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The Australian Competition and Consumer Commission

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ACCC Retail Electricity Pricing Inquiry Preliminary Report

Sumo welcomes the opportunity to respond to the ACCC’s Retail Electricity Pricing Inquiry Preliminary Report.

The Preliminary Report presents some very useful insights into the state of the energy market. We highlight some of these below. We believe some of the preliminary conclusions need to be reviewed and revised taking into account further information, which we have addressed below.

Summary

#	Market dynamic	Summary of position
1.	Retail costs	<ul style="list-style-type: none"> • Retail price increases have been driven by cost increases over which stand-alone retailers have no control. • Retail cost pressures have arisen from rising customer acquisition costs (addressed below), increasing costs of collections and bad debt, and increasing complexity of the market and its ever-changing regulatory environment, particularly in Victoria.
2.	Retail margins	<ul style="list-style-type: none"> • Retail margins have remained flat. • The margins are reasonable, and reflect the high levels of risk faced by retailers, including wholesale price risk, customer acquisition and retention risks, customer credit risk and regulatory risk. • Retail margins for a smaller retailer will typically be negative until it achieves sufficient scale. Policy uncertainty about electricity pricing and margins – particularly in jurisdictions where Governments are considering forms of price regulation – will put a freeze on investment required to sustain growth. Policies must support new-entrant retailers, by reducing cost pressures and preventing anti-competitive conduct by market participants.
3.	Cost to acquire	<ul style="list-style-type: none"> • A primary reform to improve retail competition should be a ban on retention and win-back activity, which would prohibit a ‘losing’ retailer from attempting to retain or win back a customer who has signed up with another retailer. • This would improve customer outcomes by: <ul style="list-style-type: none"> ○ reducing acquisition costs, flowing through to a material reduction in retail prices (particularly for small, high growth retailers); ○ discouraging the retail ‘loyalty tax’ (refer to page 4 for explanation) because retailers would be incentivised to look after their existing customers better; and ○ increasing customer satisfaction with the switching process.

		<ul style="list-style-type: none"> • Experience from New Zealand – where the regulator introduced a ‘switch saving protection’ regime – shows that it is not enough simply to prohibit saves/retention activity. In that case, a ban on saves had no discernible impact on competition. To be effective, any prohibition must also apply to win-back activity.
4.	Wholesale market challenges	<ul style="list-style-type: none"> • Current movements in retail prices are almost exclusively caused by increases in wholesale electricity costs. • Competition in the wholesale electricity market is declining following plant closure and consolidation, which makes it increasingly challenging for new entrant, stand-alone electricity retailers. We support the ACCC’s focus on solutions that will: <ul style="list-style-type: none"> ○ increase reliable, dispatchable generation capacity, particularly from non-vertically integrated new entrants; ○ constrain further consolidation of ownership of generation assets, and ensure ring-fencing measures are effective; ○ review transfer pricing arrangements or require generators to offer a ‘most favoured nation’ clause in wholesale supply arrangements; and ○ prevent strategic bidding by generators.
5.	Customer information	<ul style="list-style-type: none"> • We support measures that will simplify electricity product disclosure and comparison, provided these measures are applied consistently across the NEM. • The ACCC should also review the effectiveness of Government comparator websites, and consider ways to make these sites a primary mechanism for customer switching.

Retail costs and margins

The Preliminary Report confirms that most of the retail price increase over the period 2007/08 to 2015/16 has been driven by increases in network charges and the take-up of environmental schemes, and that current increases will be driven predominantly by significant increases in wholesale electricity costs. Stand-alone retailers have no control over these cost components.

The Preliminary Report also identifies some increases in retail costs over the same period. Sumo only entered the Victorian market nearer the end of this period, but in its experience, there are many factors that have pushed up retail operating costs. We detailed some of these in our submission to the Issues Paper, together with possible solutions, namely:

- smaller retailers in particular face pressure with rising customer acquisition costs. We address one of the main reasons for this and our proposed solution in detail below, under the heading ‘Prohibition on retention / win-back’;
- increasing costs of customer collections and bad debt. We estimate that more than 1% of a bill relates to bad debts, meaning an average residential customer pays more than \$15 each year to pay for the electricity bill of someone else who has avoided payment. This could be addressed by:
 - for customers experiencing genuine payment difficulty, introducing more effective Government concessions and other support, and
 - for customers who can pay but deliberately avoid doing so (for example, because they have churned away), mechanisms to make it simpler for retailers to recover debt, such as allowing the old retailer to obtain customer contact details from the new retailer, an obligation on the new retailer to recover the debt from the customer, a continuing right to disconnect for non-payment, or a centralised energy industry credit bureau to register consumers who refuse to pay and do not engage with their retailer to arrange repayment; and

- increasing complexity and more highly regulated nature of energy retailing, including more complex billing arrangements following the roll-out of smart meters and solar PV, a fractured and incomplete transition to National energy retail regulation, the introduction and then repeal of the carbon tax, and changes to market system schema to support competition in metering, to name a few.

Although the Preliminary Report notes that retail costs are higher in Victoria than in other states, it is important to put this cost difference into context. Average retail costs were reported to be \$241 in 2016/17 (page 38) and for Victoria it was \$267 (page 42), a difference of only \$26 in an annual bill. By comparison, it is conservatively estimated in the Preliminary Report that increases in wholesale electricity costs added \$105 to a Victorian customer bill in just one year between 2015/16 and 2016/17 (pages 41-42), with further increases to come.

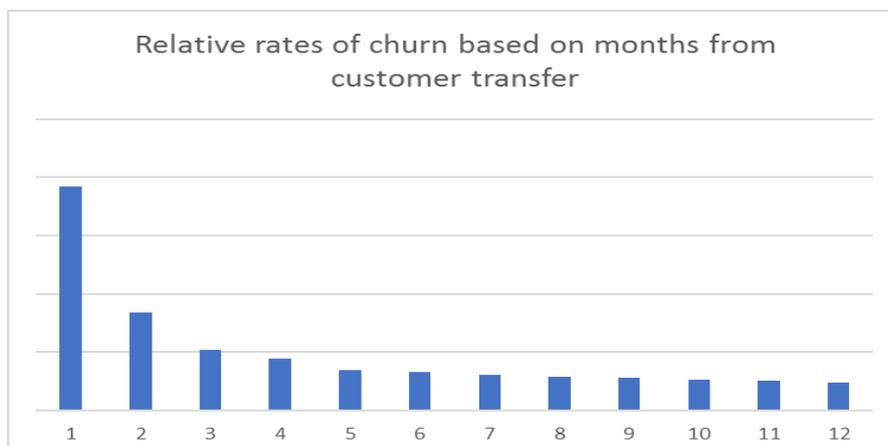
The Preliminary Report shows that retail margins remained relatively flat over the period 2007/08 to 2015/16, at around 7-8% in Victoria and NSW. Sumo’s submission to the Issues Paper discussed many of the risks inherent in retailing electricity. Chief among these is managing wholesale price risk; however, retailers also manage customer credit risk, take on execution risks of acquiring and maintaining customers, tie up significant amounts of capital to meet prudential requirements and incur costs meeting rafts of new regulatory obligations. Retail margins fairly reflect these risks.

Finally, it should be noted that retailers only achieve positive margins once they reach sufficient scale. Many smaller, new entrant retailers operate on negative margins until they reach scale, and require significant capital funding to support growth from inception. Policy uncertainty about electricity pricing and margins – particularly in jurisdictions where Governments are currently considering forms of price reregulation – will put a freeze on required investment. This places enormous risk on the viability of small, new entrant retailers. If smaller retailers are forced to exit the market, this will leave only the large incumbent retailers, whose prices will no longer be constrained by competition. We strongly encourage the ACCC to recommend measures that will reduce cost pressures in the energy sector and improve the effectiveness of competition so as to deliver better outcomes for consumers.

Prohibition on retention / win-back

Sumo considers that one of the most effective measures to reduce retailer marketing costs, to improve the effectiveness of competition and to discourage the ‘loyalty tax’ imposed by some retailers is to prohibit retention and win-back activity.

As noted in our earlier submission, a customer is most likely to churn within the first three months after it transfers to a different retailer. The rate of churn declines significantly following the three-month mark. High churn in the first three months is primarily driven by the retention and win-back practices of the customer’s previous retailer during the cooling off period and soon thereafter.



In our earlier submission, we detailed a number of issues with this retention / win-back activity. One primary consideration is cost. A retailer incurs the cost of customer acquisition upfront, and expects to recover that cost over the life of the customer. Where the retailer is unable to recover that cost of acquisition from that customer because the customer has churned away too soon, the cost needs to be recovered from all other customers. For a small retailer, this cost of churn is a significant component of overall costs, which means that competitor win-back activity represents a very real barrier to expansion. Our estimation is that the impact of this cost to a small retailer in respect of an average residential customer is up to \$50 per year.

(Notably, a retailer in Victoria is not permitted to recover the acquisition cost by way of an early termination fee if the customer were to churn away before the end of a fixed-term customer contract. Aggressive retention practices have increased as the use of fixed-term contracts with early termination fees has been phased out.)

This retention and win-back activity is unique to the energy market. Retailers are given advanced warning that a customer will transfer away. This advanced warning is intended to give that retailer an opportunity to object to the transfer on specific, narrow grounds (for instance, because the customer has a certified debt with that retailer), not to give the retailer an opportunity to retain them. It would be absurd if, for instance, a customer bought a new Samsung TV to replace their old LG TV, and the market notified LG so that LG could call the customer and arrange for them to return the new Samsung TV to Samsung and instead buy a new LG TV.

Retention and win-back offers in the energy market are highly aggressive, and are generally much more competitive than published offers made generally available. Larger retailers can fund these highly aggressive retention and win-back offers from their large customer bases and because they avoid the cost of acquiring a new customer to replace them. What this means is that non-churning customers are cross-funding recently retained / win-back customers. In other words, loyal customers are paying too much – they are incurring the ‘loyalty tax’. As noted previously, the ease with which retailers are able to retain or win back customers with these aggressive offers means that there is little incentive for them to give their existing customers the best service and price *before* that customer decides to leave.

Equally, as noted above, consumers miss out on better pricing from challenger retailers because they have to build the impacts of retention and win-back activity into their pricing for all customers, further limiting competition in favour of larger retailers.

Sumo is also concerned that the battle between new and old retailer often causes confusion and customer discontent. We have detailed our concerns here in our earlier submission.

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

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

This ban would not prevent the customer from cancelling their contract during the cooling off period, nor would it prevent other retailers from directly marketing to the customer.

In its Preliminary Report, the ACCC has referred to the ‘switch saving protection’ regime that was introduced in New Zealand. It also points to the New Zealand Electricity Authority’s post implementation review released in August 2017, which concluded that the scheme had no discernible effect on retail competition. What is important to understand is that the New Zealand ‘switch saving protection’ scheme only applied to saves (retention), and not win-backs. Furthermore, there are two

features of the New Zealand electricity retail market that impacted its effectiveness. First, the losing retailer can influence the timing of the customer's transfer away. Second, a transfer can be cancelled with retrospective effect up to 2 months after the event. The New Zealand Electricity Authority found that the losing retailers adjusted to the new scheme by accelerating the transfer process, so that they could then contact the customer sooner for a win-back. In effect, although the losing retailer was technically winning the customer back (which was permitted by the regime) and not 'saving' the customer, the outcome was effectively a customer 'save'. Retailers found a loophole and, unsurprisingly, there was little net impact on competition.

Figure 1: The switch is withdrawn before completion (retention) – before NZ switch saving protection regime

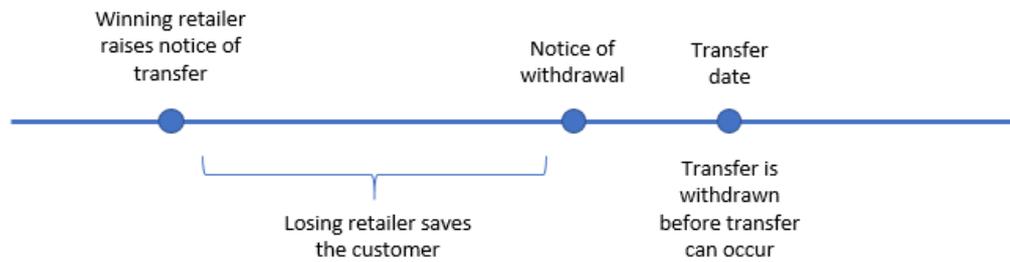
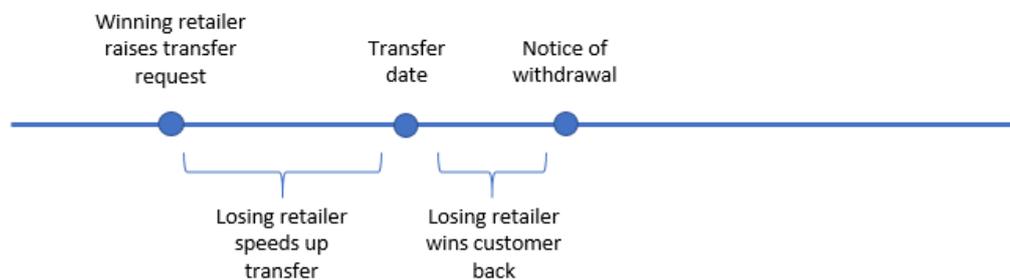


Figure 2: The switch is withdrawn after completion (win-back) – NZ switch saving protection regime



The main problem with the New Zealand 'switch saving protection' regime is that it does not ban win-back activity. In our view, win-back activity should be prohibited after customer transfer. As with the New Zealand regime, the customer would not be prevented from signing up with any other retailer during this period, but their previous retailer would not be permitted to contact them for marketing purposes.

Alternative solutions, which we presented in our earlier submission, include:

- a code of conduct for retention calls, including limiting contacts to one attempt, at prescribed times and by a prescribed method, such as email or SMS); and
- an opt in regime whereby a letter is sent to all transferring consumers with a prescribed method of opting into future contact by the previous retailer; and
- the publication of all offers (including any retention offers) on the retailer's website and on the Government comparison website, which would require retention offers to be available to all customers, and maintenance of a database of such offers; and
- fair and orderly market rules for the transfer of customers.

Wholesale market structures

The Preliminary Report confirms Sumo's assertions in its submission to the Issues Paper that:

- current movements in retail prices are almost exclusively caused by increases in wholesale electricity costs;
- increasing concentration of players in the wholesale electricity market is leading to a decline of competition in the wholesale market.

We are also deeply concerned by the ACCC's findings of evidence of transfer pricing in times of high wholesale prices (page 82).

As we have previously noted to the ACCC, the market for wholesale electricity hedges is becoming increasingly challenging for new entrant, stand-alone electricity retailers:

- Larger retailers will typically build a portfolio of wholesale hedging products, comprising swaps, caps, offtake agreements etc. In our experience, it is uneconomic for a small retailer to adopt this strategy until it has approximately 100k residential customers (or equivalent). Instead, many such retailers will seek to reduce their wholesale risk by entering into low-risk load-following hedging contracts. These contracts are historically offered by long-term base-load generators.
- As base-load generators exit the market and are replaced by intermittent generation, the availability of load-following hedging contracts is declining. The funding of new entrant generation requires long-term offtake commitments and their generation is mostly intermittent. Whereas a load-following hedging contract will cover all of a retailer's customer load, these long-term offtake arrangements necessarily do not guarantee supply. The 'shape' of any supply will not align with the 'shape' of customer demand, and so they must be complemented with other hedging products. Further, because offtake agreements are long-term, the retailer is locked into a forward position for up to, say, 10 years – this is challenging for a retailer that has been in market for only a few years and has little trading history with which to forecast future demand.
- In some jurisdictions, there is insufficient generation capacity to support an 'over-the-counter' hedging market for new entrants.
- The availability of low-risk over-the-counter hedging contracts further declines in a high-price market because generators are able to meet their targets without taking on the additional risk associated with offering such products.
- The increased wholesale price volatility is resulting in increased demands for prudential support from wholesale counterparties and from AEMO, which is further exacerbating the costs for smaller retailers.
- Smaller retailers are more exposed to movements in wholesale electricity prices because they generally don't have the capacity to hedge as far forward as larger retailers.

We support the ACCC's stated intention to identify solutions that will improve competitive outcomes in the wholesale electricity market, including:

- increased generation capacity – particularly from non-vertically integrated new entrants, and particularly reliable, dispatchable generation that will also support a liquid hedging market;
- constraints on further consolidation of ownership of generation assets, and reviewing the effectiveness of measures that ring-fence the retail and generation divisions of a 'gentailer';
- review of transfer pricing arrangements and provision of most favoured nation clause to ensure that any pricing provided to vertically integrated retailers is available to other retailers, providing a competitive "break" and ensuring all participants have access to fair pricing; and
- implementing measures that address strategic bidding by generators – the 5-minute settlements rule change may be one solution.

Retailer marketing practices

As noted in our submission to the Issues Paper, we support measures that will simplify electricity product disclosure and make comparison between offers easier for customers, as well as Government-funded public awareness campaigns to promote the benefits of competition. We are engaging constructively in consultations by:

- the Australian Energy Regulator – to simplify Energy Price Fact Sheets, and to establish a comparison price; and
- the Australian Energy Market Commission – to introduce a requirement on retailers to notify customers when benefits come to an end.

We would encourage the Victorian Government and the Essential Services Commission, Victoria to align itself with any changes made as a result of these consultations.

In recent years, commercial comparator websites have made comparison of energy products much simpler for consumers, and have been effective in facilitating a significant number of switches. Although Government comparator websites are also a useful resource for customers looking to shop around for a new energy deal, it is unclear how effective they are in practice. How many consumers use them? How many then actually switch product or retailer based on the information they find? We recommend the ACCC review the actual effectiveness of Government comparator websites, and consider ways to make these sites a primary mechanism for customer switching. For instance, it is not currently possible to select a product and sign up on the Government comparator websites – introducing this functionality would likely improve its effectiveness.

We would appreciate the opportunity to discuss these matters further, and will make contact with your office.

Yours sincerely



Paul Cullinan
Managing Director & Chief Executive Officer