wholesale charge for different retailers is not known with certainty: many retailers produce much of the electricity they sell and their cost of production is not known with certainty. In addition while they can buy directly from the spot market or enter into physical or financial


\textsuperscript{13} The Oakely Greenwood analysis is based on a 4,0 kWh per year customer (whereas the ABS data has an average annual household consumption of 5,6 kWh). We have however not adjusted for this difference in annual consumption since the largest proportion of these exogenous charges (metering charges) are recovered per connection not per MWh consumed.
contracts the terms of these contracts (and the proportion they buy from the spot market) is not known with certainty.

We therefore need to estimate wholesale electricity charges in order to derive an estimate of the derived retail charge. Before doing this, to get a sense of how the wholesale plus retail charge has varied in comparison to a wholesale market reference price (the demand weighted spot price for the Victorian region of the National Electricity Market), we have expressed both of these as an index starting at 1 in 2008.

This is shown in Figure 4. This shows that the increase in the wholesale plus retail charge does not seem to be explained by changes in the wholesale price which is much the same in 2014 as it was in 2008 and varied in a range of plus or minus 30% between these dates.

Figure 4. Index of wholesale prices and of derived wholesale plus retail charges

To estimate the retail charge (the charge by retailers for the retail service they provide) we have estimate a wholesale charge within a range of plus or minus 20% of the reference price (the spot price) and deducted the resulting wholesale charge (assuming 5,585 kWh average annual consumption – based on the ABS’ 2012 survey) to give an annual retail charge in dollars per household. This is shown in Figure 5 below.

Figure 5. Derived retail charges – upper and lower bounds
From Figure 5 we see that retail charges between 2008 and 2014 increased by about 2.4 times, and by 2014 lie in the band between $371 and $471 per household per year. Throughout this period households in Victoria were able to choose who supplied electricity to them, and from 2009 to 2014 there was no control over retail prices.

We have benchmarked our estimate for the retail charge with the estimates that others have made:

- As discussed St Vincent de Paul estimated the retail charge for customers connected to Jemena’s network in 2014 at $381. This is within the range of our estimates.
- The AEMC estimated the retail charge in Victoria in 2011 (based on standing offers) at 34.4% of the total bill. This is slightly above our upper bound for 2011.
- The ESC’s consultants produced various estimates of “gross margins” (which is definitionally comparable to our estimate of retail charge) for first tier suppliers based on standing offer and market offers. For 2012 these ranged between 26.5% and 46%. The bottom end of their range is a little above the bottom of our range and the top end of their range is above the top of our range.

**Market concentration**

From the time the market was liberalised in 2002, new entrant retailers have grown to supply about 25% of the Victorian electricity market. However since 2008 (the last year during which regulated tariffs were available) and 2014, the market share of the three dominant first tier retailers has remained roughly unchanged.

Since 2002 there have been a number of new entrant retailers. However once they reach a certain size they have been acquired by one of the three first tier retailers (and in one case by a government-owned generator already with a significant retail business in Victoria, albeit that some of these acquisitions have arisen as a result of privatisations in Queensland (Powerdirect) and New South Wales (Country Energy and Energy Australia). Specifically:

- The acquisition of Powerdirect by AGL Energy in 2007;
- The acquisition of Country Energy and Energy Australia by Origin Energy and TRUenergy respectively in 2010;
- The acquisition of Australian Power Group by AGL Energy in 2013;
- The acquisition of Lumo by Snowy Hydro in 2014.

With the exception of Lumo’s acquisition by Snowy Hydro, the pattern has therefore been a decline in the market share of the first tier retailers who have then bought customers back by acquiring second tier retailers. Snowy Hydro with its organically built Red Energy and acquired Lumo energy retail businesses stands as the one exception of a non-first tier retailer to have built a significant (circa 20%) share of the Victorian household electricity retail market.
Barriers to entry

It is not clear to us that there are meaningful barriers to entry in the Victorian electricity retail market. The ESC’s licensing requirements do not seem to place undue burdens on retailers. Likewise in the context of significant uncontracted generation we suspect it is unlikely that new entrant retailers would find the management of wholesale market price risk to be unduly onerous.

Barriers to switching

It is not obvious that there are significant barriers to switching. Around three quarters of the residential market is now supplied on market contracts. While the switching numbers quoted by the EARA and AER may be significantly higher than the actual switching rates (according to the ESC 17% in 2012, against the AER and EARA’s claim of 28% for that year), a switching rate of 17% is still a significant rate of customer churn. It is interesting to note in this regard that AGL Energy expects that by the end of the first full year after the acquisition of APG it will have lost around 35% of the APG customers it had acquired, and AGL noted that this is consistent with its business case for the acquisition of APG14.

It might be argued that search costs are low – there are numerous government-provided and commercially-provided price comparison and switching websites. Finding a better deal should not take too much effort. However St Vincent de Paul’s analysis shows that most retailers’ offers are clustered together. Consumers may be able to get much better deals by, for example, changing from one type of tariff to another, but this often requires a sophisticated knowledge of tariffs and data on annual consumption and expected consumption at different times of the day. Such data is almost impossible for the typical residential consumer to obtain.

Furthermore even if much better deals can be had in the market from time to time, it seems that such savings don’t seem to persist. As evidence of this we point to the high switching rates and AGL Energy’s expectation that it will lose more than a third of the customers it acquired through the acquisition of APG, after the first year.

Product innovation

On product innovation it seems difficult to see that there has been much progress. In its critique of the ESC’s consultant’s retail margins report, the Retailer Association’s consultant suggested a number of reasons why the ESC’s consultant had over-stated margins15. This included magazine subscriptions, airline and credit card loyalty program points, monthly cash prize draws and gift cards. At the time of writing this report we checked the offers of Victoria’s three largest electricity retailers. One of them

offered “flybuys” loyalty points at the rate of 1 per dollar spent – which is about 1400 points per household per year. To get a sense of the value of this, the “flybuys” website’s featured offer was $20 worth of clothes for 2000 points. On this calculation, almost two years of electricity purchases would be rewarded with a $20 clothing voucher.

Other new entrant retailers do offer air miles and one offers a gift card to new customers. But it is hard to imagine that this might be taken as evidence of product innovation, or as evidence that retailers’ margins (as we and others have estimated them) are overstated. The Wallis survey cited earlier suggests consumers think such rewards are inconsequential in their switching decisions.

Other “innovations” include discounts for online accounts, dual fuel, direct debt or prompt payment and so on. The Wallis survey suggests consumers place a little value on these in their switching decisions. Some retailers offer free power on saturdays or the electricity retail equivalent of “happy hours”. Most offer sign-on bonuses, typically credited to the account and some offer finder fees (again credited to the account). This might be good evidence of marketing to attract and retain customers and management by retailers of their of credit risks, but surely not of product innovation.

One new entrant retailer with a tiny share of the market is known to offer highly innovative retail products that offer consumers the opportunity to buy ahead and monitor their hourly, daily, monthly and annual consumption through online and mobile applications. This same retailer has entered the retail market in New South Wales - which according to the AEMC as noted earlier has much lower retail margins than Victoria.

Thirteen years after the Victorian retail market was opened to competition and several years after smart meters were rolled-out, the vast majority of retail sales are still on simple two part tariffs with no time of use differentiation. No retailers offer tariffs without fixed daily charges, and none offer tariffs with demand charges. Perhaps retailers have assessed that consumers don’t value this, perhaps it is because they find easier ways to attract and retain customers. It is telling that the recently departed Chief Executive of the most successful new entrant retailer in Victoria (Australian Power and Gas) described the Victorian electricity market in 2014 as an oligopoly offering a “commodity” product.\footnote{16}

\textbf{Consumer views}

National surveys consistently rate concerns about electricity prices at or near the top of the list of household concerns.\footnote{17} A recent survey\footnote{18} undertaken for the AEMC found that

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\begin{itemize}
\item \texttt{http://www.crikey.com.au/2013/07/16/power-sale-how-they-doorknocked-customers-then-sold-them-back/}
\item \texttt{http://consumersfederation.org.au/choice-consumer-survey-reveals-growing-economic-gloom/}
\end{itemize}

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retailers in Victoria scored worse than the average in the National Electricity Market in respect of household consumers’ satisfaction with their current electricity company, their quality of service, their value for money and market choice.

2.6 Conclusions

This section has surveyed others’ views of the Victorian electricity market and then presented our own, brief, analysis. On others’ views:

- The ESC is concerned about retailer margins. By contrast neither the AEMC nor the AER have expressed any concern about the competitiveness of the Victorian retail electricity market or retailer charges and margins.

- The association representing energy retailers disputed the Essential Services Commission’s concern about retail margins. In their statements to investors, the two largest stock exchange listed Victorian retailers typically describe the Victorian retail market as highly or intensely competitive. Other retailers are less effusive, describing the industry as an oligopoly.

- The Victorian Government has expressed concern about the size of fixed charges\(^\text{19}\) but also that the Victorian electricity market is one of the most competitive in the world\(^\text{20}\), although officials\(^\text{21}\) and politicians\(^\text{22}\) have expressed concern about retailer margins.

- Consumer groups representing low income consumers are concerned about market concentration and excessive retail charges.

From the evidence we have surveyed in developing this report we conclude that there do not seem to be significant barriers to entry to new entrant retailers, that the transaction costs that customers incur do not seem to be a barrier to switching retailer, and that the effort and costs that customers incur to find better deals (if not the best deals) do not seem significant. However, the effort required to find the best deal, not just a better deal - the St Vincent de Paul’s reports show consistently that there is a big gap between the best and the median - may be significant. Furthermore, the evidence seems to be that the best deal does not stay the best for long – not because other better


\(^{19}\) See for example http://www.abc.net.au/news/2015-02-07/gas-electricity-fixed-costs-up-50pc-in-victoria/6077396

\(^{20}\) See for example http://www.energyandresources.vic.gov.au/energy/electricity


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deals are available in the market – but because having attracted customers through discounts, retailers do not seem to wait long to raise their prices.

This is where the ambiguous or at best positive picture ends. There seems to be a considerable amount of highly adverse evidence:

• The Ombudsman reports electricity retail complaints reached their highest ever levels in 2014\textsuperscript{23}, 50% higher than four years earlier. Billing problems accounted for half of all complaints.

• Electricity disconnections in Victoria in 2014 – at around 1% of all connections - is at an all-time high.

• While there are some new entrant retailers offering genuinely innovative products they serve a tiny proportion of Victoria’s electricity consumers, and have anyway entered other retail markets in Australia where retail charges are much lower than in Victoria. Despite an expensive mandatory roll-out of smart meters, most consumers are still supplied on the same time-invariant two part tariffs structures that have been in place for many decades.

• The survey evidence on consumers’ views about retailers is not encouraging. Households in Victoria are less satisfied with their current electricity company, their quality of service, their value for money and market choice than the average of households in the National Electricity Market. This is despite systematically higher switching rates in Victoria than elsewhere in NEM, and that the smallest proportion of Victorian electricity consumers are supplied on reference tariffs: evidently switching retailer is not bringing Victoria’s household consumers the satisfaction they are seeking.

• The unsatisfactory consumer assessment is matched by even less satisfactory retail charges. Our assessment is that retail charges have more than doubled since regulated reference tariffs were in place in 2008, and are now far higher than elsewhere in the NEM and than the cost of producing electricity. The suggestion that a significant part of the higher retail charge is paid back to consumers in gift cards, fly-buys and other loyalty credits does not seem plausible.

• Finally, the pattern of new entrant retailers gaining scale and then being acquired by one of the three dominant retailers means that the three dominant retailers have retained their market share since prices controls were lifted in 2009. This roundabout will have delivered gains to investors in the new entrant retailers, and presumably the retailers that acquired them are satisfied (or they would not have chosen to buy). Some of the customers who switched between retailers at different points will have obtained better prices than market averages. But to what end is such a roundabout with all its attendant costs?

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A conclusion from this is that the Victorian electricity retail market does not seem to be delivering to consumers what they want, and that it seems to be offering poor value for money relative to what it has in the past and relative to retailing elsewhere in the National Electricity Market. The Victorian market has had time to evolve: households have been able to choose their suppliers for 13 years, and six years ago all price controls were lifted. Would decision-makers have set the market on its current course if they were able to predict where things seem to have got to now?

However, we stress that our report does not purport to be a comprehensive examination: our conclusions should be considered tentative. Markets are complex and finding out what is really going on takes careful study and reflection. It would be valuable to understand the position not just of consumers on average relative to retailers on average, but cohorts of consumers relative to each other and cohorts of retailers relative to each other. Have some consumers fared much better than others, and if so why? Have consumers failed to take advantage of opportunities or have retailers benefitted from those that are unwilling or unable to take advantage of opportunities?

Littlechild (2015) asks whether evidence that consumers can get a lower price by shopping should be taken as evidence that the market is working, or is evidence that they pay a higher price if they don’t shop around, evidence that the market isn’t? This seems to be a key question in the Victorian electricity market. Can consumers indeed get an (enduringly) better deal by shopping around? Do the apparently better deals that they select turn out to be worse deals in due course? And so are consumers, once bitten twice shy? Do survey’s such as the Wallace survey that suggest many consumers “can’t be bothered” to shop around, indicative of their willingness to pay higher prices or are there other explanations for this? Finally, since electricity is essential for most households, and there are limited or no substitutes in many cases, should consumers be entitled to some level of regulatory protection even if they don’t actively engage in the market, or, “the devil take the hindmost”? Can such protection be designed so as to improve outcomes for all consumers or is it inevitable that protection for some is at the others’ expense?

Further examination may support or undermine our findings or offer plausible explanations for at least some of the adverse outcomes that we have observed. However, at this stage, on the basis of the evidence we have reported on in this paper, we cannot conclude other than that the Victorian retail electricity market seems to be delivering clearly unsatisfactory outcomes, at least in respect of sales to households.
3  Possible actions

This section considers, briefly, a number of possible actions. The purpose is not to recommend any such actions but rather to describe some possibilities and identify issues that might be considered in each.

Littlechild (2015) criticises Ofgem’s various interventions in the retail market in Britain over the last few years, suggesting that the cures have been worse than the disease, or to be more precise that there was no disease in need of a cure. In Australia by comparison, there has been no administrative intervention in the Victorian electricity market since 2009. And the Victorian arrangements have been promoted by the ERAA and AEMC as the model for the deregulation of other retail electricity markets in Australia.

A decision to intervene must be justified on the basis that it will make things better. This requires judgment that there is a problem to be solved and that doing something about it will make matters better not worse. The previous section suggests that outcomes in Victoria’s household retail market are unsatisfactory, and that when there was previously some form of intervention (regulated standing offers) retail charges were much lower. It is hard to know whether consumers thought they were better off then, but it is clear that they have taken a long time to move from those regulated standing/reference tariffs: six years since administrative restraints on those tariffs have been relaxed and 13 years since consumers could choose market offers, one quarter of households are still supplied on those reference tariffs.

We also pointed to evidence that Victoria’s households think they are worse off than the average households in the NEM, and that Victoria’s retail charges are much higher (at least twice as high as elsewhere) in the NEM and that they have increased since the regulation of standing offers was withdrawn. Faced with this evidence – presuming it withstands further scrutiny – the desire to make changes is understandable.

In the rest of this section we examine three possibilities:

- Transparency
- Tariff simplification;
- Reintroduction of regulated standing tariffs;
- Regulation of fixed charges.

However, before examining these we describe work to understand the situation in Victoria better. We think work on this is essential to understanding the current situation, and in justifying any major changes that might follow.

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3.1 Transparency

Greater transparency is usually one of the first options that governments and regulators turn to in promoting markets. Considerable effort has been made on this in Victoria. The survey results on this are encouraging: 87% of respondents are quite or fairly interested in energy issues; 95% are aware of that they can choose their supplier; 79% are fairly or quite confident in their understanding of offers and options. The knowledge of comparison websites (41%) is less encouraging, but lack of information does not seem to be a major concern.

Transparency is valuable also in assessing and understanding the market. We have found the ESC’s reports invaluable in making our assessments, and the customer survey commissioned by the AEMC in 2014 has also been very useful. The ESC’s retail margin studies drew a strongly critical response from the industry. But our assessment is that their response is longer on heat than it is on light and the information obtained through this process is extremely valuable.

Further effort at understanding the operation of the market and its outcomes including those difficult to estimate – such as net margins – will be valuable. Questions that have attracted our attention include:

- Why there is apparently so little evidence of innovation? For example why is there so little up-take of time-variant tariffs and why do retailers not offer tariffs without fixed charges, surely this is a demand for such products in the market?
- Why fixed charges in retail contracts in Victoria (see Section 3.3) are so much higher than elsewhere in Australia (and internationally)?
- Whether the track record of new entrants as we have understood it – growth followed by acquisition by one of the incumbents - is a reasonable description of the pattern of new entry? If so what should be concluded from this about the competitiveness of the market?
- Whether the apparent profitability meaningfully overstated after accounting for loyalty rewards?
- How profitable retailing electricity to households and small businesses in Victoria actually is? In this regard we note the long-standing work of Ofgem and the recent work by the Competition and Markets authority in analysing retailer profitability in Great Britain. It would be valuable to obtain estimates of earnings before interest and tax (EBIT) and gross profit less indirect costs and depreciation and amortisation (D&A) from the retail sale of electricity to Victorian households and small businesses. International comparison would be helpful and ensuring a consistent approach in Victoria with the approach adopted in GB would help such international comparison.

We suggest that work to develop a better understanding of these issues would be valuable before taking further action.

3.2 Tariff simplification

The arguments for tariff simplification can be found in observations in behavioural economics that too much choice confuses and disempowers consumers. The implication is that consumers are less likely to participate in a market, and so the competitiveness of the market is diminished.

It is not clear that there is a problem of too much choice in the Victorian electricity markets. The survey commissioned by the AEMC suggests that consumers think they are aware of their options and understand the market. And the switching data points to a liquid market even if, as we suggest, consumers are not always armed with the information and skills to work out the best deal on offer.

We also refer again to the observation of the ex-CEO of Victoria’s most successful new entrant retailer, that the Victorian electricity market is a commodity market. If anything, we would have thought that the problem is not that the market seems to offer too many confusing choices, but that it offers too few sophisticated choices.

There are other good arguments against intervention to reduce choice. Littlechild (2015) observes that consumers prefer simplicity but not if it means higher prices. Forcing consumers to pay higher prices on simpler tariffs in order to enhance market liquidity is a difficult argument to sustain.

Mostly however, we seem to be at the start of a new era of distributed generation, storage and smart meters. We are more confident that competing retailers, rather than regulators, will be able to find retail products that offer value to consumers in this more complex and data intensive environment. Governments should be wary before intervening in ways that may stunt product innovation in the hope that apparent simplicity will deliver greater competition.

3.3 Reintroduction of regulated standing tariffs

Our analysis suggests that average retail charges were lower when regulated standing offers were available, up to the end of 2008. This is despite the fact that these standing offers included “headroom” designed to provide an incentive for new entrant retailers. It is tempting therefore to suggest that one possible solution would be to reintroduce regulated standing offers (just as they are being withdrawn in other regional markets in Australia).

We think it would be worthwhile exploring this further. The market share of new entrants was higher and retail charges were lower when regulated offers were available. Its difficult to see that there was any less innovation then than now and there does not seem to be evidence that consumers are more satisfied then than now: indeed as noted earlier comparing Victoria with other retail markets, the Newgate survey suggests the opposite.

On the other hand it may be suggested that reintroducing regulated tariffs is like trying to put the genie back into the bottle – an exercise in futility. And, with almost all
Victorian households and small businesses now having smart meters, many households now having distributed generation and probably some level of distributed storage in future, the job of defining appropriate regulated reference tariffs may be much harder than it was just five years ago.

For these reasons, while the reintroduction of regulated retail tariffs merits further investigation we think it should be approached with care.

### 3.4 Regulation of fixed charges

The black (vertically shaded) bars in Figure 6 below shows the annual fixed charges ($ per year) that households were paying in 2014 on reference tariffs (regulated other than in Victoria). The red (horizontally shaded) bars are the fixed charges in the regulated network tariffs that are charged to retailers in respect of their supply to household. The chart shows clearly that retailers in Victoria are paying much lower fixed charges to network service providers\(^{26}\) than retailers elsewhere in the NEM are paying to the network service providers in their areas of supply.

**Figure 6. Network and retail fixed charges ($/year) for electricity supply to households in the National Electricity Market in the year to 31 December 2014**

For an average household electricity bill in Victoria of around $1,400 in 2014, around 30-40\% of the charge is fixed. The proportion is even higher in 2015. This is a higher

\(^{26}\) Citipower and Powercor have both increased fixed charges in 2015.
proportion than elsewhere in the NEM, and we believe far higher than for household electricity bills in other developed economies\textsuperscript{27}.

In addition, as St Vincent de Paul’s tariff reports show, market offers typically offer discounts against the variable charge only – the daily fixed charge is based on the charges in standing offers. This means that the proportion that is fixed is even higher than the estimates in Figure 6 which based on reference tariffs.

The high fixed charges mean that lower consumption consumers (typically lower income households) pay much higher average prices than higher consumption households. For example, in AusNet’s area of supply, the fixed charge raises average annual prices by 4 cents per kWh for households that consume twice the average but by 16 cents per kWh for households that consume half the average.

We are not aware of any retailer in Victoria that offers a variable-only tariff (i.e. a tariff that does not have a fixed charge). One new entrant retailer that offers innovative retail products is, as far as we are aware, the only retailer to include the daily fixed charge in its calculation of discounted “powerpacks”.

It might be that a part of the higher fixed charge in Victoria is related to the recovery of smart meter charges. These have become significant (between $109 and $226 per connection) in 2015\textsuperscript{28}, though the charges have been much smaller than this in previous years and retail fixed charges were still much higher than network fixed charges even when smart meter charges were much lower.

If retail tariffs were regulated we would call on theoretical arguments that such fixed charges are inefficient: in regulated utilities as in markets, prices should be set so that they reflect marginal costs, not (sunk) fixed costs. If this leaves a revenue shortfall for some sellers, recovering the shortfall through fixed charges limits the ability of consumers to adjust their consumption in efficiency-enhancing ways. It would be more efficient to recover revenue shortfalls through volumetric or demand charges to which consumers are able to respond, if they choose to, by reducing or changing the pattern of their consumption.

In addition, tariffs with high fixed charges are regressive (lower than average household electrical consumption is correlated with lower than average household income). High fixed charges diminish incentives to efficient consumption and undermine households’ ability to reduce their bills by consuming less or producing electricity themselves to meet their own requirements.

\textsuperscript{27} In large parts of the United States for example, household tariffs are purely volumetric and in some cases have small fixed charges typically to recover customer-specific fixed charges such as metering and billing.

It might be suggested that such theoretical efficiency and fairness considerations are irrelevant because the market for supply to households is contestable. However for the reasons set out in the previous section, the effectiveness of retail competition in Victoria is not clear. In this context, and having particular regard to the regressive and anti-competitive impact of high fixed charges, we believe controls over fixed charges merit further investigation.

3.5 Conclusions

This report raises questions about the effectiveness of competition in the Victorian electricity retail market. We understand that the Victorian Government is also concerned about aspects of the market and that the ESC is investigating starting a review, building on its previous work. We have identified a few options to be pursued but suggest that understanding the market better is an important starting point. It would be helpful if the issues raised in this paper were to be investigated in further detail by the ESC and the AER, in a process that actively engages consumers and the industry.