

# Review of electricity and gas retail markets in Victoria

Discussion paper

January 2017

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# Request for comment

This discussion paper seeks comments to inform the review of electricity and gas retail markets in Victoria.

Submissions are sought on the issues raised in this discussion paper, or on any other matters relevant to the Victorian electricity and gas retail markets' ability to effectively deliver benefits for Victorian electricity and gas consumers.

## How to provide us with your comments

Written responses to the discussion paper are due by Tuesday 28 February 2017.

Responses are to be submitted by email to: [energymarket.review@delwp.vic.gov.au](mailto:energymarket.review@delwp.vic.gov.au).

Any queries should be directed to the Review Secretariat on (03) 8392 7519, or emailed to [energymarket.review@delwp.vic.gov.au](mailto:energymarket.review@delwp.vic.gov.au).

Due to the short timeframes for completion of this review, stakeholders intending to make submissions are strongly encouraged to do so by the due date.

## Publication of submissions

We will treat submissions received in response to this discussion paper as public documents and submissions will be placed on the review website at [www.engage.vic.gov.au](http://www.engage.vic.gov.au). If you believe that there are aspects of your submission that are confidential or commercially sensitive, you should mark those sections 'IN CONFIDENCE'. In such instances, formal requests for confidentiality will be honoured, however, submissions may be made available publicly under the *Freedom of Information Act 1982 (Vic)*. Any requests for public access to a submission will be determined in accordance with the Act.

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# 1. Introduction

Victoria has been at the forefront of initiatives to reform and deregulate the energy sector. Reforms implemented from the 1990s onward, including the privatisation of the former State Electricity Commission of Victoria, have transformed the competitive landscape. Full retail contestability was introduced for Victorian small customers in the electricity and gas markets in January 2002.

In January 2009, the Victorian Government removed retail price regulation with the intention that consumers could fully benefit from the competitive market. The removal of price regulation is supported by a regulatory framework that is intended to harness the benefits of competition, while ensuring that consumers have access to energy under fair terms and conditions, and at an acceptable service quality by maintaining effective protections.

Following deregulation of electricity and gas retail prices, the number of competitors has grown in the retail sector. In the 2015-16 financial year, 23 electricity and 11 gas retailers supplied the residential segment of the markets, 24 electricity and 10 gas retailers supplied small businesses, while 29 electricity and eight gas retailers supplied large businesses in Victoria.

Competition can bring benefits to consumers in the form of efficient prices, improved customer service and supply of innovative products and services. Some observers suggest, however, that retail competition in electricity and gas markets in Victoria is not delivering benefits to consumers as expected. Following eight years of price deregulation, it is timely to consider whether the electricity and gas retail markets are delivering the best outcomes for consumers.

## 1.1. The review

The Victorian Government has appointed an independent panel to conduct a review of electricity and gas retail markets in Victoria (the review). The panel comprises John Thwaites, Terence Mulder and Patricia Faulkner. The panel will prepare a final report to the Minister for Energy, Environment and Climate Change that examines the operation of the Victorian electricity and gas retail markets and provides options that would improve outcomes for consumers. The Terms of Reference for the review are at Appendix A.

The independent panel will be supported by a secretariat administered by the Department of Environment, Land, Water and Planning (DELWP).

## 1.2. Scope of the review

The review will consider the operation of the electricity and gas retail markets in Victoria in respect of supply to residential and small business consumers – defined for Victorian regulatory purposes as consumers with annual consumption less than 40MWh for electricity and 1,000GJ for gas. The review will not consider supply to large commercial and industrial consumers.

The regulatory distinction allows for greater consumer protection to be applied to smaller consumers. This is because larger consumers are likely to be better placed to negotiate and manage their energy supply arrangements on commercial terms and have different market drivers for engagement than smaller consumers. However, if you believe there are issues that are important to be considered in relation to larger consumers, you are invited to outline these in your submission.

In accordance with the Terms of Reference, the review will consider:

- the characteristics of the electricity and gas retail markets, including consumer engagement, market structure, regulation and pricing – with a particular focus on retail costs and margins;
- key drivers underlying electricity and gas retail pricing, with a focus on retail costs and margins;
- whether the Victorian electricity and gas retail markets are operating in the interests of consumers;
- whether the electricity and gas retail markets are competitive and whether there are potential constraints on competitiveness;

- whether electricity retailers are taking advantage of the impending closure of Hazelwood Power Station, in terms of their price offerings to consumers;
- consumer awareness and understanding of the retail markets, including potential barriers for particular groups of customers to engage in the markets; and
- a review of relevant policies and practices in other jurisdictions, nationally and internationally, to identify best practice in regulatory frameworks governing energy retail markets.

### 1.3. Purpose of the discussion paper

The purpose of this discussion paper is to:

- set out some of the possible issues to be explored during the review;
- present stakeholders with questions; and
- elicit evidence-based submissions from stakeholders to inform the review.

Stakeholders are invited to submit their views in response to the discussion paper, along with supporting evidence. This paper is not intended to provide an exhaustive list of possible issues and stakeholders are encouraged to share their views on any additional issues relevant to the operation of the electricity or gas retail market in Victoria.

Stakeholders are also invited to outline possible policy options that may be available to improve outcomes for consumers. The review panel is mindful of the potential for government or regulatory intervention to result in unintended consequences, and is seeking the considered input of stakeholders to identify risks and potential negative outcomes from any options identified.

### 1.4. Next steps

Submissions in response to the discussion paper are invited by Tuesday 28 February 2017. Details on how to provide a submission are outlined on page 2 of this paper.

The nature and timing of further consultation will be determined by the review panel during the course of the review. It is likely that one or more working papers exploring issues in further detail and/or potential policy options will be published for further consultation.

The panel will prepare a final report to the Minister for Energy, Environment and Climate Change by May 2017.

## 2. Competition and the long term interests of consumers

This section primarily relates to the following from the scope of the Terms of Reference:

- whether the Victorian electricity and gas retail markets are operating in the interests of consumers.

Competition was introduced into retail electricity markets in Victoria in accordance with Australia's National Competition Policy – a program of economic reforms between 1995 and 2005 that followed the 1993 report of the Independent Committee of Inquiry into a National Competition Policy.

A key principle underpinning the National Competition Policy program was that competitive markets will generally best serve the interests of consumers and the wider community. It was based on a presumption

favouring competition, but competition was a means to deliver benefits rather than an end in itself. Reforms implemented were subject to safeguards to ensure they promoted the public interest. Governments could consider efficiency, social, environmental, equity and regional objectives in assessing reform options.

Competition was introduced to improve efficiency in retail electricity and gas retail markets by creating incentives for businesses to reduce costs, improve services for consumers and innovate. There are a number of circumstances, however, where competition may fail to deliver efficient outcomes and the expected benefits to consumers.

Some observers have suggested that the introduction of competition into retail electricity and gas markets for small customers may have led to unintended adverse impacts, in particular by increasing costs in retail energy markets that are ultimately borne by consumers. Specifically, observers have pointed to increases in the 'retail charge' component of consumers' bills<sup>1</sup> that is typically made up of retailer costs and margins. These are the costs and margins associated with the retailer's activities once all other identifiable cost inputs (such as wholesale and network costs) are subtracted. The different levels of the supply chain are discussed further in section 3 of this paper, and the components that make up consumers' bills are discussed further in section 4.1.

The review seeks to understand whether the introduction of competition has achieved its objective of delivering benefits in the long term interests of consumers, particularly through improved efficiency and reduced costs.

## Questions for comment

1. (a) Has the introduction of competition to electricity and gas retail markets in Victoria delivered improved efficiency and benefits in the long term interests of consumers? Please explain the reasons for your response.  
  
(b) If not, what measures or alternative model(s) would you suggest for the efficient and effective delivery of electricity and gas in the long term interests of Victorian consumers? Please explain the reasons for your response.
2. How much have retail charges paid by consumers increased? What are the reasons for retail charge increases and does this demonstrate that the markets are not operating in the interests of consumers? Please provide detailed evidence to support your response.

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<sup>1</sup> For example, see: SKM MMA (2013) Analysis of Electricity Retail Prices and Retail Margins 2006 - 2012, Report for the ESC, May 2013; at:

<http://www.esc.vic.gov.au/document/energy/25985-skm-mma-retail-margin-for-residential-supply-report/>

AEMC (2013) 2013 Residential Electricity Price Trends report, 13 December; at: <http://www.aemc.gov.au/getattachment/fe3d2519-026d-4f01-bdd4-d65ddfae51c3/2013-Residential-Electricity-Price-Trends-Final-Re.aspx>

CME (2015) A critique of the Victorian retail electricity market, June 2015; at: [http://library.bsl.org.au/jspui/bitstream/1/5255/1/CME\\_A-critique-of-the-Victorian-retail-electricity-market\\_June\\_2015.pdf](http://library.bsl.org.au/jspui/bitstream/1/5255/1/CME_A-critique-of-the-Victorian-retail-electricity-market_June_2015.pdf)

St Vincent de Paul Society (2015) The NEM – still winging it, September 2015, at: [https://www.vinnies.org.au/icms\\_docs/228265\\_National\\_Energy\\_Market\\_-\\_Still\\_Winging\\_It.pdf](https://www.vinnies.org.au/icms_docs/228265_National_Energy_Market_-_Still_Winging_It.pdf)

St Vincent de Paul Society (2016), The NEM – a hazy retail maze – Observations from the Vinnies' Tariff-Tracking Project, December 2016 at [https://www.vinnies.org.au/icms\\_docs/256854\\_National\\_Energy\\_Market\\_-\\_A\\_hazy\\_retail\\_maze.pdf](https://www.vinnies.org.au/icms_docs/256854_National_Energy_Market_-_A_hazy_retail_maze.pdf)

CME (2016) Australia's retail electricity markets: who is serving whom?, August 2016, at: <http://cmeaustralia.com.au/wp-content/uploads/2013/09/160815-FINAL-getup-retail-report-.pdf>

### 3. Market structure and regulation

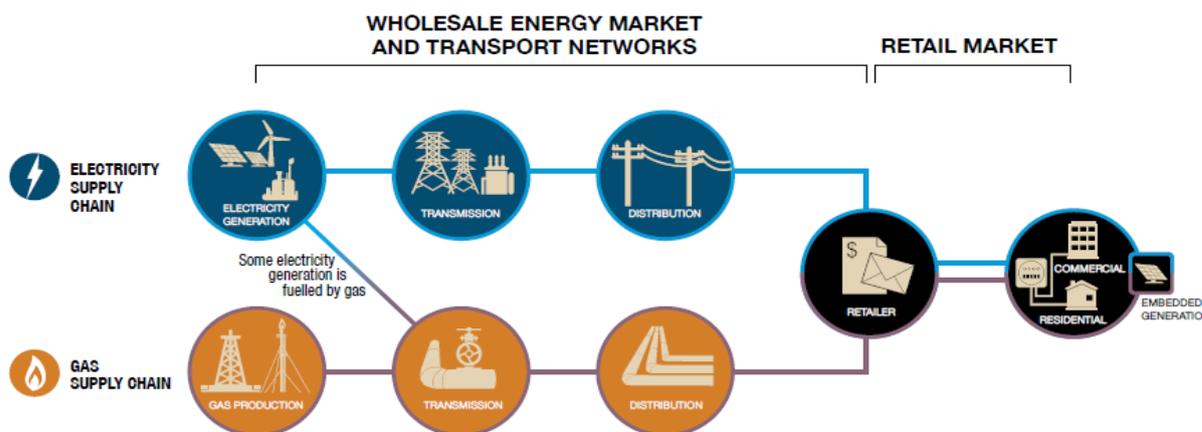
This section primarily relates to the following from the scope of the Terms of Reference:

- the characteristics of the electricity and gas retail markets, including consumer engagement, market structure, regulation and pricing – with a particular focus on retail costs and margins.

It also relates to:

- whether the Victorian electricity and gas retail markets are operating in the interests of consumers; and
- whether the electricity and gas retail markets are competitive and whether there are potential constraints on competitiveness.

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



Source: Australian Energy Market Commission, at: <http://www.aemc.gov.au/Australias-Energy-Market/Electricity>

Broadly speaking, electricity is supplied through four distinct levels of the supply chain:

- Generation – electricity is generated from a variety of sources, including brown coal generators in the Latrobe Valley, gas-fired generators and renewable sources;
- Transmission – after generation the energy is transported along high voltage power lines to cities and towns throughout Victoria and the broader National Electricity Market (NEM);
- Distribution – high voltage electricity is transformed into lower voltage electricity for distribution to customers’ premises along low voltage power lines; and
- Retail – retailers acquire energy inputs, manage risk and provide a number of additional services to supply bundled electricity services to end users.

Supply of gas is similar to electricity, with:

- Production – gas is sourced from gas fields around Victoria;
- Transmission – the gas is then transported to cities and towns along high pressure gas pipelines;
- Distribution – it is then transferred to lower pressure distribution networks to be transported to customers’ premises; and

- Retail – retailers acquire the gas inputs, manage risk and provide a number of additional services to supply bundled gas services to end users.

### 3.1. What do retailers do?

After electricity is generated or gas produced, it is measured and delivered by transmission and distribution networks to the places where it is used. Retailers then sell that energy to customers. The core functions of an energy retailer are to:

- buy energy to sell to customers. Retailers can purchase energy from the spot market or pre-purchase electricity and gas from those who produce it;
- manage risk, particularly wholesale market risk;
- set tariffs and terms for customer contracts for the sale of that energy;
- issue accurate and timely bills for the energy used; and
- provide customer support and dispute resolution services.

Beyond these core functions, retailers are providing a growing range of additional products and services, such as ‘green power’, installation of solar panels and advice on managing energy usage and energy efficiency. In the future, retailers are likely to provide further products and services as the way customers buy and use energy continues to transform.

### 3.2. Retail regulation

In Victoria, all of the businesses that supply retail electricity or gas are required to hold a licence granted by the Victorian Essential Services Commission (ESC), or be exempt from the requirement to hold a licence.

That licence requires the business to meet minimum standards in performing its regulated function. The ESC monitors and enforces compliance with these minimum standards.

For retailers, this means that they must comply with the Energy Retail Code, the Marketing Code of Conduct, the Electricity Distribution Code and the Gas Distribution System Code. Together these codes cover the terms of a contract a retailer has with customers and the way it must act in dealing with customers.

Victorian electricity retailers must also operate within the confines of the broader National Electricity Market (NEM) Rules and procedures. Documents issued by the Australian Energy Market Operator (AEMO) provide for the way a retailer purchases energy and transfers customers.

#### Question for comment

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

## 4. Pricing, costs and margins

This section primarily relates to the following from the scope of the Terms of Reference:

- the characteristics of the electricity and gas retail markets, including consumer engagement, market structure, regulation and pricing – with a particular focus on retail costs and margins; and
- key drivers underlying electricity and gas retail pricing, with a focus on retail costs and margins.

It also relates to:

- whether the Victorian electricity and gas retail markets are operating in the interests of consumers;
- whether the electricity and gas retail markets are competitive and whether there are potential constraints on competitiveness; and
- consumer awareness and understanding of the retail markets, including potential barriers for particular groups of customers to engage in the markets.

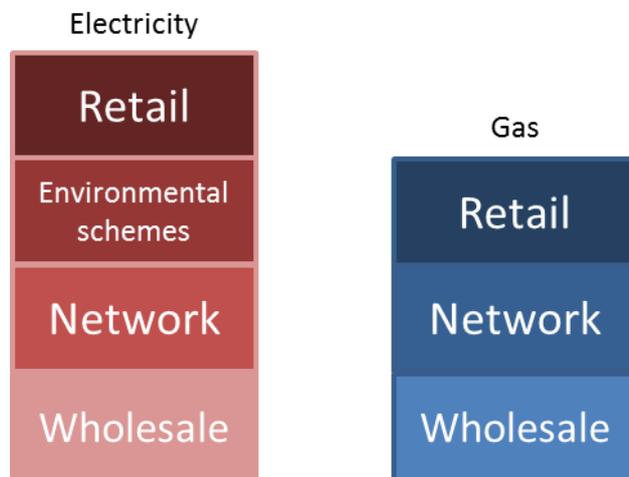
An important consideration in understanding outcomes for consumers in Victoria's competitive retail electricity and gas markets is an assessment of pricing outcomes for consumers. This includes understanding retail cost drivers, an assessment of margins, and considering whether competition has effectively driven lower retail costs and margins to the benefit of consumers. It is also likely to include an assessment of the different prices and offer structures available in the market.

The review is seeking information from stakeholders to inform its assessment of pricing outcomes, including whether the competitive market is working effectively to deliver lower energy retail costs for consumers.

### 4.1. Costs for retailers

The costs that make up consumers' bills broadly fall into a number of identifiable categories. These costs comprise a mixture of regulated costs, where all retailers are price takers and pay the same regulated rate to suppliers (distribution networks), and competitive or market based costs, where retailers' activities and business models have the opportunity to influence these costs. The following figure provides a general breakdown of the cost components that make up consumers' bills.

**Figure 2: Hypothetical illustration – composition of residential electricity and gas bills (not a representative example)**



The regulated costs include network costs – the ‘poles and wires’ or pipes – and metering costs.

There are a number of competitive or market based costs. Typically these include:

- Wholesale electricity and/or gas supply costs. These are the costs to pay for the volume of electricity or gas necessary to supply a retailer’s customer base. Wholesale costs may include purchasing hedge contracts, spot market purchases or costs of supply from vertically integrated generation.
- Environmental scheme costs. These comprise the cost of purchasing (or carrying out activities to create) certificates to meet legislated requirements of various federal and state environmental schemes; for example, schemes associated with the Federal Renewable Energy Target and the Victorian Energy Efficiency Target. Under these schemes, market participants generate certificates by carrying out certain activities, such as generating renewable electricity. Retailers are required to obtain and surrender certificates in proportion to the level of electricity consumed by their customer base. Certificates may be purchased from suppliers directly, purchased on spot markets or created through retailers’ own business activities (for example, where a retailer also owns a windfarm).
- Retail business costs. These may include cost for systems such as billing and customer relationship management systems (including call centres), day to day operational costs including employing staff and leasing office space, dispute resolution costs, and the costs of participating in the market (such as advertising, web presence and running business to business systems such as banking).

Retail businesses may increasingly incur costs to supply additional value-added or new innovative products and services to consumers, such as solar panels, batteries, energy management systems and energy efficiency products and services.

## 4.2. The retail charge and margins

Some observers suggest that retail prices in Victoria do not appear to reflect underlying cost trends, and that competition has led to an increase in the retail charge paid by consumers, particularly for standing offers and some higher priced market offers. Reports that attempt to assess the retail charge and margins in Victoria include a 2013 report by SKM MMA for the ESC<sup>2</sup>, a 2013 AEMC report<sup>3</sup>, a 2015 report by CME for the

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2. SKM MMA (2013)

3. AEMC (2013)

Brotherhood of St Laurence<sup>4</sup>, 2015 and 2016 reports by the St Vincent de Paul Society<sup>5</sup>, and a 2016 report by CME for Get Up!<sup>6</sup>

Given that retail prices are fully deregulated in Victoria, far less information is available about retailers' costs than in other NEM jurisdictions. Detailed margins analyses therefore invariably pose methodological issues and require a number of assumptions to be made about the composition of costs and other factors. For example, assumptions must be made to determine an appropriate wholesale electricity cost. In reality, retailers manage their wholesale costs and risks in different ways and, consequently, retailers are likely to face differing wholesale costs.

Nonetheless, a well-designed analysis can provide a useful picture of trends in the retail charge and margins to help assess how the competitive retail electricity and gas markets are performing for consumers.

The review will consider retail pricing outcomes, including the retail charge, margins and underlying drivers of price. To assist with its assessment of pricing outcomes, the review is seeking information and evidence from stakeholders to ensure its analysis is as accurate and meaningful as possible.

### Questions for comment

4. What factors need to be considered by the review when conducting an analysis of retail charges and margins?

5. To the extent that analyses of retail pricing and/or margins indicate a trend of increasing retail charges and/or margins, what are the explanations for this? Please provide evidence to support your claims.

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

### 4.3. Costs associated with retail competition

There are a number of costs of running a retail business that have been introduced into the supply chain or significantly increased as a result of retail competition. These include substantial marketing costs, as well as customer switching costs and other customer acquisition and retention costs. The introduction of competition can also lead to the replication of a number of fixed costs and/or the erosion of economies of scale, for example, billing and other system costs.

Costs associated with retail competition are likely to be substantial and, for competition to be efficient, must be outweighed by cost reductions or other benefits driven by competition.

The review seeks to understand which costs have been introduced or increased as a result of competition, and what cost reductions and other benefits to consumers have resulted from the introduction of retail competition.

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4 CME (2015)

5 St Vincent de Paul Society (2015) and St Vincent de Paul Society (2016)

6 CME (2016)

## Questions for comment

7. Which costs have been introduced or significantly increased as a result of the introduction of retail competition? How much cost has retail competition added to the electricity and gas supply chains?
8. What cost reductions and other benefits to consumers have resulted from the introduction of retail competition? Are there characteristics of the electricity and gas retail markets or supply chains that inhibit retail competition from delivering cost reductions or significant other benefits to consumers?

### 4.4. Price differentiation and dispersion

Another measure of the performance of the Victorian electricity and gas retail markets may be the extent of price dispersion between contract offerings.

Analysis undertaken for the St Vincent de Paul Society in 2015 suggests that for households with 'typical' consumption levels, the difference between the 'best' and the 'worst' electricity market offer increased from a year earlier, ranging from \$450 to \$530 per annum.<sup>7</sup> The Australian Energy Regulator's (AER) 2015 State of the Energy Market report noted that, in electricity, jurisdictions that have removed retail price regulation exhibit the strongest price diversity. In these jurisdictions, including Victoria, annual charges under the cheapest contract in 2015 were typically at least 30 per cent lower than under the most expensive contract.<sup>8</sup>

Some level of price dispersion is likely to be an important feature of well-functioning, competitive retail electricity and gas markets, particularly as different products and tariff structures are developed to best meet the needs of different consumer segments.

On the other hand, prices may remain dispersed as a consequence of companies discriminating on price between consumers who regularly search for, and can easily identify, better offers, and consumers who, for whatever reason, do not regularly switch or seek a better deal. Some consumers may not switch to better offers for many reasons, including complexity, consumer vulnerabilities, lack of time, search and switching costs, and/or the existence of consumer biases (see Section 5 below). From this perspective, persistently high levels of price dispersion may point to a deeper problem in the electricity and gas retail markets.

The review seeks information to understand the drivers of the high level of price differentiation and dispersion in retail electricity and gas markets in Victoria, as well as the implications of high levels of price dispersion on outcomes for consumers. The review is also seeking information to understand what happens to the price paid by consumers at the end of their benefit period and information to help identify how many consumers are on the cheapest offers from their retailer compared to higher priced standing and market offers.

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7. St Vincent de Paul Society and Alvis Consulting Pty Ltd (2015) Victorian Energy Prices, July 2015, at: [https://www.vinnies.org.au/icms\\_docs/221190\\_Victorian\\_Energy\\_Prices\\_July\\_2015.pdf](https://www.vinnies.org.au/icms_docs/221190_Victorian_Energy_Prices_July_2015.pdf).

8 AER (2015) State of the Energy Market 2015; p.21

### Questions for comment

9. Why do prices remain so dispersed in Victorian electricity and gas markets? Does price dispersion indicate that some consumers are not obtaining the price benefits of competition? Why or why not?
10. When do consumers end up on standing offers or higher priced (typically undiscounted) market offers? What happens to consumers at the end of their contract period?

## 4.5. Fixed supply charges

Retail energy offers come in many forms. Typically, offers comprise both fixed and variable charges. Consumers pay a fixed charge, often referred to as a daily supply charge, irrespective of the volume of energy they consume. They then pay a usage charge, based on the volume of energy consumed. Rates charged for usage may vary at different times throughout the day, or for different volumes (or 'blocks') of usage within a billing period.

Some observers have raised concerns with the level of fixed retail charges observed in the Victorian retail market.<sup>9</sup> Some stakeholders have suggested that the level of fixed retail charges, when compared to fixed network charges, are unexplainably high in Victoria. Others have argued that there is no place for fixed charges in a competitive market and competition should drive prices to be entirely fixed or variable.

The review seeks information to better understand the role of fixed and variable charges in retail electricity and gas markets in Victoria, and whether the level of fixed charges may indicate that the market is not delivering efficient pricing structures to Victorian consumers.

### Question for comment

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

## 4.6. Product and service innovation

In competitive markets, consumers often benefit from a number of non-price improvements, including innovative product and service offerings. Product and service innovation is a potentially important part of a competitive energy retail market as retailers compete to meet the changing needs of customers.

Different models for the delivery of integrated energy services are now emerging and may result in a fundamental change in how markets work. For instance, new technologies are providing options for self-generation and decentralised generation to consumers; and new service providers are offering products such as solar-power purchase agreements and solar leasing. These advances may transform retail energy markets and reduce the role of traditional retailers. The emergence of new business models may also create

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<sup>9</sup> For example: CME (2015);

St Vincent de Paul Society (2016);

Dr Ron Ben-David (2015), If the retail market is competitive then is Lara Bingle a Russian cosmonaut?

Dr Ron Ben-David (2016), Shock Therapy. Reviving retail competition in the energy market

more scope for product and service innovation, as well as low priced tariffs leading to increased competition and improved consumer outcomes in retail energy and related product and service markets.

### Question for comment

12. What product or service innovation has been introduced by Victorian electricity retailers? Are there any barriers preventing the entry of new, innovative energy business models or products and services in Victoria?

## 5. Consumer awareness, understanding and engagement

This section primarily relates to the following from the scope of the Terms of Reference:

- the characteristics of the electricity and gas retail markets, including consumer engagement, market structure, regulation and pricing – with a particular focus on retail costs and margins; and
- consumer awareness and understanding of the retail markets, including potential barriers for particular groups of customers to engage in the markets.

It also relates to:

- key drivers underlying electricity and gas retail pricing, with a focus on retail costs and margins;
- whether the Victorian electricity and gas retail markets are operating in the interests of consumers;
- whether the electricity and gas retail markets are competitive and whether there are potential constraints on competitiveness.

Retailers choose what prices and products to offer when selling energy, and these prices and products vary. This creates the availability of potentially better price and product outcomes for customers. Large price differences between different energy tariffs exist in Victorian retail energy markets, and many households could achieve significant savings by changing product or retailer.

However, consumers can only achieve better outcomes if they switch offers or are 'engaged in the market'. Relevant to this is a consumer's ability to switch.

A priority for the review is to understand the extent to which Victorian electricity consumers are:

- actively engaged in selecting energy offers that are cost-effective and meet their needs;
- in a position to make informed choices about energy offers; and
- otherwise able to switch.

Most Victorians are aware that they can choose their retailer – 25 per cent of electricity and 22 per cent of gas residential customers switched retailers in Victoria in 2015.

There may be concerns, however, about the extent to which switching activity can be taken as a robust indication of informed consumer engagement and participation in the market. Rates of switching may mask barriers preventing more Victorian consumers from accessing the benefits of competition.

Barriers to switching may include:

- a lack of confidence in choosing the best value offer according to way a customer uses energy;
- an inability to compare offers because of their complexity, or because they are explained differently;
- a lack of certainty around the positive or negative outcomes of switching, including a lack of awareness of consistency of treatment a customer is likely to experience if electing to switch; or
- a perception that switching is difficult or takes a lot of time to complete, and could outweigh the available savings.
- A perception that retailers are likely to vary the offer at a subsequent time.

Not all consumers switch. Around 9 per cent of residential electricity and 11 per cent of gas consumers in Victoria remain on standing offer contracts. A large proportion of these consumers are likely to have never switched retailer or offer. The presence of inactive or 'sticky' customers may be a reflection of consumers' incentives, information barriers, actions by retailers or structural features of the market.

The ability of retailers to charge higher prices to customers who do not engage in the market means those customers are, in a sense, excluded from the competitive process and the benefits of competition. The large price differences between the most competitive market offers and high priced market and standing offers suggest that some retailers may take advantage of barriers to engagement and customer inertia to segment active and inactive customers, charging a significant premium to those consumers who are less engaged.

This review seeks to identify barriers to consumer engagement in the market and understand the implications of any barriers to engagement on outcomes for consumers.

### Question for comment

13. What are the key drivers of active consumer participation in retail energy markets? What barriers prevent consumers, or certain groups of consumers (including vulnerable consumers), from engaging in the market and/or selecting a product that best meets their needs?

## 5.1. Standing offer contracts

A standing offer contract is a set of terms and conditions that a customer is placed on if a market offer is not selected. This can be the case where a customer has never selected a market contract since the privatisation of the market, a customer takes supply at a new premises without agreeing a contract, a customer's current contract lapses or a customer is transferred to a new retailer in a retailer of last resort event.

Standing offers ensure terms and conditions for supply for customers who do not select any, and in this sense act as a safety net. However, the prices paid by customers on standing offers are among the highest available in the market.

There is a concern that standing offer contracts may be perceived as a 'default' tariff by some consumers and reduce consumer engagement or have other unintended consequences on consumer outcomes in the Victorian retail market. A particular concern relates to the observation that some customers on (higher

priced) standing offer contracts are more likely to be older or living in regional areas.<sup>10</sup> This may mean that the higher price terms of standing offer contracts may disproportionately penalise some vulnerable customers.

Consumers may therefore curtail their search for alternative, better offers and end up paying higher prices than they otherwise would. In the longer run, consumers may participate less in the competitive process, which would lead to a less well functioning market. The existence of standardised focal points coupled with reduced consumer search activity may also compromise product diversity and innovation.

The review is interested in how the presence of standing offer contracts and the prices set for supply under those contracts affect consumer outcomes, and whether there are alternative arrangements to standing offers that enable basic and important consumer protections to be maintained.

### Question for comment

14. Does the requirement on retailers to offer standing offer contracts lead to poor outcomes for consumers, or groups of consumers such as vulnerable consumers? If so, why?

## 5.2. Discounting

In its 2016 review of retail competition, the AEMC highlighted that retailers continue to compete by discounting. The size of the discount and how it is applied varies. Some discounts are applied to the whole bill, while others are only applied to usage. Some discounts were offered in comparison to the retailer's standing offer tariffs, while others were in comparison to another of the retailer's market offers, which in some cases were higher than the retailer's standing offer tariffs.<sup>11</sup> The widespread practice in Victoria of advertising market offers on the basis of discounts may raise concerns about the extent to which consumers are in a position to make accurate cost comparisons and select a product that is appropriate for their circumstances.<sup>12</sup>

The AEMC highlighted that the level of discounts in market offers has been growing over time and, as a result, there is a growing separation between standing and market offers in Victoria. The AEMC noted that this is a critical finding because it raises concerns that:

- there are customers who do not switch to market offers;
- customers on market offers may experience a significantly higher bill where a payment is late and they forfeit a 'pay on time' discount, so pay a bill equivalent to the standing offer price; and

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10 AEMC (2015); 2015 Retail Competition Review Final Report, June 2015, p. iii (Executive Summary), at: <http://www.aemc.gov.au/getattachment/56a8c56f-0aeb-48cc-9097-9f2b5e645428/Final-Report.aspx>

11. AEMC (2016); pp.126-127

12. This issue recently came to the forefront in two separate Federal Court decisions whereby Origin Energy and AGL Energy were required to pay penalties for making false or misleading representations concerning the level of discount that residential consumers in South Australia would receive. Australian Competition and Consumer Commission (2015) Origin Companies ordered to pay penalties of \$325,000 for misleading consumers about discounts under energy plans, 10 February; at: <https://www.accc.gov.au/media-release/origin-companies-ordered-to-pay-penalties-of-325000-for-misleading-consumers-about-discounts-under-energy-plans>; and Australian Competition and Consumer Commission (2015) AGL SA ordered to pay \$700,000 penalty and to offer refunds to consumers for false or misleading discount representations, 25 April 2015, at: <http://www.accc.gov.au/media-release/agl-sa-ordered-to-pay-700000-penalty-and-to-offer-refunds-to-consumers-for-false-or-misleading-discount-representations>

- customers who have not switched in more than a few years and whose discount periods have ended may be on prices that are closer to standing offer levels than the best market offers available today.<sup>13</sup>

While discounting may have adverse consequences for consumers in some circumstances, it may also be an important aspect of innovation in retail products and services.

The review seeks to understand the extent to which discounting reduces comparability, transparency and consumer engagement.

### Question for comment

15. What implications does discounting raise for consumer outcomes, including consumers' ability to compare offers and for retail competition more generally?

## 6. Restraints on competition

This section primarily relates to the following from the scope of the Terms of Reference:

- whether the electricity and gas retail markets are competitive and whether there are potential constraints on competitiveness.

It also relates to:

- the characteristics of the electricity and gas retail markets, including consumer engagement, market structure, regulation and pricing – with a particular focus on retail costs and margins;
- key drivers underlying electricity and gas retail pricing, with a focus on retail costs and margins;
- whether the Victorian electricity and gas retail markets are operating in the interests of consumers; and
- consumer awareness and understanding of the retail markets, including potential barriers for particular groups of customers to engage in the markets.

Theoretically, competition could be restrained from delivering benefits to consumers in a number of ways. This could include restraints that inhibit competition from developing, such as:

- barriers to entry or expansion could prevent new suppliers from entering the market or expanding, inhibiting competitive pressure from new entrants; and
- barriers that prevent the development and supply of new innovative products and services, pricing structures or new business models that might otherwise enhance competitive pressure in the market and deliver benefits to consumers.

Even where competition is not inhibited from developing, markets may have characteristics that restrain it from fully delivering benefits to consumers, or particular groups of consumers. For example, a lack of consumer response to the availability of improved offers, which may result from high search and switching costs, complexity, lack of transparency and/or the existence and persistence of consumer biases.

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<sup>13</sup> AEMC (2016); p.134

A number of the issues discussed throughout this paper could result from, or act as, restraints on competition. The review seeks to understand whether any other possible restraints on competition exist that inhibit the market from delivering efficient outcomes to Victorian electricity and gas consumers. Other possible restraints on competition that have been raised previously by stakeholders include:

- the presence of vertically integrated retailers that also own generation assets, which could increase the costs of wholesale risk management for non-vertically integrated retailers, impacting on their ability to enter or expand;
- higher financing costs and prudential requirements for non-vertically integrated retailers; and
- retailers that may need to supply both electricity and gas to expand beyond a certain point.

### Questions for comment

16. Are there any features of Victoria's retail electricity and gas markets that restrain competition from delivering benefits to consumers?

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

## 7. Experience in other jurisdictions

This section primarily relates to the following from the scope of the Terms of Reference:

- review of relevant policies and practices in other jurisdictions, nationally and internationally, to identify best practice in regulatory frameworks governing energy retail markets.

Retail energy markets in other national and overseas jurisdictions are governed by different regulatory frameworks, and have different market structures and arrangements. Some jurisdictions have reviewed the governance of their markets and considered whether they are delivering outcomes in the interests of consumers.

The review will consider relevant policies and practices in other jurisdictions, nationally and internationally, to identify best practice in regulatory frameworks governing energy retail markets. To assist with this, the review seeks information from stakeholders about relevant experiences in other jurisdictions, and identification of any key learnings and specific policies, regulations and initiatives that could be considered as part of the review for improving the operation of the market and consumer outcomes in Victoria.

### Question for comment

18. Are there examples of other retail electricity and gas markets that deliver strong outcomes to all consumers? What are the key characteristics of these markets, their regulatory frameworks, and/or examples of policy initiatives implemented that have helped improve consumer outcomes?

## 8. Price increases from Hazelwood closure

This section primarily relates to the following from the scope of the Terms of Reference:

- whether electricity retailers are taking advantage of the impending closure of Hazelwood Power Station, in terms of their price offerings to consumers.

The Hazelwood Power Station has been supplying up to 25 per cent of Victoria's baseload electricity since 1971. In November 2016, Hazelwood's French majority owner ENGIE announced its commercial decision to shut down the power station in March 2017. Following the announcement, electricity retailers announced significant price increases. This was attributed to an increase in forward contracts for wholesale electricity and anticipated increases in future wholesale spot prices in the NEM due to the exit of a significant volume of base-load generation.

The review will consider the level of price rises following the announced closure of the Hazelwood Power Station and whether electricity retailers are taking advantage of the impending closure of the generator, in terms of their price offerings to consumers.

### Questions for comment

19. What factors should the review consider in assessing price increases as a result of the expected closure of Hazelwood? What methods should the review consider to determine the likely impact of the Hazelwood closure on wholesale prices and the associated impact on retail prices?

20. What is a reasonable level of expected retail price increase resulting from the closure of Hazelwood? Please provide detailed evidence to support your response.

## 9. Possible initiatives to improve consumer outcomes

This section relates to the objective in the Terms of Reference that the review will provide options that would improve outcomes for consumers.

An objective of the review is to identify policy options that would improve outcomes for consumers. The review seeks advice from stakeholders on potential policy options.

The review welcomes suggested policy options and measures that would address any of the issues discussed in this paper, including:

- the efficient supply of electricity and/or gas in the long term interests of consumers;
- market structure or regulation;

- the level of retail charges and margins;
- price differentiation and price dispersion;
- fixed supply charges;
- the level of product and service innovation;
- consumer awareness, understanding and engagement;
- standing offer contracts;
- discounting;
- restraints on competition; and
- price increases from the Hazelwood closure.

The review also welcomes suggested policy options that seek to address any other issues raised by stakeholders in submissions.

Stakeholders are encouraged to identify policy options that have been implemented in other jurisdictions that could improve outcomes for consumers in Victoria.

The review acknowledges that policy options, measures and initiatives carry their own potential risks including possible unintended consequences. The review also seeks input from stakeholders to highlight possible risks and unintended consequences.

### **Question for comment**

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

## 10. List of consultation questions

1.	<p>(a) Has the introduction of competition to electricity and gas retail markets in Victoria delivered improved efficiency and benefits in the long term interests of consumers? Please explain the reasons for your response.</p> <p>(b) If not, what measures or alternative models would you suggest for the efficient and effective delivery of electricity and gas in the long term interests of Victorian consumers? Please explain the reasons for your response.</p>
2.	How much have retail charges paid by consumers increased? What are the reasons for retail charge increases and does this demonstrate that the markets are not operating in the interests of consumers? Please provide detailed evidence to support your response.
3.	Are there any features of market structure or regulation that inhibit the market from delivering outcomes in the best interests of consumers?
4.	What factors need to be considered by the review when conducting an analysis of retail charges and margins?
5.	To the extent that analyses of retail pricing and/or margins indicate a trend of increasing retail charges and/or margins, what are the explanations for this? Please provide evidence to support your claims.
6.	Please provide any other information or evidence you consider may help the review to accurately assess retail charges and margins or pricing outcomes for consumers.
7.	Which costs have been introduced or significantly increased as a result of the introduction of retail competition? How much cost has retail competition added to the electricity and gas supply chains?
8.	What cost reductions and other benefits to consumers have resulted from the introduction of retail competition? Are there characteristics of the electricity and gas retail markets or supply chains that inhibit retail competition from delivering cost reductions or significant other benefits to consumers?
9.	Why do prices remain so dispersed in Victorian electricity and gas markets? Does price dispersion indicate that some consumers are not obtaining the price benefits of competition? Why or why not?
10.	When do consumers end up on standing offers or higher priced (typically undiscounted) market offers? What happens to consumers at the end of their contract period?
11.	What factors influence the level of fixed charges imposed by retailers? What are the implications of fixed charges for consumer outcomes?
12.	What product or service innovation has been introduced by Victorian electricity retailers? Are there any barriers preventing the entry of new, innovative energy business models or products and services in Victoria?
13.	What are the key drivers of active consumer participation in retail energy markets? What barriers prevent consumers, or certain groups of consumers (including vulnerable consumers), from engaging in the market and/or selecting a product that best meets their needs?
14.	Does the requirement on retailers to offer standing offer contracts lead to poor outcomes for consumers, or groups of consumers such as vulnerable consumers? If so, why?

<b>15.</b>	What implications does discounting raise for consumer outcomes, including consumers' ability to compare offers and for retail competition more generally?
<b>16.</b>	Are there any features of Victoria's retail electricity and gas markets that restrain competition from delivering benefits to consumers?
<b>17.</b>	Are there any issues that have not been considered in this discussion paper that you consider should be considered during the review?
<b>18.</b>	Are there examples of other retail electricity and gas markets that deliver strong outcomes to all consumers? What are the key characteristics of these markets, their regulatory frameworks, and/or examples of policy initiatives implemented that have helped improve consumer outcomes?
<b>19.</b>	What factors should the review consider in assessing price increases as a result of the expected closure of Hazelwood? What methods should the review consider to determine the likely impact of the Hazelwood closure on wholesale prices and the associated impact on retail prices?
<b>20.</b>	What is a reasonable level of expected retail price increase resulting from the closure of Hazelwood? Please provide detailed evidence to support your response.
<b>21.</b>	What potential policy options and measures exist to address any issues with the operation of retail electricity and gas markets? Please explain how these policy options and measures would improve outcomes for consumers and identify any potential risks arising from these options and measures.

## Terms and abbreviations

Term	Definition
AEMC	Australian Energy Market Commission – the rule maker for Australia’s electricity and gas markets, including the National Electricity Rules, National Gas Rules and National Energy Retail Rules. AEMC also provides market development advice to governments.
AEMO	Australian Energy Market Operator – operates the energy markets and systems and delivers planning advice in eastern and southern Australia. AEMO supports the industry to deliver an integrated, secure, cost-effective national energy supply.
AER	Australian Energy Regulator – regulates energy markets and networks under the national energy market legislation and rules in setting prices for using energy networks to transport energy to customers in eastern and southern Australia.
DELWP	Department of Environment, Land, Water and Planning – ensures Victoria has the right conditions to enable economic growth, while delivering liveable, inclusive and sustainable communities.
ESC	Essential Services Commission – Victoria’s independent economic regulator of prescribed essential utility services supplied by the electricity, gas, ports and rail freight industries.
Hedge contract	Financial contracts that companies can trade to manage the risk of price variations in the wholesale electricity market by agreeing to pay/receive a specified price at a specified point in time in the future.
Market offer	Contracts for electricity or gas that include minimum terms and conditions prescribed by law. Market contracts also include other terms and conditions not included in standard contracts. (Also known as a market retail contract).
MWh	Megawatt-hour – a unit of energy equivalent to 1 million watts expended over one hour.
NEM	National Electricity Market – a wholesale market through which generators sell electricity in eastern and southern Australia. The main customers are energy retailers, which bundle electricity with network services for sale to residential, commercial and industrial energy users.
Standing offer	A basic contract for electricity and gas with terms and conditions that are prescribed by law and designed to protect customer rights. (Also known as a standard retail contract.)
Vertical integration	Vertical integration occurs when a company operates in multiple stages of the supply chain. In the context of electricity, a vertically integrated company generates electricity and operates in the retail market.

# Appendix A: Terms of Reference

## Background

Previous reviews have suggested that competition in the Victorian energy retail market is strong and has provided benefits to many consumers. The Australian Energy Market Commission's 2016 Retail Competition Review found that of all National Electricity Market (NEM) jurisdictions, Victorian consumers had among the highest levels of awareness of choices, the highest rate of customer switching and among the highest customer satisfaction ratings. Victoria also had the lowest level of market concentration of the big three retailers.

While the market appears to be delivering benefits to Victorian energy consumers, a number of reports have indicated that retailers in Victoria may have some of the highest electricity margins in the NEM, particularly for consumers on standing offers. These reports include a 2013 report by SKM MMA for the ESC, a 2013 AEMC report, a 2015 report by CME for the Brotherhood of St Laurence, a 2015 report by the St Vincent de Paul Society, and a 2016 report by CME for Get Up! The AER's 2015 State of the Energy Market report noted that for electricity, jurisdictions that removed retail price regulation, including Victoria, exhibited the strongest price diversity and annual charges under the cheapest contract were typically at least 30 per cent lower than under the most expensive contract<sup>i</sup>. A particular concern relates to the AEMC's finding that some customers on (higher priced) standing offers were more likely to be older or living in regional areas<sup>ii</sup>.

## Objectives

The objectives of the review are to examine the operation of the Victorian electricity and gas retail markets and provide options that would improve outcomes for consumers.

## Scope

The review will consider:

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

John Thwaites, Terry Mulder and Patricia Faulkner will prepare a final report to the Minister for Energy, Environment and Climate Change that identifies ways in which the operation of the Victorian electricity and gas retail markets can be improved. This report will be provided by May 2017.

## Consultation

John Thwaites, Terry Mulder and Patricia Faulkner will undertake public consultation and targeted consultation with key stakeholders in the energy sector as part of the review. This includes taking submissions and seeking information from relevant stakeholders to inform their recommendations.

# Privacy Collection Statement

The Department of Environment, Land, Water and Planning (DELWP) is committed to protecting personal information provided by you in accordance with the principles of the Victorian privacy laws. For more information read DELWP's Information Privacy Policy at:

[http://www2.delwp.vic.gov.au/\\_\\_data/assets/pdf\\_file/0019/5464/DELWP-Privacy-Policy.pdf](http://www2.delwp.vic.gov.au/__data/assets/pdf_file/0019/5464/DELWP-Privacy-Policy.pdf)

The information you provide will be used for the Review of electricity and gas retail markets in Victoria (the Review) which has an objective of examining the operation of the Victorian electricity and gas retail markets and providing options that improve outcomes for consumers. The information in your submission is collected by DELWP to administer the public consultation process only.

Your contact details may be used by DELWP or its contracted service providers under confidentiality agreements as part of the Review process.

DELWP may do the following with your submission (your personal information will not be included):

- publish a copy of your submission on the DELWP website or other Victorian Government website
- quote directly from your submission in the Review report and/or the Government response to the Report
- make available to other Victorian Government agencies.

For transparency and accountability, the contents of your submission may be published on a Victorian Government website which is accessible worldwide. Any person may view your comments.

Your comments may remain on external servers, even once your comments are removed from the original website it was published on.

All submissions are public documents and may be accessed by any member of the public unless you request, and your comments are given, confidential status.

If you are making comment as an organisation, then your comments may be published, including the name of your organisation.

If you are making comments as an individual, then your comments may be published, including your postcode but with no other details.

If you freely and voluntarily provide any 'sensitive information' under the Privacy and Data Protection Act 2014 in your submission, DELWP will consider that provision to be consent to collect the information and will then protect it under the Information Privacy Principles in the Act. Sensitive information is information relating to racial or ethnic origin, political opinions, membership of a political association or trade association/union, religious or philosophical beliefs or affiliations, sexual preference or criminal record."

You have the right to access and correct your personal information. Requests for access should be sent to the Project Manager, Secretariat of the Review of electricity and gas markets in Victoria, 8 Nicholson Street, East Melbourne, Victoria 3018 or contact by phone on 03 9637 8858.

