30 June 2017

The Australian Competition and Consumer Commission
By email: retailelectricityinquiry@accc.gov.au

ACCC inquiry into retail electricity supply and pricing – Issues Paper

Sumo Power welcomes the opportunity to respond to the ACCC's electricity inquiry issues paper.

Sumo Power is a new entrant energy retailer and is one of the fastest growing in the market. It commenced operations in around July 2015 and now services 24,000 small electricity customers in Victoria. It also holds a Victorian gas retail licence, and is authorised to retail electricity in New South Wales, Queensland, South Australia, Tasmania and the ACT.

As a new entrant retailer, Sumo Power has a unique perspective on the state of retail competition, retail costs and prices. We would welcome the opportunity to discuss the issues below directly with the ACCC.

In summary:

#	Key market dynamics	Recommendations
1	**Increasing retail costs and prices**	**1A** – Policies to deliver: • reliability of wholesale electricity supply, including ensuring the orderly transition from old to new generation, storage and demand management technologies, and putting downward pressure on wholesale prices • ongoing Government support for renewable and micro-generation solutions
		1B – Regulation that reduces unsustainable cancellations and churn and improves switching outcomes (see recommendations 3A – 3E below)
		1C – Greater Government support for customers experiencing financial difficulty to pay their energy bills
		1D – Consideration should be given to policies that make it more difficult for a customer to avoid payment once they have churned away, such as mechanisms for the retailer to obtain contact details from the new retailer, right to collect payment from the new retailer and a continuing right to disconnect for non-payment
2	**Retail margins are under pressure**	**2A** – Sumo Power would be happy to discuss retail margins with the ACCC on a confidential basis
3	**Aggressive retention practices leading to**	**3A** – Monitor retention activity and outcomes, for example market transactions, the nature of offers,

	poor customer outcomes and higher prices	customer complaints and the impact on competition generally
		3B – A requirement to publish all offers (including any retention offers) on the retailer's website and the Government's comparator website, ensuring they are available to all customers
		3C – A ban on retention and win-back activity, except where the customer opts in.
		3D – Failing the above, a code of conduct for retention activity, including a limitation of one contact by the previous retailer in a prescribed method and form
		3E – Orderly market rules for the transfer of customers, ensuring for example that cancellations are genuine and are processed before transfer, and retrospective transfers back only occur were the original transfer was made in error
4	**Competition in the wholesale electricity hedging market is declining**	**4A** – Generators to be compelled to offer fairly priced, competitive hedging products, on at least the same terms as those provided to related parties
		4B – The ACCC should review the effectiveness of measures that ring-fence the retail and generation divisions of a gentailer's business
		4C – When considering proposed mergers & acquisitions, the ACCC should pay particular regard to the impact on the wholesale electricity hedging market
5	**Complexity of retail tariffs is well managed by comparison services**	**5A** – Government-funded public campaign promoting the availability of competitive energy offers and the importance of customers exercising choice

State of retail competition – Overview

The retail energy market has a good number of retailers competing, but the three major retailers still hold around 80% of the market. This continued concentration of market share creates barriers and significant challenges that make it difficult for new and innovative entrants to compete.

In Victoria, more than 20 retailers compete, predominantly on price, putting intense pressure on retail margins. New entrant retailers are providing better service and innovative new products (see, for example, Sumo Power's All You Can Eat electricity offer), and larger, incumbent retailers are responding.

Small customers are generally disengaged when it comes to electricity. According to the Victorian Government's price comparator website, Victorian Energy Compare, nine out of every 10 users can save money by switching energy offers. Customers would benefit greatly from higher engagement with the retail market, and should be encouraged to shop around to find a better deal.

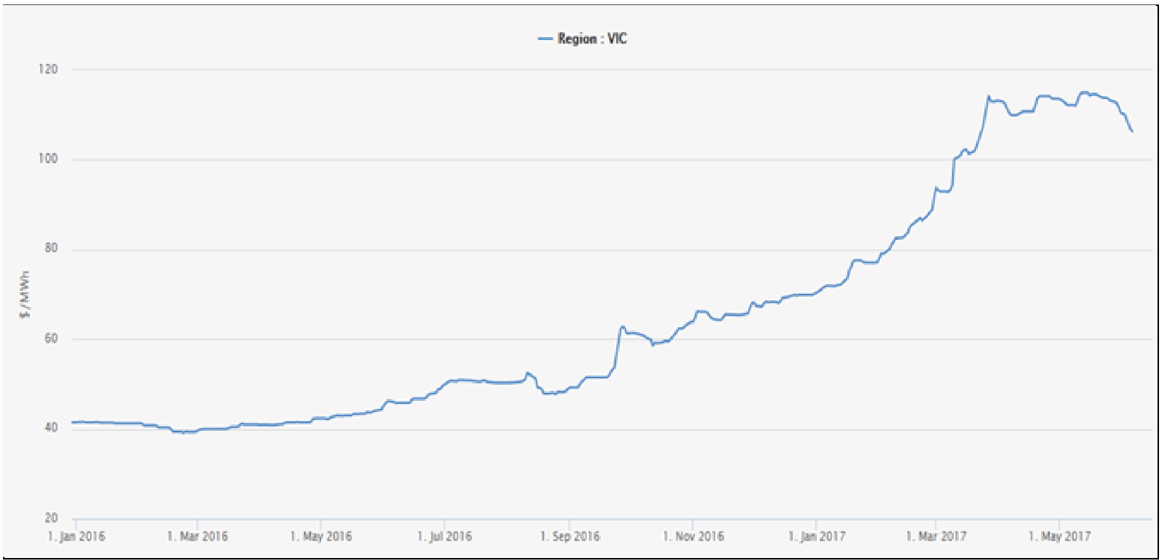
The high level of retailer switching – which is a sign the market is working – is generated in large part by new entrant retailers who pro-actively market to customers. Without new entrant retailers, competition levels would subside. This kind of competition is healthy and delivers benefits for customers. However, as detailed below, these new entrant retailers are facing new challenges, and the market framework needs to evolve to continue to support and sustain this competition.

Increasing retail costs and prices

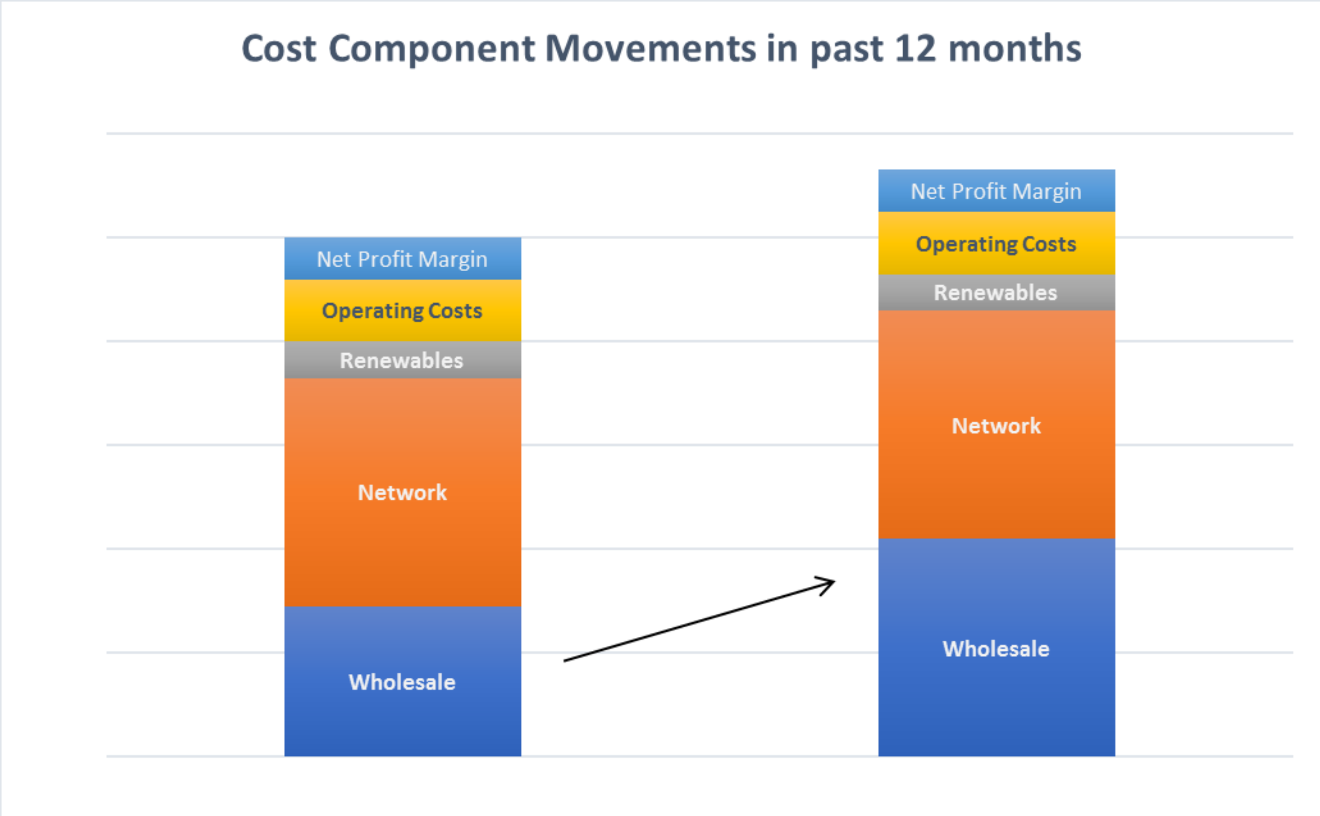
As is widely known, electricity retail prices are on the rise. This has been contributed to by the closure of coal-fired power stations and an increasing reliance on gas-fired generation, which itself has been subject to higher wholesale costs.

This price shock is almost exclusively due to significant increases in market driven wholesale electricity prices. While generators and gentailers benefit greatly from these increased wholesale prices, stand-alone retailers have no influence over them, and have no choice but to pass them on to customers.

Electricity retailers must buy electricity on the National Electricity Market, and will typically hedge their exposure to wholesale price volatility, for example by entering into financial hedging instruments. The forward market price for electricity hedges has more than doubled in the past 12 months (see figure below which shows the 2018 Victorian forward curve since January 2016).



The following diagram illustrates the impact of rising wholesale costs on the cost stack for residential retail prices. The Operating Costs incorporate customer billing and service, bad debts and the cost of prudentials, each described more fully below. They don't include the cost to acquire or corporate head office costs. The only movement is in the wholesale cost.



Governments need to bed down policies that give investors certainty, ensuring reliability of wholesale electricity supply and putting downward pressure on wholesale prices. This needs to include the orderly transition from old to new generation, storage and demand management technologies, and ongoing Government support for renewable and micro-generation solutions.

Some of the wholesale cost increases have already been factored into retail price increases this year, but the bulk of the impact is yet to come. Unless urgent action is taken to address market failures (discussed below), high prices are likely to remain.

In addition to wholesale electricity costs, retailers manage a number of other costs:

- **Network and metering costs** – These costs make up the largest component of a retailer's cost stack. Network and metering charges are regulated and change annually (although metering will be competitive from 1 December 2017 in jurisdictions other than Victoria). Given they make up such a significant proportion of a retailer's costs, retailers typically change their retail prices in line with changes to network prices.
- **Environmental schemes** – The cost of the Federal Government's Renewable Energy Target is at its ceiling. SRECs are trading at the ceiling price, and LRECs are trading at the tax-adjusted penalty price. As with electricity prices generally, bringing down the price of environmental certificates will rely on clear Government policies that give investors in renewable or low-emissions generation certainty, and so drive greater supply of eligible certificates.

- **Marketing and customer churn** – The cost of direct marketing and sales is typically incurred upfront. Increasingly aggressive competitor retention and win-back activity means that many customers will cancel or churn away within the first few months with a new retailer which artificially increases the cost of acquiring customers. In Victoria, energy retailers are not permitted to charge an early termination fee to recover this upfront sales commission, and so the marketing cost must be recovered across a portfolio of customers. Customer cancellations and churn – particularly in the first three months after sale – has a material impact on a retailer's margins, and reform is required to address the negative effects of this churn. We discuss solutions to address this high churn scenario below. As noted below, we believe the impact of this cost to residential consumers' bills is up to $50 per year or as much as 3%.
- **Bad debts** – As the collection house for the whole electricity supply chain, retailers wear the risk for customer default.
    - The number of energy customers on payment plans or classified as being in hardship in Australia is at record high levels. Greater Government support for customers experiencing financial difficulty, directed specifically at paying for essential energy services, would help customers remain on supply and lower the costs for all consumers.
    - We estimate that more than 1% of a bill relates to bad debts, with most due to customers who have churned to another retailer (i.e. not customers in hardship who are genuinely trying to pay their bill). What this means is that the average residential customer pays more than $15 each year to pay for the electricity bill of someone else who has avoided payment by switching retailers. It is very difficult for a retailer to recover debt once a customer has churned away – the customer can no longer be disconnected for non-payment, may have provided false contact details and the amounts are usually too small to warrant legal recovery action. We recommend that consideration be given to policies that make it more difficult for a customer to avoid payment once they have churned away, such as mechanisms for the retailer to obtain contact details from the new retailer, an obligation on the new retailer to pay this debt (if within 90 days) and recover it from the customer, or a continuing right to disconnect for non-payment.
- **Prudential requirements** – AEMO imposes onerous wholesale market prudential requirements on retailers. While the need to tie up capital by providing bank guarantees can be mitigated to some extent by entering into reallocation agreements with wholesale counterparties, these arrangements are expensive, equating to more than $6 on an average annual residential customer bill.
- **Complex billing and service arrangements** – The combination of complex (and often inaccurate) industry data (arising from smart meters and distributed generation, for example) and the highly prescriptive, and often changing, nature of regulatory obligations, contributes to increases in the costs of servicing customers.

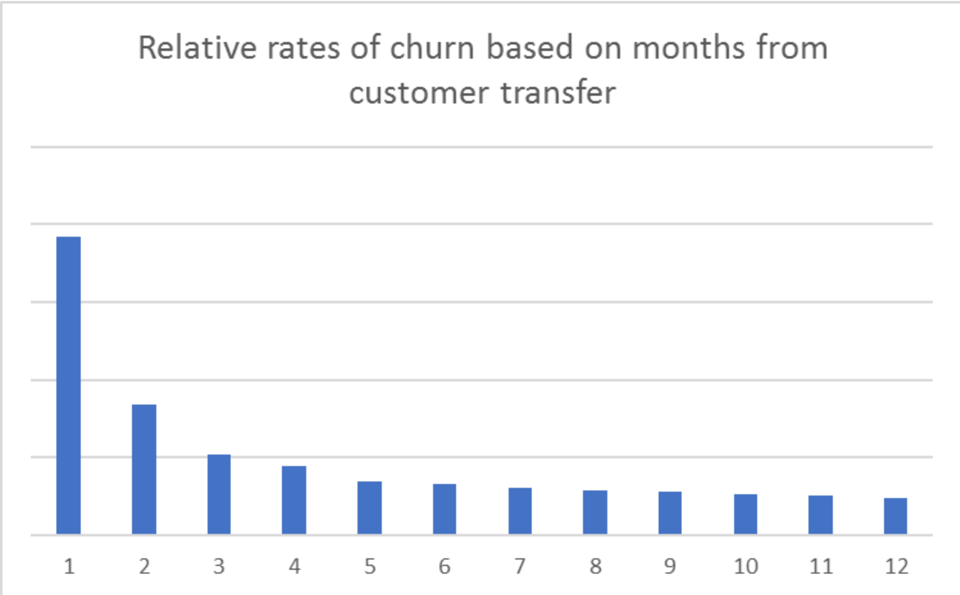
Retail margins are under pressure

Concerns about retailer margins are unwarranted. As above, retailers are subject to high levels of competition (significant volumes of which are now transacted through price comparison sites) which put intense pressure on margins, and current increases in retail prices are driven by unprecedented increases in wholesale supply costs.

Sumo Power would be happy to discuss retail margins directly with the ACCC on a confidential basis.

Aggressive retention activity leading to poor customer outcomes

New entrant electricity retailers seeking to make a foothold in the market and grow to scale must confront the highly aggressive retention and win-back tactics of larger players. These retention tactics are unfair and arguably anti-competitive. The impact can be seen in the following diagram, which shows the churn profile of an average customer in the first 12 months after they transfer to the new retailer. As this illustrates, the impact of retention and win-back activity is that churn is at its highest in these first three months, before stabilising to normal levels.



Without change, consumers face higher prices as a result. Increased churn attributable to retention activity in the first three months of a customer's life means that the retailer needs to recover the acquisition cost from other customers. Furthermore, the retention activity itself must be borne by customers and reflected in customer bills. We believe the impact of this cost to a small, new entrant retailer in respect of an average residential customer is up to $50 per year.

Larger retailers are directing significant below-the-line marketing efforts at retaining customers once they have decided to switch to another retailer. They do this by contacting the customer and offering bigger discounts or large cash rewards. It is difficult for the new retailer to beat these retention offers. The existing retailer is at a distinct advantage because it doesn't incur the upfront sales commission (i.e. it is cheaper to retain a customer than to acquire a new one), it has a large, stable customer base and large balance sheet that can fund the retention offers, it can play on the customer's aversion to risk and reluctance to change, and it can 'cherry-pick' the higher value customers.

This retention activity currently flies under the radar. Retention offers are secretive – they are not published and therefore not available to all. And while competition in the electricity retail market is often measured by switching activity (which is being artificially constrained by aggressive retention tactics and teams), retention activity cannot be measured in this way because, when successful, the result is that there is no switch at all. We recommend that retention activity should be monitored, for example by reporting on market transactions, the nature of offers, customer complaints and the impact on competition generally.

On a limited view, this aggressive retention practice might be seen as just fierce competition which leads to a great outcome for the individual customer (at least, temporarily). However, on a deeper level, this is competition gone bad:

- As noted, retention offers are generally not published, and so are not available to all – they are only made available via a phone call after the customer has agreed to switch to another retailer.
- It results in acquisition activity being made less rewarding for the new retailer, given the higher number of cancellations but without a proportionate reduction in acquisition cost. At their most extreme, some retention offers could amount to predatory pricing, forcing new entrant retailers out of the market. At the very least, the prices are unsustainable. Retailers could not offer them to all customers.
- Given the ease with which customers can be 'saved' from switching away, the incumbent retailer has little incentive to deliver better products and service to its remaining, loyal customers. As a consequence, the remaining customers are very likely paying too much.
- Aggressive retention activity can be expensive, and result in confusion and irritation for the customer:
  - When a retailer acquires a customer, it lodges a transfer request in the market. The existing retailer receives notification of the pending transfer, and has an opportunity to object (although, in Victoria, the retailer only has a right to object if the customer has a 'certified debt' with that retailer). In practice, the existing retailer uses this time to contact the customer and seek to retain them. If the customer agrees to stay with their existing retailer, they need to contact the new retailer to cancel the agreement (sometimes the existing retailer will try to do this on the customer's behalf). If this doesn't occur in time, the customer will transfer to the new retailer, and the previous retailer will then need to raise a new transfer request to bring the customer back, which may be retrospective.
  - Throughout this process, the customer may be hounded by multiple sales/retention calls. They may change their mind. They may switch from one retailer to another, and then be switched back, receiving 'welcome pack' material and transfer letters on each occasion, and possibly bills from each retailer for different periods. Customers can be confused about which offer is better for them, and therefore give up and take the easiest option of remaining with their current supplier. Additionally, it can be unclear – for both the customer and the retailers – as to which retailer has the customer's final consent to supply.
  - This amount of activity is time-consuming and expensive, involving multiple phone calls, market transactions and, when customers ultimately complain, managing those complaints. Third party sales channels – who face higher cancellations as a result and therefore fewer sales commissions for their efforts – must recover their costs by increasing sales commissions. The new retailer, having lost the customer back to the previous retailer, will have to wear the cost of acquisition.

Some possible solutions include:

- The publication of all offers (including any retention offers) on the retailer's website and on the Government comparison website – retention offers must be available to all customers; eligibility must not be limited to customers who are otherwise transferring away. A requirement to make retention offers available to all customers may temper the most aggressive, unsustainable, predatory offers.
- Limitations on retention activity (a form of anti-slamming law), such as:
    - A ban on retention and win-back activity, with the ability for a customer to opt in to receive win-back calls from their previous retailer. There is precedent for prohibitions on retention activity – the Electricity Authority in New Zealand decided to restrict retention activity in 2014[1]; or
    - A code of conduct for retention calls, including limitations on the number of times a customer may be called for retention purposes (e.g. one contact may be made at a prescribed time and by a prescribed method, such as email or SMS).
- Fair and orderly market rules for the transfer of customers (the telco industry is a good case study for speedy and more orderly customer transfer), ensuring that:
    - retailers do not request cancellations on a customer's behalf;
    - cancellations are processed before customers transfer, to avoid the need for retrospective transfers as much as possible;
    - retrospective transfers are only requested and processed where the initial transfer was made in error;
    - customer portability of relevant data with consumer opt-in to minimise transaction costs – such as payment mechanisms etc;
    - except where the original transfer was erroneous, customers are not transferred back to the previous retailer immediately after the transfer away.
- Significant regulatory consequences for breaching the above to discourage these behaviours.

Competition in the wholesale electricity hedging market is declining

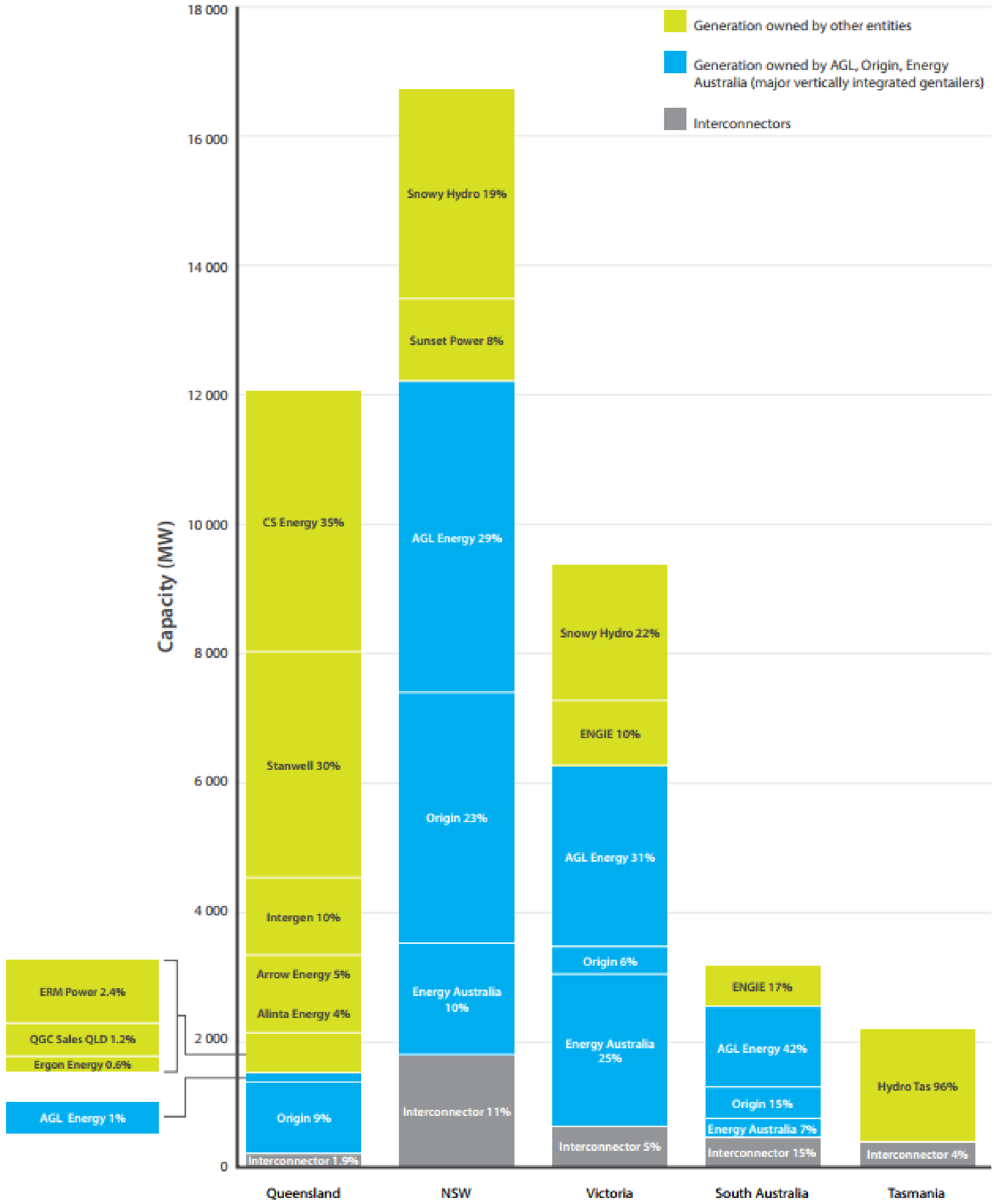
As noted above, retailers manage wholesale electricity price risks by entering into hedging contracts. The ability to procure hedging instruments that appropriately manage a retailer's risk at reasonable prices is essential for a retailer to operate.

Of concern, the market for wholesale electricity hedges is becoming less competitive. There are at least three reasons for this:

- Increasing consolidation of generators, including vertical integration of retailers and generators into 'gentailers', means there are fewer counterparties willing to offer hedging products, and less volume available to third parties (see figure below, taken from the Independent Review into the Future Security of the National Electricity Market, Blueprint for the Future, June 2017, Dr Alan Finkel AO, which shows generation ownership by State).

[1] Electricity Authority, Competition effects of saves and win-backs – Decisions and reasons, 21 October 2014

Figure 3.4: Generation ownership by NEM region 2017[149]



- Funding of new entrant generation requires long-term offtake commitments and their generation is mostly intermittent. These long-term offtake arrangements will usually be incompatible with a new entrant retailer's risk management strategy.
- There have been no new non-physical sellers in the over-the-counter market in recent years. Electricity derivatives can be traded on the ASX, but these products are also not suitable for new entrant retailers, who require tailored hedging products and have limited working capital to support ASX margining obligations.

High wholesale electricity prices will also make it increasingly difficult for retailers to source low risk hedging products, such as load-following hedges. This is because generators are able to meet their revenue targets without taking on the additional risk associated with offering such products.

This trend is resulting in fewer counterparties, less liquidity and less diversity of risk management products in the hedging market. We have already seen this play out in South Australia, and can see it emerging in other jurisdictions, including Victoria. In the case of Tasmania, there is only one generator, so competition is effectively non-existent. It is consequently more and more difficult for new entrant, stand-alone retailers to compete on equal terms with more established retailers or gentailers.

Generators should be compelled to offer fairly priced, competitive hedging products, on at least the same terms as those provided to related parties. In this regard, consideration will need to be given to transfer pricing arrangements between entities. This would ensure a level playing field for all retailers and encourage retail competition. The ACCC should review the effectiveness of measures that ring-fence the retail and generation divisions of a gentailer's business. When considering proposed mergers & acquisitions, the ACCC should pay particular regard to the impact on the wholesale electricity hedging market.

Complexity of retail tariffs is well managed by comparison services

Comparing electricity offers can be complex. Most retail tariffs are structured in a similar fashion to the underlying network tariff. With the exception of flexible pricing, and even more recently, demand tariffs, these tariff structures are not new. They are as complex as they have always been. The variable component of a retailer's tariff reflects the variable costs of supply (the unit cost of the energy supplied), and the fixed daily supply charge reflects fixed costs (like metering charges and overheads). Customers want simplicity – which is why they have rejected flexible tariffs – but simplicity comes at a cost. Simpler tariffs create risk for the retailer, and so are priced accordingly.

Retailers offer discounts because customers like them. They are simple to understand and reward behaviour that drives down cost (such as paying on time, or setting up direct debit).

It should also be noted that retailers must navigate pages and pages of regulation prescribing how electricity offers are to be communicated to customers, both before and after sale. Although well meaning, the highly prescriptive nature of this regulation can make it difficult for retailers to present product and pricing information in a simple manner.

While electricity tariffs have always been complex, the emergence of comparator sites – both Government and commercially owned – is making the comparison much simpler. If they decide to, customers can find good deals relatively easily, simply by contacting a retailer directly or engaging with a comparator service.

Where there is a concern that consumers are not accessing the best deals in the market, the problem does not lie with comparator sites or offer information presented by retailers. Rather, the problem is with the many customers who have not yet engaged with the market. Those customers who are paying too much are not those who shopped around and chose the second-best offer; rather it is those who never shopped around *at all*.

Efforts should be directed at helping these customers to exercise choice and find a better deal. For instance, a Government-funded public campaign promoting the availability of competitive energy offers and the importance of customers exercising choice.

Please contact me if you would like to discuss any aspect of this submission.

Yours faithfully

Paul Cullinan
CEO