



**EnergyAustralia**

LIGHT THE WAY

30 June 2017

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Dear Mr Sims

**Submission to the inquiry into retail electricity supply and pricing issues paper**

EnergyAustralia welcomes the opportunity to comment on the issues paper for the inquiry into retail electricity supply and pricing (Issues Paper) being undertaken by the Australian Competition and Consumer Commission (the Commission).

EnergyAustralia is one of Australia's largest energy retailers with more than 2.6 million electricity and gas accounts in NSW, Victoria, Queensland, South Australia, and the Australian Capital Territory. We also own and operate a multi-billion dollar energy generation portfolio across Australia, including coal, gas, and wind assets with control of more than 4,500MW of generation in the National Electricity Market (NEM).

The recent escalation in wholesale electricity prices resulting from government policy uncertainty is driving up retail electricity prices for customers in eastern Australia. While the wholesale market is working as designed, the Independent Review into the Future Security of the NEM (i.e. 'Finkel Review') has highlighted that further planning and policy certainty is required. Agreement between State and Federal governments to implement the review's recommendations, in full, to encourage the right generation investment would increase confidence that the current high wholesale prices will be temporary.

EnergyAustralia understands that these increases have an impact on customers and, in response, we have committed an additional \$10 million towards initiatives to assist our vulnerable customers reduce their electricity bills. This includes energy efficiency assistance and debt management measures.

The Commission's inquiry is investigating all aspects of the retail electricity market, including retailer practices and overall outcomes for customers. Clearly, price rises are not good for customers. Over the past decade network and policy-related charges (duplication between jurisdictions, policy uncertainty, and the introduction of new

obligations), and more recently wholesale costs, have added to the cost of energy for households and businesses. It follows that a stable policy environment and robust regulatory regime are integral to managing all components of electricity bills.

We consider that the retail electricity market is performing well with more than 30 retailers operating in the NEM. There are no barriers to entry or expansion causing detriment to new or less established participants, apart from issues of policy inaction and high regulatory burden that affect all participants. Our submission explores the role of vertical integration of generation and retail in the NEM and demonstrates that while this produces some outward differences between participants, these are not a cause for concern.

The high level of retail competition in the NEM is leading to continuous improvement in customer service levels, increased innovation in products and services and downward pressure on prices. We do, however, recognise that it can be hard for some customers to engage effectively in the market, particularly when they are confused by marketing activity. We identify several ideas for further consideration to help customers better participate in the market.

Some commentators have recently suggested that the electricity market is failing customers; a view which we believe demonstrates a lack of understanding of the market and is based on incomplete data. The reality is that retailer returns on invested capital are lower than those of regulated electricity network companies. Throughout the past ten years, market conditions have changed markedly yet retailer market entry and exit has occurred in a steady manner, which also reflects the absence of so-called super profits.

In summary, we observe that generation and retail markets in the NEM are vigorously competitive and are delivering more for customers in service and innovation than they ever have in the past, and are well-placed to continue to improve. There is a current issue with high prices but remedies have been identified and are available. It should not be concluded that the whole market has failed. The complexity and high pace of change in the market coupled with affordability issues will always require continual revision and improvement of business practices, regulatory policy and frameworks.

If you require any further information on our submission, please contact James Chisholm on 8628 1202.

Yours sincerely



**Catherine Tanna**  
Managing Director  
EnergyAustralia



EnergyAustralia

**The EnergyAustralia submission to the  
ACCC inquiry into retail electricity supply and  
pricing – Issues paper**

**30 June 2017**

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## 1. Wholesale Electricity Supply and Prices

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### 1.1. Factors affecting electricity supply and wholesale prices

The NEM facilitates the exchange of electricity between generators and end-use customers (in most cases through their retailer). Generators sell electricity through the market which allows instantaneous matching of supply and demand. From the generators' bids and offers, the Australian Energy Market Operator (AEMO) dispatches the combination of generation to meet demand in the most cost-efficient way. AEMO then issues dispatch instructions to these generators. By this process, a wholesale spot price is derived every 5 minutes and averaged over the half-hour for settlement in each of the five regions of the NEM. The wholesale electricity market design in the NEM is an energy only mandatory gross pool. This design allows AEMO maximum control to efficiently match generation to customers demand across the NEM in real time. Spot prices are bound by the reliability settings (the price ceiling, price floor and cumulative price threshold). The reliability settings are determined by the AEMC Reliability Panel to ensure the market provides reliable supply for customers.<sup>1</sup>

Generators will offer to generate electricity in the expectation of being able to cover their fuel and operating costs (short-run marginal costs, SRMC) as well as some portion of cash and financing costs.<sup>2</sup> Competition sets prices with generators offering prices at or above SRMC, and will rely on short periods of spot price volatility (and the subsequent ability to sell higher priced hedging contracts) to cover fixed costs and to make adequate returns of capital investment.

The long-term nature of investments in generation does mean that investors need certainty in the policy landscape to commit to investments. The sustained national policy uncertainty over the past ten years has resulted in a lack of new investment, which is a key driver of the current high wholesale prices and the reliability issues observed in the NEM. On the other hand, the recent levels of new renewables projects being developed in the NEM, demonstrates that where policy certainty exists and a pricing signal exists, the market is working and investors are prepared to commit to new generation. The Finkel Review has recently reported on these issues and made recommendations that will facilitate an adequate generation level and mix that will reduce wholesale prices.<sup>3</sup>

Periods of high prices are essential in an energy only market to inform and promote efficient investment in, and operation of, generation resources (or demand response) to ensure reliable supply of electricity. In a market over-supplied with generation capacity, prices are lower and this signals that no more generation is required. The reverse is true in an under-supplied market.

We have recently come through a period where several low-cost generators have closed because of inadequate returns. There has been no replacement of this generation, leaving the market susceptible to generation shortages and pushing up prices. The wholesale price is only now reaching levels suitable for investment in new gas generation.

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<sup>1</sup> These settings are currently under review by the Australian Energy Market Commission (AEMC): <http://www.aemc.gov.au/getattachment/c52dec51-b57a-4d9c-a6bf-3c225a8ef084/Issues-Paper.aspx>

<sup>2</sup> Requirements include: capital spend, operating expenditure, financing costs and the ability to pay off debt and make a return on investment.

<sup>3</sup> Dr Alan Finkel, *Blueprint for the Future: Independent review into the future security of the National Electricity Market*, June 2017.

The high wholesale prices we are currently experiencing are expected to attract new generation build which would cause prices to fall again. This investment response is already evident in the many new generation projects announced and the decision by some mothballed gas generators to return to service.<sup>4</sup> However, an efficient market response is being impeded by the large amount of policy uncertainty and Government interventions affecting investment decisions in any generation option.

There are other reasons wholesale prices have increased:

- Gas generators are experiencing high gas costs resulting in higher SRMC and run for less time as they might otherwise do. Gas costs and supply limitations also force some gas generators to run their plant on diesel at times which is also an expensive fuel source.
- Over the last ten years, the Renewable Energy Target and various energy efficiency schemes have been introduced, enhanced or strengthened. These add explicit costs to capture the intended policy benefits

The gas market is also contributing to current wholesale prices as gas generators are experiencing high gas prices so they have a higher SRMC and run for less time as they might otherwise do. Gas costs and supply limitations also force some gas generators to run their plant on diesel at times which is also an expensive fuel source.

While the electricity spot market exhibits periods of volatility during an extreme day, or for periods of time across a summer season, over the last decade it has rarely exhibited the sustained wholesale price levels required to attract significant new investment in generation. The last time wholesale prices were very high was in the drought of 2007-08 where there was a short-term supply contraction. Queensland generators had been exporting most of their energy to other States, but many thermal (coal/gas) generators were reliant on limited water supplies for cooling purposes. In addition, Snowy Hydro had low water storage levels. During this period, prices were not as high then as they are now – only around \$60-70/MWh, up from \$35-40/MWh – but the high price period lasted for around 18 months and pushed up contract prices two to three years out. Retail prices also increased significantly over this period reflecting the increase in forward costs (see section 1.3.2).

## **1.2. Is the generation market competitive?**

The Commission is looking at all aspects of competition within the wholesale and retail markets including the extent and impact of vertical integration in the NEM.

### **1.2.1. Market entry and exit**

The electricity generation market is a complex market requiring long-term investment of capital and, as discussed above, interest in building new generation is only just starting to occur again. There are no fundamental structural barriers to entry and exit; however potential investors must consider a range of factors – e.g. policy uncertainty, regulatory approvals for construction, competitively priced fuel, extensive obligations to operate within the National Electricity Rules and meet AEMO requirements, as well as safety and

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<sup>4</sup> For example: ENGIE's Pelican Point power station in South Australia (an additional 240 MW now being offered into market from June 2017); AGL's cancellation of plans to mothball the Torrens Island A turbines, which will be replaced in early 2019 with a new 210MW power station and a number of large scale renewable energy projects under construction, completed or starting in 2017 (an additional 3,200 MW of committed renewables)

environmental laws and regulations, etc. We are starting to see many 'new build' generation projects being raised. There is a diverse range of parties involved in these projects from government to large merchant projects and existing participants.<sup>5</sup> There is no apparent bias in the nature of the parties seeking to enter the market; however, it is notable that all parties are favouring renewable generation.

Another factor inhibiting investment can be that merchant investment is risky and an investor's risk management policy or creditors may require a long term financial contract or offtake agreement with a credit worthy counterpart. Part of the recent problem has been an environment in which there is no mutual commitment between parties to work together to encourage longer term contracting in the interests of a more stable long-term supply that will ultimately make electricity more affordable. For example, commercial and industrial (C&I)<sup>6</sup> customers (a sizeable portion of the retail load) are tending to contract for an average of 12 months; far too short a period to help underpin new generation investment. Short-term contracting characterises a market plagued by ongoing policy uncertainty.

### 1.2.2. The market definition is changing

We note that there is a dramatic shift occurring in the electricity generation and retail markets where the traditional arrangement has been that generators produce electricity and customers consume it. In various guises, there is a noticeable emergence of producer-consumers (customers with solar panels, batteries, advanced electronics that allow aggregation of small site exports). Overall this is leading to a growth in intermittent and small-scale generation entry to the market. Another change is that demand response is becoming more sophisticated and can be managed across aggregated sites and has an increasing potential to influence wholesale market operations and therefore to change the nature of the generation market.

The effect of these shifts is a shrinking generation market in the traditional sense and this should not be overlooked in assessing market trends and competition indicators. Often the change is seen as being small and incremental, but has the potential for being disorderly and potentially inefficient if not properly managed.

### 1.2.3. Market concentration and market power

The ACCC has previously identified concentration of generation ownership potential inhibitor of competition in the NEM.<sup>7</sup> While it is possible to get concentration of generation ownership within regions, we don't see concentration as a problem across the NEM. AEMC reviewed market power, delivering their report in 2013 and found that there was no evidence of sustained generator market power in the NEM.<sup>8</sup> This review recommended that the Australian Energy Regulator (AER) be given explicit functions to monitor the effectiveness of competition in the wholesale market. This function is now

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<sup>5</sup> For recent examples: The South Australian Government's *Our Energy Plan*: <http://ourenergyplan.sa.gov.au/assets/our-energy-plan-sa-web.pdf> ; the joint Commonwealth and State governments of New South Wales and Victoria *Snowy 2.0*: <http://www.snowyhydro.com.au/our-scheme/snowy20/>; Lyon Group's *Nowingi Solar Storage* project; EnergyAustralia's pumped hydro feasibility study; <https://www.energyaustralia.com.au/about-us/media/news/consortium-assessing-pumped-hydro-storage-plant-south-australia>

<sup>6</sup> Usually denotes customers who use more than 160MWh of electricity per year.

<sup>7</sup> Australian Competition and Consumer Commission (ACCC), *ACCC opposes AGL's proposed acquisition of Macquarie Generation*, Media Release 4 March 2014 and ACCC, *Report to the Australian Competition Tribunal: Re proposed acquisition of Macquarie Generation by AGL Limited*; File 1 of 2014, para 7.219 – 7.221.

<sup>8</sup> <http://aemc.gov.au/Rule-Changes/Potential-Generator-Market-Power-in-the-NEM>

incorporated in the National Electricity Law and the AER will formally review and report on the effectiveness of competition in the wholesale market at least every two years.

#### **1.2.4. The contract market**

Theoretically, a competitive wholesale electricity market would be expected to have a liquid forward trading market. We observe the NEM has a variety of contracting structures, namely, futures, over-the-counter and bilateral contracts all being available in significant volumes for risk management. In assessing contracting behaviour, contacting level and spot outcomes, it's important to understand that much of the data on contracting activity is not publicly available. The price for generation for any particular contract type, State and time period can vary greatly, and often do not reflect wholesale prices in the spot and contract markets. This should not be unexpected as generators often contract a large portion of their output well ahead of time and so may only receive limited income from the spot market.

Pricing in the contract market will tend to reflect participants' expectations of spot prices for that future period. While there is a premium to be paid on contracts, participants will arbitrage away any implied premium. So, in periods where spot prices remain relatively stable, there will be a greater amount of similarity in spot and contract prices.

### **1.3. Vertical integration as a risk management strategy for retailers**

Selling or purchasing electricity on the wholesale market is a high cost and potentially risky activity for all market participants. For retailers, this is the risk of being exposed to high spot prices for unhedged load; for generators, this is the risk that their assets may not perform also leaving them exposed to high spot prices. There are a range of approaches retailers use to hedge their customer loads to minimise exposure to high wholesale prices. Clearly, vertically integrated retailers can use their own physical generation as a hedge in addition to the other financial hedging methods. The choice of hedging strategy and the timing of hedging prior to a period are guided by a retailer's risk management policies, risk appetite and the availability and price of different hedging products.

#### **1.3.1. Perfect hedging**

Vertical integration is not a perfect hedge, so all NEM retailers are participating to a greater or lesser degree in the contract and spot markets. Perfect vertical integration could be defined as a situation where a gen-tailer was always self-sufficient and never had to buy or sell to the market. This would require a mix of generation suitable for baseload and fast-start peaking generation. This is clearly not possible in the NEM, so vertically integrated retailers need to set up alternative hedge arrangements to complement vertical integration to some degree.

Retailers often don't hedge their retail load, or can't accurately predict their retail load in order to hedge it completely – any unhedged volumes are known as residuals. For any large NEM retailer, their exposure on residuals can often be greater than for most small retailers despite being vertically integrated. Vertical integration does not provide a means for retailers to avoid being exposed to the contract and spot markets. This exposure is substantial as the vertically integrated retailers have a higher total load flex<sup>9</sup> and are

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<sup>9</sup> Load flex is the amount that customer demand can increase for a peak day compared to an average day.

generally shorter to a higher total volume at times of peak demand than stand-alone retailers (as hedging too far above typical demand levels<sup>10</sup> is considered inefficient).

### **1.3.2. Benefits and disadvantages to vertical integration**

There can be a benefit for retailers to have the option to use a physical hedge. This is evident in the different approaches taken by the largest four gen-tailers: AGL, Origin Energy, Snowy Hydro-Red/Lumo and EnergyAustralia. Each is vertically integrated to different levels and with a very different generation mix (e.g. baseload and peaking plant), indicating a diversity of approaches between parties and States. However, we see having a physical hedging option as a strategic choice that may or may not translate to a financial benefit, and therefore does not necessarily provide a material competitive advantage over non-vertically integrated retailers.

The cyclical nature of wholesale market prices has a flow on effect to vertically integrated retailers, in that sustained high spot and contract prices are beneficial, but sustained low prices can be put the entire business model at risk. Non-vertically integrated retailers who hedge effectively may avoid these highs and lows. For example:

- During a period of high wholesale prices, to purchase contracts at the going rate is only a problem if these costs cannot be recovered from retail customers.
- When wholesale prices are low, a stand-alone retailer may purchase electricity at a low cost without having to carry generation assets with low or no profitability.

We observe that there has been a mix of vertically integrated and stand-alone retailers in the NEM for some time and that there are no obvious signs that one strategy benefits over the other over the long-term. Even large vertically integrated retailers can get their hedging decisions wrong, resulting in the need to write down or write off asset values, or close down their generators due to lack of profitability. Mothballing or closing a generator comes with substantial costs. Apart from the obvious effect on employees and the associated costs, turning off a plant for long periods makes it much more difficult and costly to restart. Closing a generator means that a company must remediate the site to make it safe in physical and environmental terms and these are often long-term, specialised and costly projects.

Over the last decade, there have only been two periods where wholesale electricity market prices have been at, or marginally above, the long run marginal cost of generation (i.e. the current period and during the drought of 2007/08). If vertical integration provided a material hedging advantage, then you would expect to see stand-alone retailers struggle financially, or exit the market, when wholesale electricity market prices are high. However, during these periods, we have seen few retailer failures (or exits) and the ones we have seen have not failed due to sustained high prices.

High risk hedging policies, lack of working capital, and poor business models are sometimes the reason for some failures and do not appear related to a lack of access to hedging arrangements. Further, we have observed that when prices rally quickly this creates a perverse incentive for retailers to exit for opportunistic reasons – e.g. to liquefy their hedge book. This can have an adverse effect on customers who are off-loaded in the process.

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<sup>10</sup> That is, typical demand levels are considered to be a one in two year [50% probability of exceedance (POE)] or a one in ten year [10% POE].

### 1.3.3. Differences in wholesale pricing approach between different retailer types

We would expect differences in hedging approach, retail pricing strategy and risk appetite to drive differences in how vertically integrated and stand-alone retailers calculate the wholesale component of their retail prices. Short-term hedging is often an approach taken by stand-alone retailers<sup>11</sup> and is a good strategy when prices are falling, as cost decreases can be passed on more quickly to customers in retail prices, but the opposite is true in a rising market. The more acute responsiveness of smaller, stand-alone retailers appears to arise from their more limited capital requirements.

There has recently been an example of this effect. Victorian retailers typically change their prices once a year in January when network prices increase, but recently many second and third tier Victorian retailers announced price increases effective from July 2017. This effect is also seen in the highly competitive C&I market. The frequent broker auctions and tender processes for C&I customers provide constant feedback to participating retailers on the attractiveness of their pricing and offers compared to other retailers.

Stand-alone retailers could find some additional protection against market price increases if they were to hedge earlier and more conservatively. The reallocation mechanism can be particularly useful to some retailers in allowing them to reduce their exposure to bank guarantees. Under this mechanism, two parties can reduce their collateral requirements by asking AEMO to make matching debits and credits to the financial position of those market participants with AEMO.

## 2. Market Structure and Retail Competition

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### 2.1. Market structure

Electricity retailers in the NEM operate in a facilitated market specifically designed to maximise competition and minimise barriers to entry. The design of the NEM's mandatory gross pool ensures that any retailer or market customer has access to wholesale electricity supply on the same terms. Similarly, open-access, regulated monopoly networks ensure all retailers and market customers receive the same terms and service for physical supply to the premises.

Competitive markets are a powerful vehicle for delivering the outcomes customers genuinely want and value. The dynamic process of effective retail competition accomplishes three very important things on behalf of customers:

1. The minimisation of wasted resources deployed in the provision of energy services (efficiency) – by penalising suppliers with relatively high cost bases for a given service;
2. Insulation from poor business decision making – whereby retail businesses wear the cost risk of bad investments (especially in generation); and
3. The promotion of new and better ways of providing energy services (innovation) – by rewarding suppliers with new ideas that add value from the perspective of customers.

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<sup>11</sup> For example, see Vocus Group Ltd, *Investor strategy day webcast, transcript*, 14 June 2017, p18. Available at <http://vocusgroup.com.au/investors/company-performance/webcasts/>

Retailers compete to provide a range of services to, and on behalf of, customers including:

- Offering price, product and service differentiation to suit customer needs, including information about energy use and energy efficiency;
- billing and service functions for the entire energy delivery chain;
- purchasing wholesale energy on behalf of customers;
- managing the risks associated with wholesale market volatility;
- purchasing renewable energy certificates;
- purchasing energy efficiency scheme certificates;
- assisting customers experiencing hardship; and
- managing credit and bad debt risk (across the whole bill, including network costs).

In developing new propositions, EnergyAustralia uses these various product, pricing and service levers; our aim is to encourage customers to choose, trust, stay and hopefully advocate on our behalf.

### **2.1.1. Customer segment needs**

The retail electricity market is categorised by three broad categories of customers, residential, small business and C&I all seeking a variety of products. The breadth of the customers allows retailers to formulate business plans that target niche markets in order to keep costs down and maximise return on investment. For example, some retailers may focus on specifically targeting customers interested in green products, those who are attracted to different price structures, or customers who only interact with their retailer online (thereby reducing costs required to operate a call centre).

New market entrants will always attempt to innovate and to entice subcategories of customers away from established retailers. Innovation and disruption are necessary elements of an evolving, competitive and mature retail market. The broader the customer base, the broader the diversity of products and services required to satisfy customers' needs. EnergyAustralia as a larger retailer, must appeal to customers across a wide range of segments by continuing to innovate and diversify in order to retain customers targeted by new competitors with specialist products.

In a competitive market environment, EnergyAustralia must (and does) continue to innovate and derive efficiencies for customers or face ongoing and increasing erosion of its customer base.

This submission will focus on mass-market customers unless stated otherwise.

## **2.2. Retail competition**

A competitive retail market will deliver products and services that customers need and drive competitive pricing (i.e. downward price pressure). Customers should be engaged, active and satisfied (including vulnerable customers). Retailers should compete fiercely with each other, through product, price and service and by innovating and differentiating their offerings. There is no formal definition of what a competitive electricity retail market

should look like and within the NEM; participants are most familiar with the AEMC's annual assessment approach.

The AEMC has been tasked to monitor the level of competition across the NEM. In its assessment of retail competition in the NEM, the AEMC considers a number of market indicators:

- customer activity in the market;
- customer outcomes in the market;
- barriers to retailers entering, expanding or exiting the market;
- the degree of independent rivalry among retailers;
- whether retail energy prices are consistent with a competitive market;
- experiences and outcomes related to new and emerging energy products and services; and
- outcomes for vulnerable customers.<sup>12</sup>

The AEMC's most recent report on the retail electricity market determines competition to be effective across the NEM jurisdictions of South Australia, Victoria, New South Wales and Southeast Queensland. Key indicators have shown improved outcomes for consumers in terms of customer's satisfaction with their electricity retailer, the quality of customer service and value for money.<sup>13</sup> EnergyAustralia supports the current retail competition assessment undertaken by the AEMC and their findings to date which show that the markets across the major NEM States are competitive and are improving. The following sections expand on these indicators.

### 2.2.1. Market size and share

The regulation of retail electricity markets has evolved to promote competition and influence the pace of these markets' transition through the competitive stages – i.e. the introduction of retail market contestability, and mass-market electricity price deregulation.<sup>14</sup> Retail market concentration has decreased as each jurisdiction has moved further in time away from regulated pricing regimes as new retailers are attracted to enter the market. This is particularly obvious for the larger markets in Victoria and NSW.

The larger markets of Victoria and NSW have experienced a decrease in the market concentration among the 'big three'<sup>15</sup> and an increase in market share for smaller retailers. We expect that this trend will be shown to have continued throughout 2016 when AEMC releases its 2017 Retail Competition Review.<sup>16</sup>

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<sup>12</sup> Australian Energy Market Commission (AEMC), *2016 Retail Competition Review, Final Report 30 June 2016*, p1-2.

<sup>13</sup> Ibid, pi.

<sup>14</sup> Ibid, p3.

<sup>15</sup> The 'big three' is an industry recognised reference to AGL Energy, Origin Energy and EnergyAustralia.

<sup>16</sup> We anticipate this report will be released by AEMC in the coming weeks.

**Table 1: Number of customer and retailers by State (2014-2016)<sup>17</sup>**

		2014 Review	2015 Review	2016 Review
<b>New South Wales</b>	small customers	3.35m	3.39m	3.42m
	retail brands/ businesses	15/13	20/16	26/22
<b>ACT</b>	small customers	0.17m	0.18m	0.18m
	retail brands/ businesses	3/3	4/4	4/4
<b>Victoria</b>	small customers	2.67m	2.70m	2.74m
	retail brands/ businesses	18/16	21/17	25/22
<b>South Australia</b>	small customers	0.84m	0.85m	0.85m
	retail brands/ businesses	13/13	15/13	18/15
<b>South East Queensland</b>	small customers	1.34m	1.36m	1.4m
	retail brands/ businesses	11/10	11/10	13/11

In relation to market share, the AER notes that tier one retailers still have 70% of customers, but observes that:

*“smaller retailers acquired 8 per cent of customers from the three market leaders between 2012 and 2016. In 2015–16, smaller retailers increased their market share by 25 per cent in NSW, and by 20 per cent in Queensland. Snowy Hydro—owned by the NSW, Victorian and Australian governments—has grown sufficiently in size to be considered a fourth significant retailer, with 7–8 per cent market share in electricity and gas. Victoria has the highest penetration of smaller retailers, with 20 supplying electricity to around 37 per cent of the state’s electricity customers in 2016, and eight supplying gas to 30 per cent of gas customers. In South Australia, smaller retailers supplied 22 per cent of electricity customers and 12 per cent of gas customers. Smaller retailers increased their market share by 4–6 per cent in 2015–16 in those States.”<sup>18</sup>*

The AER data demonstrates that rivalry is strong: the biggest three retailers have declining market shares and that other retailers have a strong foothold in Victoria and are making ground in other States.<sup>19</sup> The number of retailers and spread of market share is directly related to the timing since retail price deregulation – i.e. that Victorian deregulation was followed successively by SA, NSW and then Queensland.

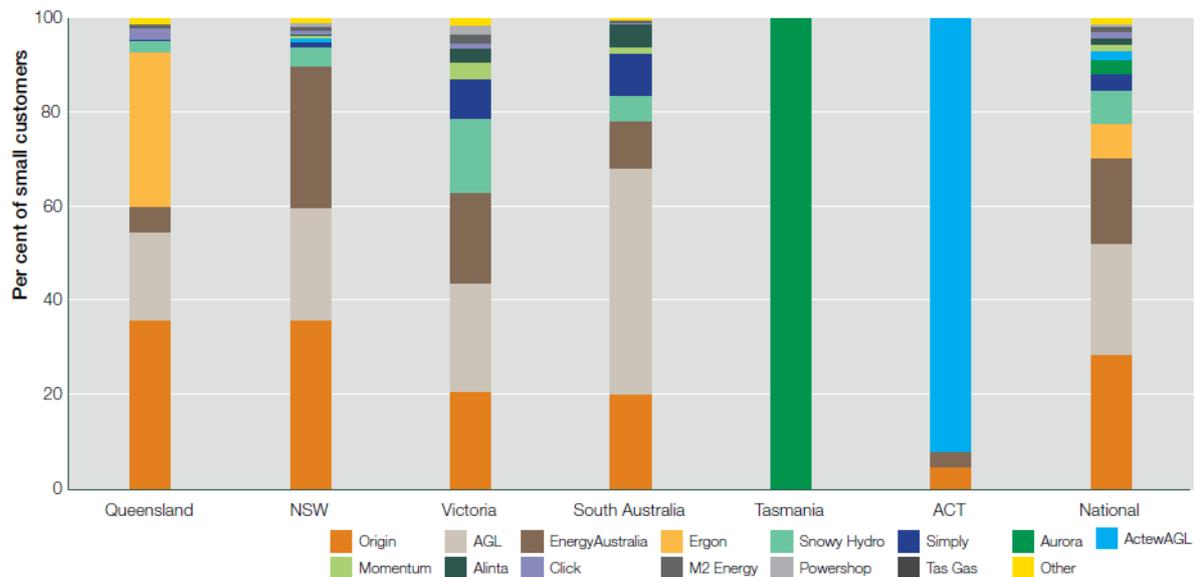
<sup>17</sup> Ibid, pp173, 180, 189, 197 and 212.

<sup>18</sup> Australian Energy Regulator (AER), *State of the Market Report*, May 2017, p137.

<sup>19</sup> The main exceptions here are the smaller States, Tasmania and the ACT which both still have State-owned retailers, electricity price regulation.

**Figure 1**

Retail market share (small customers), June 2016—electricity



### 2.3. Barriers to retail market entry and expansion

The AER stated recently that vertical integration “*can drain liquidity from derivatives markets, posing a barrier to entry for retailers that are not vertically integrated.*”<sup>20</sup>

However, we see that a steady and healthy number of new start-up, non-vertically integrated retailers are seeking retail licences from the AER.<sup>21</sup> One recent applicant was based in South Australia and was seeking a licence for all the main AER States. We also observe that new entrant retailers often start operations in one State and then later open in other States. This shows that there are no significant barriers to entry to the retail electricity market.

Economic theorists continue to postulate that vertical integration may be a barrier to entry to non-vertically integrated retailers, but the numbers in Table 1 tell a different story; the presence of different retail structures and business models within the market are demonstrative of mature and evolving market infrastructure.

### 2.4. Customer switching

Customers interact more with the market as they understand that they have the ability to shop around, the ways in which they can approach, compare and select a retailer and as they become aware of the range of offers and services available to them.

We continue to observe increasing numbers of customers switching between retailers and an overall net drift of customers from tier one retailers to tier two and three retailers. EnergyAustralia has observed an annual net loss over the last few years. Of those customers leaving us, an increasing percentage are switching to tier two retailers. These trends are not obvious from the usual reports of switching activity (figure 2) which show that overall annualised switching rates are relatively constant in each State over the last few years.

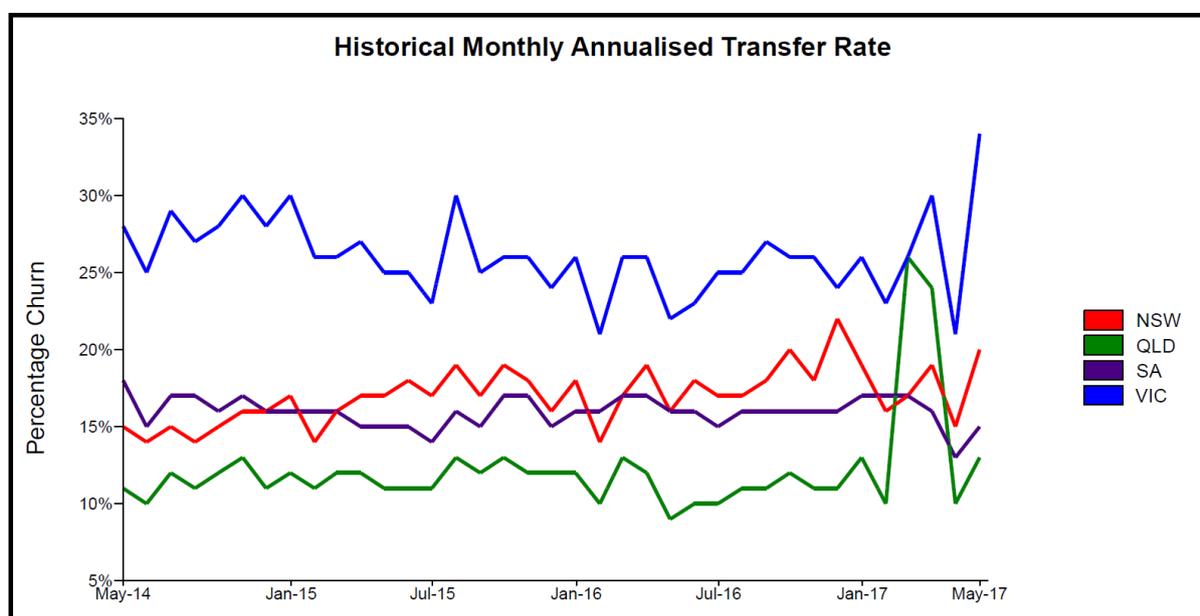
<sup>20</sup> AER, State of the Energy Market Report, May 2017, p140.

<sup>21</sup> <https://www.aer.gov.au/retail-markets/authorisations/public-register-of-authorised-retailers-authorisation-applications>

Price is identified as the key determinant in customer movement within the retail market. In recent years, the impetus for large numbers of customers within the mass market is at the point of annual price review. Bill shock and bill creep are the primary impetus for customers to commence researching and interacting with retailers and comparator sites. Therefore, in order to attract and maintain their customer base, a retailer must be competitive on price and focus on reducing retail operating costs while improving customer experience through ongoing innovation and other non-price terms.

We note that the churn rates in figure 2 are indicative of customers switching retailers only. However, it is not necessary for all customers to be actively shopping around to demonstrate engagement in the market. We know that there are a number of existing customers who are engaged and change plans internally or who are happy with their existing offer and don't move (approximately 10% of our customers change plans internally per annum).

**Figure 2: NEM Historical annualised transfer rate 2014-2017<sup>22</sup>**



Customer switching activity is only one of many indicators of retail competition and there is no definitive rule as to the optimal level. The importance of customer switching is that it translates to healthy trends in market share data as customers exercise free choice and this is exactly what is observed (see earlier discussion in section 2.2.1).

## 2.5. Competition in retail pricing and discounting

Pricing and discounting trends in the retail electricity market show that competition between retailers is fierce.

Pricing of electricity is becoming more diverse – both between retailers and from any one retailer. There are a range of different discounts commonly available in the market. Structural changes to prices (for example creating different prices for different times of the day, demand charges in addition to usage charges, capped dollar prices per period,

<sup>22</sup> Australian Energy Market Operator (AEMO), *National Electricity Market Monthly Retail Transfer Statistics*, May 2017.

etc.) provide benefits to customers by giving them greater choice and control in respect of energy spend or by increasing the predictability of their bill.

It is very important to us that customers understand and trust our offers and feel able to make effective choices. For these reasons:

- All our customer material is written in plain language that is as simple to understand as possible and outlines the offer in a clear and complete way.
- Discounts are not removed or altered without adequate prior notice of any changes and provision of alternative offers.
- Assisting customers to consider the net price after discounts are applied - some retailers focus on having large discounts to attract customers but their overall offer is not good value.
- We have Australian-based sales and service call centres who provide over the phone (or online chat) assistance to customers to understand our offers and to select the most appropriate one.
- As prescribed by regulation, we provide 'price factsheets' which outline the prices and any special terms and conditions in a consistent format, and upload our offers to independent comparator sites.
- We have led the market in stopping door-knocking as a retail channel due to the difficulty in ensuring that customers get clear and complete information about our prices and discounts.

Electricity pricing and discounting is a complex area and this reflects the underlying complexity of cost drivers in wholesale and network costs. Retailers can and do simplify their pricing to customers, but there can be very stark differences in costs for retailers supplying electricity to mass-market customers based on: the network tariff assigned by their network company, location, the type of meter they have, whether they pay their bills on time or not, what their consumption profile is, whether they have a solar feed-in-price, etc. Ignoring significant differences in costs between customers effectively creates cross-subsidies and can leave retailers exposed to losing profitable customers to other retailers and only retaining the less profitable customers.

Pricing and discounting is inherently complex and there is no easy way to simplify this in a way that will result in lower overall energy bills for customers. However, there are opportunities to make further improvements in how customers can make sense of the offers available to them. In section 4 we explore options to improve customers' understanding of the offers available to them and make informed choices.

### **2.5.1. Solar feed-in-prices**

In our view, 2017 has shown competition to be working well for the setting of solar feed-in-price offerings for small market customers. With the significant changes in the wholesale markets, and the removal of a regulated rate in South Australia, we've seen retailers make the most significant changes to feed-in-price offerings in recent years. Wholesale prices have been a key driver of the setting of solar rates, as well as anticipated competitor behaviour. We consider that retailers' recent announcements of large increases in solar feed-in-prices are proof positive that the market can work effectively. However, we note that ongoing price monitoring<sup>23</sup> implies a threat of future

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<sup>23</sup> Essential Services Commission of South Australia (ESCOSA)'s monitoring regime and power to set a minimum price and IPART's publication of benchmark rates in NSW.

price regulation if competitive market outcomes don't conform to politically acceptable views.

Victoria continues to regulate feed-in tariffs and now includes a social component which we think is unjustified and likely to be more expensive to serve. There is also a proposal to include a time and location base in the feed-in tariff which, whilst economically efficient, will be more expensive to implement. This type of intervention diminishes any incentive for retailers to exceed the rate as regulated in Victoria.<sup>24</sup> Accordingly, we would like to see the removal of prescription of feed-in tariffs in Victoria and reduced regulatory constraints in this aspect of pricing across all jurisdictions.

## 2.6. Customer outcomes

EnergyAustralia's own internal analysis confirms that a significant portion of retail customers attribute value to positive customer experiences. We know that, after pricing considerations, poor customer service is the second primary driver for customers to start shopping around.

In order to acquire new and retain existing customers, EnergyAustralia adopts a customer centric approach to its business model. We know from experience that when we proactively engage with our customers we see an improvement in the levels of customer satisfaction. This is evidenced by improvements in our Strategic Net Promoter Score (SNPS)<sup>25</sup> of more than 10 points each year since 2015. EnergyAustralia has invested heavily in improving customer outcomes at specific contact points and has implemented (and continues to implement) initiatives to improve the experience of our customers at each point of interaction.

AEMC's research supports our findings, in that consumer satisfaction with electricity retailers is improving as the retail market matures, some examples of customer satisfaction with interaction are:

- General overall improvement in customer satisfaction with the level of choice in the energy market (Although consumers in the less competitive ACT, Tasmania and regional Queensland were the least satisfied, indicating that they would like more choice of energy companies and plans).<sup>26</sup>
- Most consumers who had switched their electricity company or plan were happy with their decision and satisfied with the process involved.<sup>27</sup>
- In comparison with 2015, consumers were significantly more confident that they could find the right information to choose a suitable energy plan<sup>28</sup>
- Consumers who had investigated energy options but had not switched energy company or plan were either happy with their current retailer, plan or have taken up a better offer with their existing retailer.<sup>29</sup>

<sup>24</sup> Essential Services Commission (ESC), *Minimum electricity feed-in tariff to apply from 1 July 2017: Decision Final*, February 2017.

<sup>25</sup> A commonly used management tool used to measure customer experience and predict business growth. For more information see: <http://www.bain.com/publications/articles/introducing-the-net-promoter-system-loyalty-insights.aspx>.

<sup>26</sup> AEMC, *Consumer Research for 2016 Nationwide Review of Competition in Retail Energy Markets* (Newgate Research), June 2016, p43.

<sup>27</sup> Ibid, p68.

<sup>28</sup> Ibid, p46.

<sup>29</sup> Ibid, p24.

### 2.6.1. Assistance for vulnerable customers

EnergyAustralia has an established program to provide tailored assistance to customers who have difficulty paying their energy bills. This program, *EnergyAssist*, is delivered in cooperation with Kildonan Uniting Care who provide some services for customers and training to our staff to have respectful conversations with our customers. We were ranked as the number one Victorian retailer by the Financial and Consumer Rights Council for our efforts to assist vulnerable consumers in 2016.<sup>30</sup>

Our work in this area has assisted us to identify where customers need further help and we can tailor our responses for each individual. Engagement is the core pillar behind the success of our program which is demonstrated by our graduation rates, customer satisfaction levels and disconnections process. We continually try to improve our engagement with vulnerable customers by providing options like payment matching that provide incentives rather than penalties to customers. We also find it beneficial to trial new ideas and evolve our program to ensure it delivers benefits to customers.

In 2016 we put \$4 million operational expenditure into our EnergyAssist team, including a tripling of our staff from 2014 and extensive training including having respectful conversations, staff resilience training and identifying customers experiencing difficulty.

We are very serious about our commitment to customers in this category:

- Our Hardship Optimisation Program is underway and is aimed at improving our current systems to help identify customers in need even sooner.
- We have developed a Financial Inclusion Action Plan that brings our support programs together and makes us more transparent on how we help people manage financial difficulties.
- We have tailored support systems including payment plans, payment matching, debt waivers, appliance swaps, translation service, dedicated financial counsellor line, dedicated line for hardship customers, and other important initiatives.

On 9 June 2017, we announced we would commit an additional \$10 million and other support for some of our most vulnerable customers during this period of rising electricity and gas prices.<sup>31</sup> The funding will be used to expand our existing *EnergyAssist* program for electricity and gas customers in New South Wales, Victoria, South Australia, Queensland and the Australian Capital Territory. It will expand on our current offerings including energy audits, efficiency and appliance swaps, and also goes towards doing new research aimed at alleviating chronic, long-term financial difficulty.

### 2.7. Competition on non-price terms

Retailers also compete by offering non-price incentives that are attractive and valuable to customers. These include:

- varied payment options,
- billing frequency,

<sup>30</sup> See <https://www.energyaustralia.com.au/about-us/media/news/energyaustralia-welcomes-report-customers-financial-hardship>

<sup>31</sup> See <https://www.energyaustralia.com.au/about-us/media/news/energyaustralia-expands-hardship-support> published 9 June 2017.

- service quality,
- loyalty schemes,
- energy efficiency advice,
- access to products or finance for solar or other appliances, and
- environmental benefits such as green power or a commitment to offset emissions.

There is a noticeable increase in different styles of energy plans (fixed price per month), and bundles involving batteries and other new technologies. These initiatives are indicative of an evolving market with a greater focus beyond price. Smaller retailers can grow more successfully than large retailers by focussing on niche customer segments, whereas large retailers appear to try to appeal to a broad range of customers.

We are doing a lot of work in this space to make our offers more appealing and provide better customer outcomes.

For example, EnergyAustralia:

- recently launched a Velocity Points Partnership with Virgin;
- is offering a carbon neutral commitment to customers at no additional charge – i.e. we are helping customers to make electricity at home carbon neutral by purchasing carbon offset units from a range of Australian and international offset projects which include, for example:
  - renewable energy projects in developing countries
  - land management
  - tree planting in Australia;
- is continually improving our e-billing service, to allow customers to view usage data where it is available and provide customers with the options of more frequent billing where customers want it; and
- is making significant ongoing improvements to our customer service levels and new innovative product and technology bundles (see also discussion in sections 2.6 and 2.8).

## **2.8. Innovation in products and services**

### **2.8.1. Changes to the market landscape**

Retailers don't just focus on price, but try to compete on customer service and new types of products and services to differentiate themselves as outlined above. The retail market is moving away from traditional 'retailer-to-consumer' model. For example, solar power purchase agreement providers sell energy generated from solar panels installed at a customer's home or business. As the market continues to diversify, retailers are exposed to continued risk and must invest in research and innovation programs to compete. In doing so retailers should and will continue to seek to achieve reasonable returns on investment.

The 'traditional' centralised energy supply model is being challenged by emerging technologies, products and services. These include rooftop solar panels, battery storage and smart meters. Many of these new products and services provide customers greater

control over how their electricity is delivered and consumed. Some allow customers to cede control over how their electricity is delivered and consumed to third parties. Retailers (and others) are also effectively finding cheaper or more attractive ways to supply customer needs than centralised generation and in doing so are moving them away from grid supply.

Markets are also evolving for:

- *“energy management services such as brokerage services, energy aggregators and load management services;*
- *energy generation (such as solar PV) and storage products (such as batteries);*
- *off-grid energy systems (including stand-alone systems and microgrids with some link to the grid) and the management of these systems.”<sup>32</sup>*

EnergyAustralia is at the forefront of innovation with a number of initiatives being rolled out during 2017 (see below).

### **2.8.2. EnergyAustralia’s initiatives**

EnergyAustralia is very active in expanding into new technologies and services to appeal to customers. We see that the market is changing rapidly and that to continue to be successful we need to do more to make energy simpler, provide more control and more affordable energy for customers. Some of our recent initiatives are listed below and we note that many others are in development and testing.

- In October last year, EnergyAustralia announced a partnership with solar and battery inverter system developer, Redback Technologies. This partnership shows how we’re investing in the development of reliable, affordable and cleaner technology which puts the customer in control of their energy consumption. The Redback Smart Hybrid Solar Inverter system combines a smart solar inverter, battery enclosure and ‘intelligent’ energy management software into a seamless package. The technology will allow customers to decide how they use, save and even sell energy captured from their roof-top solar panels, from a smartphone.
- We are rolling out our Billing Perceptions initiative whereby we have provided additional soft-skill and process refresher training to our call centre consultants to ensure information provided to customers is relevant and assists with driving energy efficiencies. A separate part of this project is to improve our website content, providing customers a better understanding of their retail bill and energy usage.
- We are focusing on smart meters and smart meter-enabled products and propositions based on meter types.
- One of the most significant changes in the last 12 months has been the change in metering for NSW solar customers from gross metering to net metering. In terms of solar, we have a focus on offering tailored solar energy services to consumers. This includes customising solar options for customers and helping arrange finance for those wanting solar systems through HSBC.

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<sup>32</sup> AER, State of the Energy Market Report, May 2017, p137

- EnergyAustralia has teamed with Tesla Energy to offer customers the Powerwall battery storage system. This allows customers to store energy from their solar panels when the sun is shining or from the grid when rates are low, so they can use the stored power at night, or at some other time.
- For embedded networks, we have a greater focus on digital options with simple energy tariffs for those within the embedded network. Being involved in the feasibility assessment and initial planning stage we're finding more developers want their project to be clean and smart. Installing solar panels on the roof is becoming the norm.

### **2.8.3. The pace of change**

The wider appeal of some new innovative products is sometimes limited by technology and more often by the cost of the technology. There are a range of new possibilities in this part of the market and non-traditional business models are also attracted to this part of the market. Batteries and other new technologies will combine with more established product offers like flexible pricing and solar panels to create more interesting and valuable offers in the future.

The adoption of new technologies and innovative offers may not occurring as quickly as some commentators would like; and similar claims were made in relation to solar panels years earlier. We observe an increasing number of new customer offers and products being trialled and put out to market by electricity retailers (see sections 2.7 and earlier in this section). While not every innovation changes the market, this does not mean the market is not innovating. Where something works, it does take off - as solar panels did.

We see that innovation and market development is extremely healthy and will certainly deliver expected improvements to a larger portion of customers within the next few years. In making an assessment, we urge the Commission to consider: what the early stages of market disruption look like; the considerable investment and risks undertaken by retailers; and the substantial regulatory change burden faced by this industry.

## **2.9. Opportunities for improvement**

The retail electricity market is a facilitated market expressly designed to achieve low barriers to entry. All retailers buy from the gross pool on the same terms, all retailers supply through open access networks on the same terms. That is more than 70% of the supply chain costs as open access or facilitated markets.

Any barriers of entry hinder all participants whether existing or new – for example, the retail electricity market remains heavily regulated and we are experiencing growing uncertainty in regulatory matters resulting in decreasing confidence across the market. Of note, is Victoria's continued reluctance to adopt the National Energy Consumer Framework (NECF), the associated additional costs of compliance and operational inefficiencies add to our retail cost base. These issues are also exacerbated by:

- the expected requirement to implement the Essential Service Commission of Victoria's Payment Difficulties Framework in early 2018. In its current form we expect the framework will increase retailers exposure to bad debt and therefore retailers cost of capital;

- feed-in tariffs still being regulated in Victoria, and requiring retailers to change systems and customer billing/quoting for a complex new feed-in tariff in 2018;
- differences in exempt seller regimes (for alternate retailer operating models) between Victoria and other States;
- large variation in the operating requirements to manage State-based electricity rebate (concession) schemes;
- Victoria's decision to defer the start of electricity metering competition from 2017 until at least 1 January 2021 (which is part of the Power of Choice reform package);<sup>33</sup> and
- the requirement to comply with out-of-date regulatory instruments, such as the 2009 Code of Conduct for Marketing Retail Energy.

In almost every area of customer protection regulation, Victoria's approach is diverging from the other NEM States.<sup>34</sup> We suspect that the Victorian inconsistency with other NEM jurisdictions is a complication to new and existing retailers.<sup>35</sup>

These issues are a considerable challenge for retailers trying to improve operating efficiencies. They also present difficulties for retailers trying to improve their customer service and introduce more innovative products and services. Regulatory changes affecting our systems, operational processes and employees often displace the implementation of other customer-facing initiatives. EnergyAustralia has also recently had to reconsider improvement and innovation initiatives due to the outcome, or pending outcome, of a regulatory decision that directly complicates or wipes out the benefits of our planned change.

Currently NEM retailers are preparing for the Power of Choice regulatory changes which will be the largest change to retail regulations and market procedures in the last decade. Initially, this change may make little difference to customers as it introduces a contestable market for electricity metering for all customers that large operates in the background. However, it requires a large effort and focus across the industry. It should be taken into account that this market is arguably the most operationally complex retail energy market in the world and regulatory change does hamper the level of innovation that would otherwise occur.

Other sources of burden to electricity retailers come from the gas market. Retailers often want to provide both electricity and gas to customers. The current gas market environment hinders retailers getting access to gas supply agreements and transportation arrangements in some States. Gas prices are going up in Australia, especially in Victoria and New South Wales. New sources of supply would normally be encouraged into the market to increase competition as a response. However, jurisdictional moratoriums on conventional and unconventional gas development are preventing this. We note also that the Commission and the AEMC are currently reviewing

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<sup>33</sup> The Victorian Government announced a delay to the introduction of metering competition in Victoria beyond its national start on 1 December 2017. At the time the announcement was made preparations for the national introduction were well underway and all Victorian participants are now adapting their systems and processes at short notice and the operating approach in Victoria will remain misaligned with other States creating ongoing inefficiencies.

<sup>34</sup> We have commented further on this topic in our submission to the Victorian Government's Review of Gas and Electricity Markets, EA's submission can be found at: <https://engage.vic.gov.au/review-electricity-and-gas-retail-markets-victoria>, p9-12.

<sup>35</sup> We note there have been no new retail licences issued in Victoria since May 2016.

or working on gas market reforms across eastern Australia which aim to improve price and access to gas.

### 3. Retail Prices and Margins

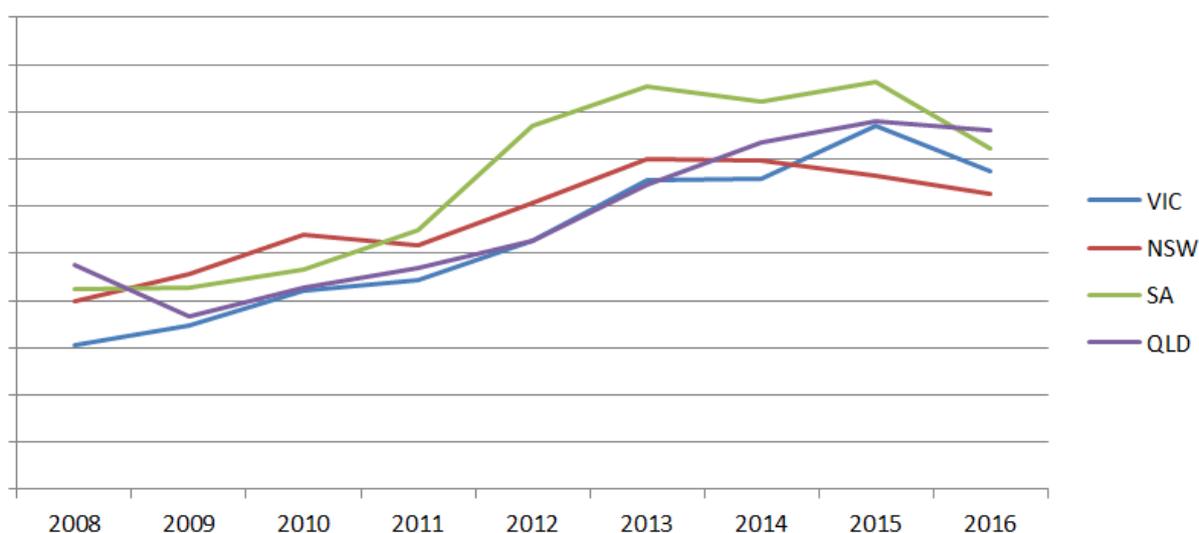
#### 3.1. Retail price components

Retail prices offered by retailers are a function of the costs of supply to customers and comprise: network costs (including metering), forward looking wholesale energy cost (including costs of energy efficiency certificate schemes), retail operating costs and margin. All costs of supplying electricity to mass-market customers are combined into one overall, bundled price. For C&I customers, a similar concept applies except that separate prices are determined for each customer, and there is a greater degree of itemisation (unbundling) of the charges on the customer’s bill.

#### 3.2. Network costs

A major component of electricity prices is the pass through to customers of the transmission and distribution costs. Network costs have grown dramatically in the last ten years as shown in figure 3.

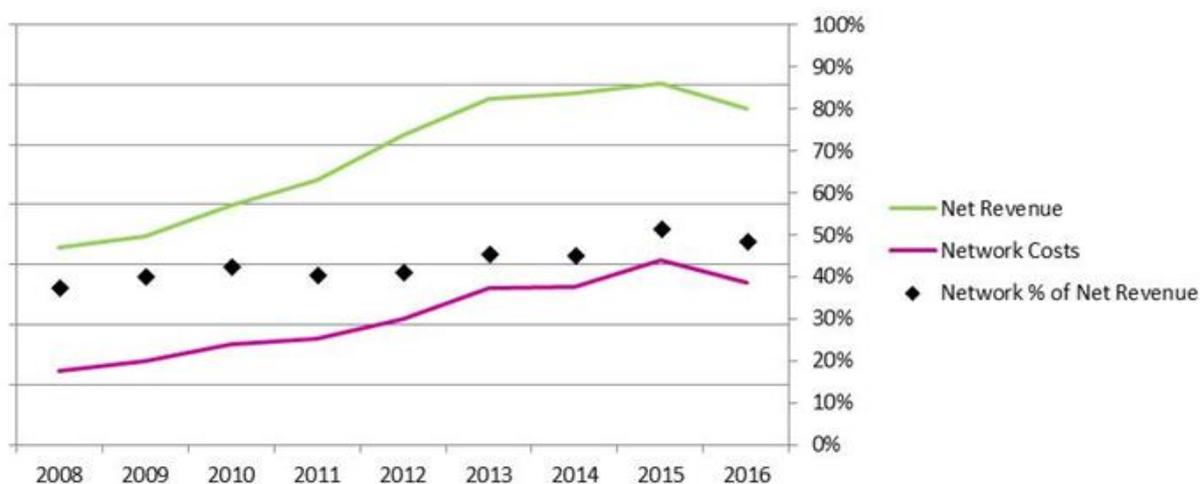
**Figure 3: EnergyAustralia, actual, mass-market network cost increases 2008-16**



The Issues Paper notes that the network costs comprise a significant proportion of the overall retail bill, our own data confirm network costs for 2016 in NEM States in the range of 44-58% of a retail bill (post discount, noted as net revenue).<sup>36</sup> These percentages have trended up over the last ten years in NSW, QLD and SA, but have been most pronounced in Victoria (figure 4) where network costs in 2008 were just over a third of net revenue and more recently accounts for close to half.

<sup>36</sup> Net revenue is total revenue less discounts.

**Figure 4: EnergyAustralia, actual Victorian electricity network costs compared to net (post discount) revenue**



Network companies typically receive greater returns than other parts of the market (see figure 4 in section 3.5). A review of electricity retail pricing matters should also consider margins made by other parts of the supply chain and the proportional increase in risk and higher bad debt incurred by retailers in trying to recoup network costs from customers.

### 3.3. Wholesale energy costs (including green schemes)

The second largest component of a customer's bill is the cost of energy at approximately 25% of the total retail price in 2016. Retailers manage the risk of wholesale electricity price volatility for customers by progressively hedging their retail load prior to the start of the upcoming period the retailer is setting prices for. Electricity is one of the most volatile commodities – price fluctuations can (and often do) range from -\$1000/MWh to around \$14,000/MWh during a single day. The ability of retailers to protect customers from this volatility and offer consistent usage prices (c/kWh) over a much longer period is vital to an effective retail electricity market.

Costs associated with green schemes are also a factor in increasing costs for customers. The variety of State based schemes does mean the impact can differ between States. In 2016 costs related to green schemes accounted for approximately 5% (or ~\$100 per annum) of the bill for a residential customer in Victoria.

Retailers also usually manage this volatility risk on behalf of C&I customers for the same reason. Very few customers have the interest and ability to manage spot price exposure themselves. However, with a possible wider rollout of technology (e.g. like our Redback offering)<sup>37</sup> that can optimise electricity usage by monitoring and controlling appliances and solar and battery charge and discharge we may see that more customers will be interested in a spot price offer in future years.

The combined effect of changes in the wholesale market prices and customer usage patterns can radically alter a retailer's wholesale costs from year-to-year (price updates usually occur once a year for mass-market customers). This means there can often be large changes in the retailers' overall retail prices due to the wholesale cost movements. This effect also occurs in price regulated markets unless a State government steps in to

<sup>37</sup> See section 2.8

subsidise or offset those movements in some way. This has very recently occurred in Tasmania and Queensland.<sup>38</sup>

### 3.4. Retail operating costs

Retail operating costs include typical retail functions, such as billing, marketing and contact centres, but also include other functions that are less apparent, but equally important, such as credit management and hardship support.

EnergyAustralia's retail cost categories are impacted by various factors, such as interest rates (Credit), vendor costs (Product and Marketing) and national economic conditions (Hardship and Complaints). Retailers make decisions on potential cost movements on these items a year ahead when they set annual prices. While retail operating costs form a small portion of the overall retail price, we work hard to continually achieve efficiencies in these areas.

The largest component of retail operating costs is credit costs including bad and doubtful debts. In EnergyAustralia's case this means carrying a large outstanding debt on behalf of residential customers. Retailers carry the debt cost for the entire delivery chain – wholesale, transmission and distribution – meaning retailers have to pay all of these businesses in the delivery chain regardless of whether customers pay their bills. At any point in time EnergyAustralia has more than 45,000 customers on payment plans and 14,000 customers in our *EnergyAssist* program. The hardship debt alone carried by EnergyAustralia amounts to more than \$20 million and may never be fully paid off due to the challenging circumstances faced by our hardship customers.

EnergyAustralia does not publicly report details of our cost to serve, but we continually attempt to improve it further. Retail operating costs are the most controllable costs for customers and we always attempt to minimise these costs by streamlining systems and processes, reducing inefficiencies and overheads, negotiating better deals with vendors, and attempting to gain better economies of scale (i.e. increasing the size of our customer base helps us reduce the effect of large fixed costs such as IT systems).

There are several upward pressures on retail operating costs, some of which are outside our control, and many of which are associated with large amounts of capital expenditure. The sources of increases in retail operating costs include:

- the substantial burden of regulatory and compliance requirements that are not always in the best interests of customers (see discussion in section 2.9);
- the need to invest in improvements and innovation to remain competitive;
- purchasing a customer base or acquiring another retailer – for example, when we acquired the customers of the previous State-owned EnergyAustralia

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<sup>38</sup> Note that Southeast Queensland is a price-deregulated market, but as the networks in Queensland are government owned, the Queensland government has made a decision to reduce network costs for the 17/18 year to offset the increase in wholesale costs that retailer are facing for this period. See: <http://www.brisbanetimes.com.au/queensland/government-steps-in-to-reverse-decision-on-power-price-hike-20170531-qwh0vs.html>. In addition, the Tasmanian Government also state they "will not let these massive price hikes be passed on to Tasmanian customers. We have already introduced legislation to cap power price increases at around two per cent for the next 12 months, at a cost of around \$70 million in forgone revenue. This means that the average household will save around \$300 over the next 12 months." [http://www.premier.tas.gov.au/budget\\_2017/budget\\_releases/keeping\\_downward\\_pressure\\_on\\_power\\_prices](http://www.premier.tas.gov.au/budget_2017/budget_releases/keeping_downward_pressure_on_power_prices)

business, we had to pay substantial costs for these customers to be serviced by Ausgrid prior to moving all the customers onto our systems;<sup>39</sup> and

- increases across network and wholesale costs also increases retail operating costs – i.e. the increase in working capital costs, bad debt, hardship costs.

### 3.5. Retail margins

There have been several recent reports that have questioned the margin of energy retailers.<sup>40</sup> These reports fail to accurately reflect reality, largely because they under represent retailer wholesale hedging or operating costs, or they overestimate the revenue received by retailers, particularly when discounted tariffs are considered. Energy retailers (like a market participant in any sector) will apply a margin which they consider represents a reasonable return on investment, the risk involved in seeking that return and the prevailing market conditions. These risks have been increasing in recent times.

In trying to understand margin levels and trends within the industry, and particularly for the large three vertically integrated retailers, we’ve looked at the Return on Invested Capital (ROIC) as a proxy. The ROIC of the three major retailers over the last six years ranges from 2% to 8.2%, with the weighted average being 4% to 5.7%. Over the same period the average Weighted Average Cost of Capital (WACC) was 8.02%. Whilst this analysis is NEM wide, with most jurisdictions now fully deregulated it shows that the major retailers are not covering their investment costs.

**Figure 5: Major retailer ROIC & WACC comparison<sup>41</sup>**



\* Industry WACC calculated from Bloomberg WACC for AGL, ORG and EA based on internal analysis

Note : ROIC calculation excludes all impairments, gain on sale of investments, acquisition and other normalisations and divestiture relates expenses.

<sup>39</sup> Independent Pricing and Regulatory Tribunal (IPART), *Review of regulated retail prices for electricity 2013 to 2016: Draft Report*, April 2013, p88.

<sup>40</sup> Wood, T & Blowers, D "Grattan Institute, *Price Shock: Is the retail electricity market failing consumers?*" March 2017; Carbon Markets and Energy, "Australia' retail electricity markets: who is serving whom? A report prepared for GetUp!" August 2016.

<sup>41</sup> Material sourced from Bloomberg, AGL and ORG investor presentations and AER regulatory determinations. Note: ROIC calculation is normalised for all impairments, gain on sale of investments, acquisition and divestiture relates expenses. DNSP data for all NEM States except Tasmania and the Ergon area of Queensland.

As a point of comparison, Figure 5 shows the average rate of return<sup>42</sup> for distribution network service providers (DNSPs) over the same period, as allowed by the AER, was around 9%. DNSPs are monopoly business with little of the risk that retail and generation businesses are exposed to and, as a result, have higher credit ratings and lower borrowing costs.

It is evident from the discussion in section 2 that even if the major retailers wanted to increase margin to achieve a ROIC comparable to their WACC, they would not be able to as smaller retailers would continue to undercut them on price and/or service and take further market share.

#### **4. Customer Interaction in the Market**

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The test of any effective market is the ability of customers to confidently engage in the market to seek the most appropriate product and service to suit their needs. As discussed throughout this submission, there are a several variations in products and services available to customers when selecting an energy provider.

An effective market will also give people of varying levels of interest and education the ability to engage in the market in some form and make an informed decision. We acknowledge that for energy products this can be, at times, confusing and all reasonable efforts should be made to make this process as easier as possible for customers.

It is important to note that given energy is an essential service the regulatory framework establishes a minimum product/service offering to customers – known at a ‘standing offer contract’.

##### **4.1. Customers’ ability to choose their retailer**

Across the NEM (excluding Tasmania and Queensland), the majority of customers are aware of their ability to choose between different retailers and between different energy plans.<sup>43</sup>

In the last few years, as customer mobility has increased within the retail market, customers have been seeking improved access to energy usage data and greater control over energy consumption and energy management. The apparent driver for this has been increasing energy prices that have led customers to expect tools to be able to monitor and manage their own consumption. Another example is an increasing demand from South Australians customers to get batteries to avoid blackouts, particularly businesses.

EnergyAustralia has run large campaigns to encourage customer groups to interact with the market. This has included, proactively contacting customers on standing offer tariffs<sup>44</sup> to offer them a product that will lower their energy bills and attempting to retain existing customers requesting transfers with better offers or tariffs that may suit their consumption profile.

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<sup>42</sup> AER determinations on returns are for 5 years. The gradual decline in network returns from December 2013 reflects the misalignment of regulatory periods for distribution networks across the NEM.

<sup>43</sup> AEMC, *Consumer Research for 2016 Nationwide Review of Competition in Retail Energy Markets* (Newgate Research), June 2016, p17.

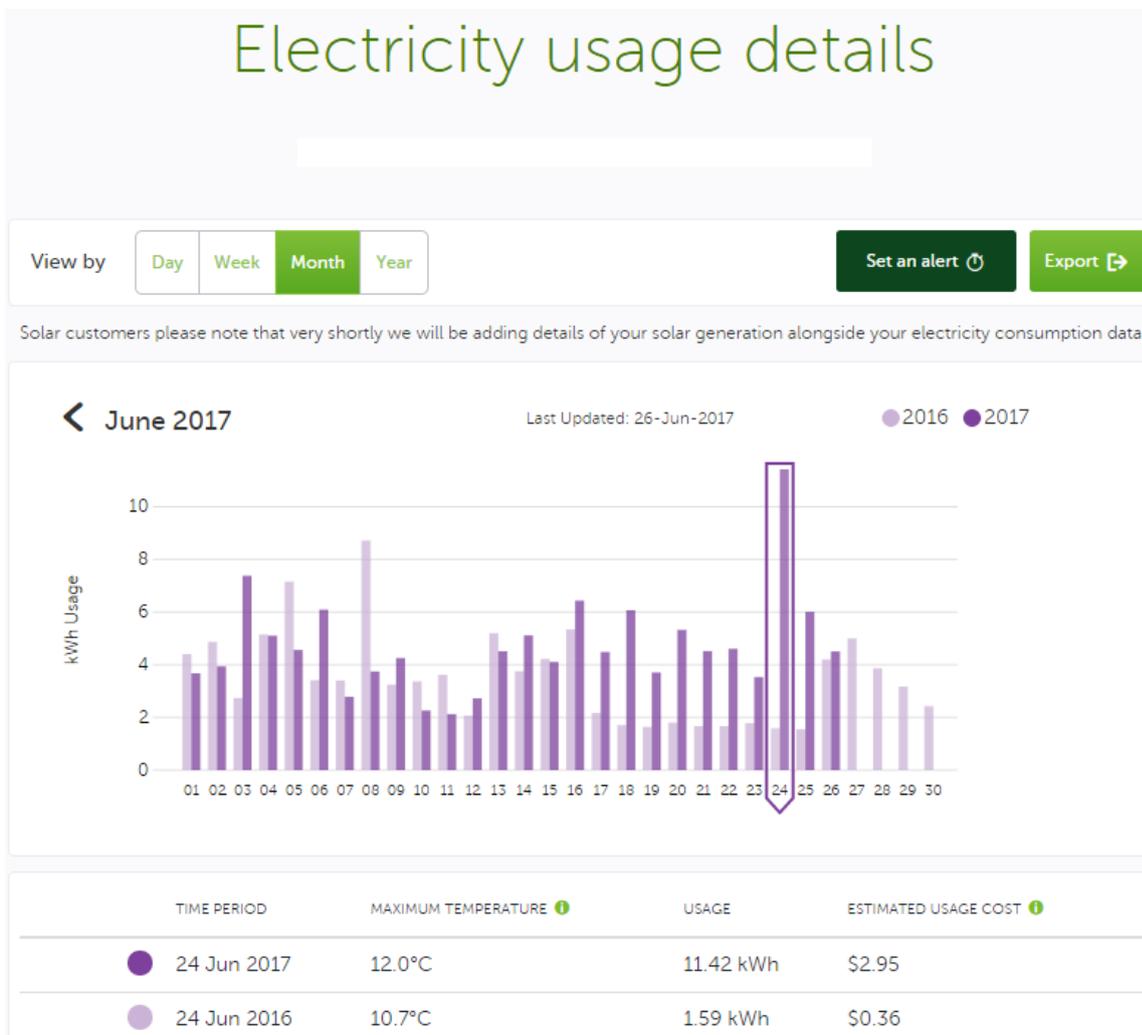
<sup>44</sup> Standing offer tariffs are a base level price that has no discounts and is often a sign that the customer has not shopped around to find a better offer.

**4.2. Customers’ ability to access their information**

In order to assist customers understand the variety of offers available to them, they first need to understand their individual usage needs and profile. We are continually investing in our systems to improve access to energy usage data and allow customers to have greater control over energy consumption.

In particular, EnergyAustralia is currently working on improving its e-billing systems, which already allows customers to view long term history and data about their individual (and household comparison) profile. In 2017, we launched an online account management portal, *My Account*, which allows customers to view their energy usage by day and provides the capability to issue customers with proactive alerts if they use an above average amount of electricity so they can start to understand the impact of their activity on their energy usage. Our longer-term aim is to continue to improve the availability of information, and providing flexibility in the billing cycle.

**Figure 6: Example of usage reports available to EnergyAustralia customers on the My Account portal**



### 4.3. Customers' ability to make informed choices

#### 4.3.1. Energy comparison rates

EnergyAustralia supports the introduction of an energy comparison rate as you see with home loans or petrol consumption metrics for cars. This would enable customers to make an adequate comparison by providing a consistent measurement.

From our research, we know customers get confused by rates such as c/kWh so an annual or quarterly bill calculation (based on a consistent consumption formula) may be most helpful to customers. Any comparison would need to make allowance for non-monetary benefits such as loyalty programs. The relevant comparison rate could be included in Energy Price Facts sheets.

#### 4.3.2. Comparator sites

The variety of offers available to customers has seen the growth of private comparison sites and encouraged governments to create their own comparator websites such as *Energy Made Easy*<sup>45</sup> and the *Victorian Energy Compare*.<sup>46</sup>

To understand the retail electricity market and their options within in it, customers increasingly prefer internet-based research as a starting point, including online comparison tools to simplify the complex array of competing offers and find the best deal.

Despite consumers regarding internet-based information sources as the most useful for investigating offers and options, their awareness of independent government comparator websites remains low.<sup>47</sup> While people will commence their research online, they will often then follow up directly with a retailer over the phone to:

1. confirm the research they have done (due to the complexity of the offers);
2. attempt to negotiate a better price than what they observed online (which they often can); and
3. ascertain the quality of service they will receive from a new supplier.

Commercial comparator websites are more easily accessed as they are heavily marketed and easy to find via internet searches. However not all retailers, nor all offers, are presented to customers on these sites. There also can be a lack of transparency on how offers are ranked and presented. Despite these potential issues with commercial comparator sites, customers still use them for simplification and ease and to obtain a shortlist of offers – sometimes using anonymous details to avoid future contact from sales consultants. Such customer experiences with commercial sites do not promote confidence in the market nor assist in the empowerment of customers to make informed decisions. EnergyAustralia believes that the ideal comparison site is an objective, unbiased assistant – a tool that helps to clarify the decision-making process by delivering a convenient, easy to understand and trusted ranking of current market offers.

To improve customer choice, EnergyAustralia recommends that all commercial energy comparator services could be required to be nationally accredited and:

- disclose all commissions in a similar manner to the financial services sector;

<sup>45</sup> <http://www.energymadeeasy.gov.au/>

<sup>46</sup> <https://compare.switchon.vic.gov.au/>

<sup>47</sup> AEMC, *Consumer Research for 2016 Nationwide Review of Competition in Retail Energy Markets* (Newgate Research), June 2016, p156.

- advise that they do not show all retail offers available;
- rank offers and present information in accordance with a defined industry standard; and
- provide a link to an independent government or regulator comparator and advise customers that this is an independent site containing offers from all retailers.

A possible future improvement of independent comparator sites could be to make it easier for customers to obtain their usage data from their retailer in a standard format that can be easily uploaded to an independent comparator site with minimal clicks.

Governments could increase awareness of their own comparator sites via simple means such as investing in Google optimisation which would make it easier for customers to locate the relevant site. Additionally, consider having one comparator site for all jurisdictions which is promoted as a source of unbiased information to reduce complication for consumers.