2 November 2018

Energy Retail Market Monitoring
Independent Pricing and Regulatory Tribunal
PO Box K35
Haymarket Post Shop NSW 1240

Submitted online

Review of the performance and competitiveness of the retail energy market in NSW – Draft Report ('Draft Report')

Sumo welcomes the opportunity to respond to IPART's Draft Report.

Sumo is a dynamic new entrant energy retailer, and one of the fastest growing in the market. It commenced operations mid-2015 and now services almost 70,000 small energy customers in Victoria and NSW. It launched its electricity retail business in NSW in September 2018. Sumo also now delivers home broadband internet services, offering additional savings for consumers who take up an energy and internet bundle.

Having only very recently entered the NSW electricity market, Sumo brings the perspective of a retailer seeking to overcome the barriers to expansion in the NSW market.

Summary

In summary:

1. Retailer retention and win-back activity is leading to higher energy prices for consumers and making it difficult for smaller retailers to grow market share, and the practice should be prohibited.
2. Increased generation capacity from non-vertically integrated, new entrant generators – particularly reliable, dispatchable generation that will also support a liquid hedging market – is required to enable new entrant electricity retailers to compete on a level playing field in the wholesale electricity market.
3. Procuring a supply of wholesale gas is expected to be very challenging as a new-entrant retailer in the NSW market.
4. A Default Offer, as recommended by the ACCC, is not in the interests of consumers because it places an unacceptable risk on retailers – particularly smaller retailers – who need to manage volatile costs on behalf of customers. As impacted retailers freeze investment or withdraw from the market, consumers will ultimately experience less innovation and pay higher prices.

Retention and win-back activity

Sumo recommends a prohibition on retailer retention and win-back activity.

In section 3.4, the Draft Report outlines the analysis and findings of the ACCC in its report Restoring electricity afforda*bility & Australia's competitive advantage*, June 2018, that a key impediment to smaller retailers expanding their customer bases is the aggressive customer retention practices of the large retailers.

Sumo agrees that aggressive retention and win-back activity makes it difficult for small retailers to grow market share. We have experienced this in Victoria; early signs are that it is far worse in NSW. More importantly though, retention and win-back activity has a material impact on the price consumers pay for energy. This increased price arises from:

1. the wasted marketing effort and expense arising from retention and win-back activity – as noted in the Draft Report, the cost impact is higher for a smaller retailer, who must recover those costs from a smaller customer base
2. the ease with which a customer can be retained or won back by making a short-lived retention offer means there is little incentive on the incumbent retailer to give their loyal customers a better price or service. The misaligned incentive means that loyal customers are not only cross-funding customers who are active switching, but also pay a 'loyalty tax'.

In early 2018, Sumo commissioned a report by ACIL Allen which estimated that the combined impact of wasted marketing costs and the loyalty tax imposed a burden of between $149 and $189 per customer per year. We have provided a copy of this confidential report to IPART, and would strongly encourage IPART to carry out a further investigation to understand the customer impacts of retention and win-back practices in NSW.

Sumo's view is that the best way to address this issue – eliminating the wasted marketing costs and killing the loyalty tax – is to prohibit retention and win-back activity.

The experience in New Zealand was cited as a reason the ACCC decided not to recommend a ban on retention and win-back activity. 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.

Wholesale markets

Sumo has previously commented that 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 time in a market with which to forecast future demand.
- 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 or the level of future certainty to hedge as far forward as larger retailers.

Sumo's experience in NSW is that there is less wholesale electricity competition than in Victoria. Fewer generators are offering load-following hedges. Market participants in NSW are less inclined to offer load-following or customised products.

In general, Sumo supports measures that will lead to:

- increased generation capacity – particularly from non-vertically integrated new entrants, and particularly reliable, dispatchable generation that will also support a liquid hedging market; and
- 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'.

Although Sumo has not yet entered the NSW gas retail market, we make the following observations:

- There is no NSW-based gas production. Gas must be purchase and transported from Victoria (Gippsland) or from Cooper.
- Retailers must therefore secure a gas transportation agreement. These are often long-term contracts with no flexibility to mimic residential demand (load factor/seasonality). It is near impossible for a capital-light, new entrant retailer to secure such an agreement.
- Unlike the Victorian Declared Wholesale Gas Market, the NSW market is not integrated. A retailer must secure access arrangements with each sub-network if it wants to supply gas across the State.

Default offer

Sumo recommends that NSW reject the 'Default Offer' as proposed by the ACCC, and instead focus on initiatives that will drive down costs (including with respect to the marketing and wholesale costs described above) and improve transparency and consumer experiences.

Sumo's view is that price reregulation is not in the long-term interests of consumers because:

- it distorts market outcomes – if the price is set too high, consumers pay too much; if set too low, it would damage market participants by unfairly squeezing margins;
- the risk of prices being set too low would impose an unacceptable risk on retailers, particularly on stand-alone retailers with limited ability to absorb changes in wholesale cost;
- as a consequence, retailers would either freeze investment, including in renewable generation and demand management, or would withdraw from the market altogether; and
- either of these outcomes would drive higher prices and less innovation for consumers over the medium-long term.

As a new entrant retailer that relies on tapping into capital markets to fund its growth, the impact of price regulation will be felt well before the regulated price is ever determined. The threat of price regulation makes investors nervous and may mean some retailers will be unable to raise the capital required to fund future growth.

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

Yours faithfully

Alex Fleming
GM – Legal, Regulatory & Compliance