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Draft Determination: Default Market Offer Price

The Australian Energy Council (the AEC) welcomes the opportunity to make a submission to the Australian Energy Regulator's (AER) Draft Determination on the *Default Market Offer Price.*

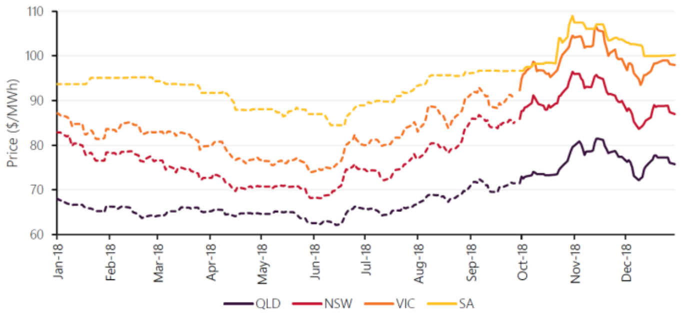
The AEC is the industry body representing 23 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

Noting the AER has no policy role in determining the benefits or otherwise of implementing the Default Market Offer (DMO), the AEC is concerned by a number of issues raised in the Draft Determination. This submission will focus on these matters for clarification. Our members will provide comments on the appropriateness of the DMO prices.

Impact of the DMO on existing offers

The Draft Determination states that the AER expects retailers will take reasonable steps to ensure that customers are not worse off under the DMO compared to what they are currently paying. We agree with this sentiment, however are concerned that the AER is suggesting that retailers will be unable to restructure their offers in light of the changing regulatory framework. As noted by some retailers in submissions to the Approach Paper, referencing standing and market offer prices at one point in time may not reflect their actual costs over a longer period. Similarly, retailers may have withheld previous price increases, or structured their offers based on different assumptions to those made by the AER. This is of critical importance given the Draft Determination utilises retailer prices from October 2018 to set the DMO for 2019/20. Since October 2018, wholesale prices are trending up. This highlights a key concern of retailers. If the price is set based on out of date assumptions, the risk that retailers will be unable to recover their input costs increases. The below diagram highlights this recent volatility. From January 2019, we have seen futures prices continue to rise by a further 16% in NSW.

Figure 19 ASX energy – Calendar year 2019 swap prices by region



Source: AEMO Quarterly Energy Dynamics Q4 2018

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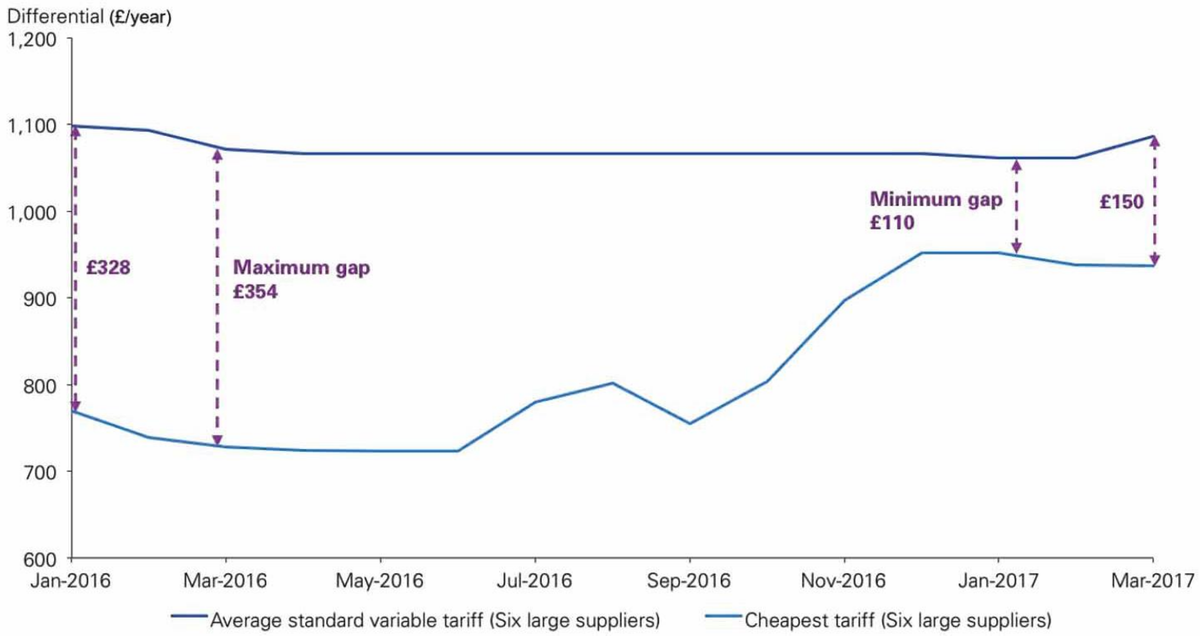
The AEC opposes additional controls on retailers' ability to set prices. At present, the only obligation placed on retailers under energy regulation is to ensure that market offers are not higher than their equivalent standing offer. Retailers should retain flexibility to adjust tariff structures and vary standing and market offers provided they comply with both the energy regulations and the new mandatory Electricity Industry Code. Moreover, some retailers' cost structures may have changed since October 2018 that warrant a change in pricing strategies and pricing structures. Retailers monitor the market to assess a range of factors including the wholesale market, competitor offers, churn levels and adjust their pricing and product mix over time in line with these changes in market conditions.

Restrictions on retailers' flexibility with respect to standing offer pricing may have broader consequences. While the AER wants to avoid disrupting retail competition as far as possible, we note the AEMC's conclusion that the narrowing of prices through the withdrawal of the most competitive offers is a predictable and highly likely consequence of retail price regulation. This is because the introduction of retail price regulation creates considerable uncertainty about retailers' ability to recover costs over the medium to longer term.

The AER must explain what it and the ACCC would consider an acceptable commercial response to the DMO – for example, in terms of retailers' changes to their pricing structures for standing offers - and the scope of its monitoring.

In their advice to the COAG Energy Council in December 2018, the AEMC provided clear evidence of how prices narrow in a regulated market, citing recent UK experience with the re-introduction of a temporary default offer cap[1].



The AEMC also referred to consumer behaviour under price regulation, suggesting that consumers would become less engaged in the market or perceive a regulated price as a safer choice than retailer's tariffs even if in that choice they are worse off.

The AEC is concerned that these genuine practical impacts are not being appropriately considered by the Government in implementing these fundamental market reforms. In order to mitigate the negative outcomes this intervention will cause, the AEC strongly recommend the AER clarify in its final determination:

[1] AEMC, Customer and competition impacts of a default offer, Final report, 20 December 2018, p. iv.

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- how the DMO will operate in practice, including how it will integrate with the Retail Law and Retail Rules, including the RPIG
- how the ACCC and AER will perform their respective roles and coordinate their activities under the new framework - specifically their monitoring of retailers' compliance with regulatory requirements
- whether the AER and ACCC will streamline and/or coordinate any information requests to streamline the compliance burden on retailers
- whether the AER intends to make consequential changes to its guidelines and/or propose rule changes based on the introduction of the Code.

Determining the DMO in future years

We strongly support the AER's Draft Determination use of a top down approach for 2019/20. We are comfortable with the suggestion that the AER might utilise a cost based bottom up approach to check the appropriateness of a DMO set, however given the policy intent, this should be used as a key indicator only, rather than setting the price itself.

We support the views of the ACCC that the DMO is not intended to reflect an efficient retail price, nor should it be close to the lowest prices in the market. In implementing the DMO, it is incumbent on the AER to ensure that the cheaper priced offers currently available in the market are not lost, as this will be to the detriment of engaged consumers.

The AEC supports the AER undertaking indexing of cost components year on year to determine the appropriate future value of the DMO, and encourages consistency in methodology to the extent possible. Of particular concern to retailers is the ongoing volatility of wholesale electricity costs in the NEM. Given this volatility, it is critical that the AER closely monitors these input costs to ensure that the DMO remains set at a price that allows retailers to recover their costs. This is particularly important for small energy retailers without upstream investment in generation. These smaller retailers are often at the forefront of price and innovation, and the AER needs to be cautious to ensure their ongoing sustainability is not put at risk as a result of this intervention.

In the end, for the benefits of the competitive retail market to be realised, retailers must have confidence that future pricing determinations will allow them to recover their investments in improved systems and processes. Without this confidence, consumers will likely see decreases in innovation and customer experience, and ultimately higher energy prices.

For any questions about our submission please contact me by email at Ben.Barnes@energycouncil.com.au or on (03) 9205 3115.

Yours sincerely,

Ben Barnes
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