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Position Paper: Default Market Offer Price 2021-2022

The Australian Energy Council ('AEC') welcomes the opportunity to make a submission to the Australian Energy Regulator's ('AER') Position Paper on the *Default Market Offer Price 2021-2022 (DMO 3).*

The AEC is the industry body representing 22 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.

Given the position of the AEC as a representative of competitor businesses, we operate in strict compliance with the Competition and Consumer Act (the 'CCA'). The CCA prohibits the AEC discussing with members confidential information relating to costs and how they set their prices. This submission has been drafted in line with our CCA obligations, and will focus on best practice price regulation methodologies, rather than the preferred methodologies of individual members. Our members will provide more detailed views on the issues raised.

The AEC continues to support the indexation approach undertaken by the AER in setting the DMO. This approach, if undertaken appropriately presents the least risk to consumers from price regulation. However, simply because the approach is the lowest risk, that does not mean that there is not a need for genuine scrutiny on the AER's assessment methodology to ensure that decisions made do not inhibit the ability of the competitive retail market to thrive. The DMO is not intended to represent an offer that consumers should be opting into. Its role is to provide a backstop to ensure that disengaged consumers are not charged higher than reasonable prices.

The AEC had a number of concerns with the AER's approach to indexation in setting the 2020-2021 DMO (DMO 2). These issues related to the impact of using early network cost estimated that were materially too low and inconsistent indexation between actual and predicted cost data. This submission will provide alternative approaches that would give industry confidence that the DMO will continue to meet its policy objectives. The AEC is also keen to see an evolving maturity in the AER's methodology, particularly regarding approaches to account for unexpected costs, and recovering the costs of regulatory interventions.

Methodology for Setting DMO 2

As noted above, the DMO is intended to represent a safety net offer to ensure customers are not unreasonably penalised for not engaging in the electricity market. The ACCC in its Retail Electricity Pricing Inquiry Final Report suggested that the means for setting the DMO should be to set the price at around halfway between the median market offer, and the median standing offer prices.

The ACCC's proposed methodology was intentionally imprecise, noting the ACCC did have retailer cost data to enable it to understand price setting more than any other regulator looking at the Australian energy market.

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The AER was tasked by the Australian Government to implement the DMO consistent with the ACCC's recommendations. Whilst it was intended that the DMO would represent efficient costs with a reasonable margin and an allowance for the costs of acquisition and retention, as well as the costs of supplying the offer with additional consumer protections, the ACCC expressly dismissed suggestions that the DMO should be driven as low as possible, noting that the "default offer should not exist to be a price accessed by most, if not all, consumers in the market".[1]

Given this, the AEC considers a simple indexation approach based on input costs represents the most effective means of delivering on the ACCC's recommendation. However, to deliver on this and provide confidence to consumers that its methodology will ensure low cost competitive market offers remain available, the AER should publish a set of clear objectives that will be followed in undertaking this annual reset process. These objectives should include:

1. Prioritising the protection of cheaper market offers, over reducing the DMO arbitrarily
2. Ensuring the DMO is reflective of objective changes in the costs of energy supply
3. Clear, predictable approaches to setting and indexing costs that are not known at the time of determination

The below submission will provide further views on how the AER's proposed approach aligns with these objectives.

Objective 1: Prioritising the protection of cheaper market offers, over reducing the DMO arbitrarily
As noted in the position paper, in setting the DMO the AER is required to estimate costs for the coming year. In some instances, accurate estimates of costs are available (for example by using forward prices to estimate wholesale costs), whereas others require estimates based on indicative or predicted data (for example, unfinalised network prices and SRES costs). Other costs are not predictable through any data-based mechanism and can only be estimated using historical information (for example, retail costs).

It is incumbent on the AER to seek to identify changes in costs as accurately as possible, based on objective, publicly available data. This means that genuine reductions and increases in input costs are indexed appropriately. Any suggestion that because the DMO is a 'higher priced offer', some inaccuracy is acceptable should be refuted.

The AEC acknowledges that where costs are required to be set based on predicted data, the resulting challenges are often not caused by the AER's methodology, but rather the date they are required to publish the DMO. In these circumstances, there is a need for the AER to take additional care to make reasonable predictions and ensure retailers are able to recover efficient costs.

The AEC does not consider this objective was met in setting DMO 2. For example, the AER used indicative network prices that did not take into account the most recent available information. In its Draft Decision, the AER stated that it would use annual tariff proposals and revenue changes to estimate costs where the final determination had not yet been published. Instead, the AER used indicative prices that were materially too low, resulting in an under-recovery of network costs in DMO 2, with no mechanism for true-up.

Other costs, such as retail operating costs and the costs of implementing regulatory interventions cannot be reasonably estimated based on published data. In setting these costs, the AER is required to consider historical information (such as that published in the ACCC's REPI), ASX data, and data used by policy makers as part of cost benefit assessments.

[1] ACCC Retail Electricity Pricing Inquiry – final report, pg 249.

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Following this objective, the AEC does not see any benefit to consumers in seeking to develop a mechanism in the DMO for 'productivity enhancements'. Whilst consumer advocates continue to voice support for such mechanisms, this appears to reflect a lack of understanding about the intended role of the DMO, and in particular, the risks that a DMO that is set too low will increase the prices paid by all other customers.

As noted above, the ACCC did not envisage the DMO to be the lowest possible price. In fact, it directly assumed the opposite – that it should be an offer that as few customers as possible received. The AEC does not oppose the DMO reducing where objective estimates illustrate that retailer input costs are declining. That being said, there is no clear evidence that retail costs are reducing in line with an industry wide productivity factor, particularly when considered in line with the ACCC's objective that the DMO include the 'full costs of providing consumer protections such as paper billing and bill smoothing. Offers that did not provide for these protections are directly referenced by ASX listed retailers as the rationale for reductions in retail operating costs noted by the AER in the Position Paper.

The AEC contends that arbitrary productivity factors are not conducive to the objectives of the DMO, and should be dismissed. In future, where objective and quantifiable reductions in retail operating costs across the industry can be identified, these reductions should be directly implemented by the AER in accordance with its indexation methodology.

Objective two: Ensuring the DMO is reflective of clear changes in the costs of energy supply
Following on from issues raised above, it is important that the AER develop consistent and predictable methodologies for identifying shifts in the costs of energy supply.

The AEC supports the AER's proposed approach for setting the wholesale cost component. A longer book build is a prudent approach, and means retailers are not unduly penalised for managing their expected load in advance. The AEC strongly supports the 95th percentile approach utilised by ACIL Allen, and has advocated for this methodology to be utilised by the ESC in setting the Victorian Default Offer. Given the DMO is not intended to be a low-cost offer, it is imperative that retailers are able to be confident that their wholesale costs can be recovered. The 95th percentile approach best meets this objective in most instances.

The AEC supports steps by the AER to differentiate load profiles between residential and small business customers. This approach would provide additional certainty for retailers, and ensure that any material differences do not unreasonably disadvantage retailers who only focus on one customer segment.

The AEC strongly supports efforts from the AER to identify and allow for increased costs of dealing with COVID-19 under the step change framework. While our members will provide further detail on expected cost increases during the DMO 3 period, the AEC encourages the AER to undertake some modelling to better understand the debt impacts in particular of the pandemic. As noted in the Position Paper, customer debts are increasing, requiring retailers to make significant allowances for an increase in bad debt. This is highlighted by recent data published by the AER that debts on entry to hardship have increased almost 20% since before the pandemic. This is a significant forward indicator, illustrating the risks retailers will face.

The AEC understands that recent changes to accounting standards require retailers to make predictions as to their expected bad debt impacts in the coming financial year. The AER should utilise this data as a reasonable estimate for an increase in retail costs under the existing step change framework.

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The AEC further recommends the AER considers additional allowances for the significant regulatory intervention program due to be implemented in the DMO 3 period. These reforms will place significant pressures on retailers, and will result in costs unable to be recovered in the existing retail cost methodology. These reforms include:

- Five minute settlements to be implemented in October 2021
- Wholesale Demand Response Mechanism to be implemented in October 2021
- Global Settlements to be implemented in March 2022
- Consumer Data Right to be implemented in 2022

Our members will provide further detail of the cost implications of these and other upcoming regulatory interventions.

Broadly, the AEC welcomes the approach of the AER in identifying reasonable methodologies to setting the individual price components in the DMO. Utilising low risk methodologies will minimise the chance that the DMO will be set too low.

Objective 3: Clear, predictable approaches to setting and indexing costs that are not known at the time of determination

The AEC does not consider the AER appropriately utilised the indexation methodology when determining DMO 2.

Issues arise in an indexation approach when cost components are determined based on forecasts that later become known to be inaccurate. The AEC strongly encourages the AER to consider developing and publishing an indexation guideline that provides confidence to participants that indexation will be undertaken appropriately. To date, the AEC has been concerned with the AER's application of the indexation approach, and there remains a lack of clarity about how it will be undertaken in practice. As an example, the Position Paper highlights that the AER relied upon indicative network pricing in DMO 2 that were materially lower than they were once finalised. In this situation, the AEC would expect the AER would clearly use the indicative network prices used in DMO 2 as the baseline for the DMO 3 indexation consideration, rather than updating the base year to reflect the accurate costs.

The concerns about the application of the indexation approach highlighted above was illustrated in DMO 2. In its final decision, the AER utilised updated Clean Energy Regulator data to identify SRES costs, however undertook its indexation from the previous year's actual data – which was unknown at the time the previous decision was made. This resulted in the AER making a decision that failed to take into account the predicted change in costs between the current year and the base year.

The AEC considers that clear and published guidance would ensure that these types of errors do not repeat themselves. This would further provide for retailers and consumers to have greater confidence in the DMO's indexation approach, and increase understanding across the sector.

Any questions about this submission should be addressed to me by email to ben.barnes@energy.council.com.au or by telephone on (03) 9205 3115.

Yours sincerely,

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