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Position Paper: Default Market Offer Price 2020-2021

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 2020-2021*.

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.

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.

As noted in previous submissions on this issue, the AEC does not support price regulation, and considers alternative approaches would deliver customers better outcomes in the longer term. There are immense difficulties in attempting to regulate retail prices in an environment where the cost of procuring energy, and other costs, are outside of a retailer's control. The consequences of a miscalculation are serious. Setting the DMO too high may see customers pay too much while setting the DMO too low may damage competition, particularly if the DMO does not allow smaller retailers to recover their costs. These adverse effects on competition cannot be easily remedied and will only disadvantage engaged customers.

Notwithstanding these concerns, we welcome the AER's early consultation on setting the Default Market Offer for 2020-2021 ('DMO 2'). Providing stakeholders with reasonable time to assess and respond to the proposed methodology options will help ensure DMO 2 is calculated appropriately, softening the inherent risks that come from price regulation. This gives it the best possible chance to provide a safety net to the most disengaged customers while mitigating some of the negative impacts on competition.

High-Level Comments on AER Approach and Policy Objectives

The AER has chosen to use the same policy objectives from the 2019-2020 DMO ('DMO 1') to guide setting DMO 2. These objectives recognise the importance of competition to a healthy retail market and that this leads to better outcomes for engaged customers. It is important that the DMO reflects this message and signals to customers that market participation is still the best way to receive a cheaper offer.

The AEC supports the index approach outlined in the position paper for setting DMO 2. In a price-regulated world, this approach provides the most suitable pathway for fulfilling the AER's three policy objectives. In the event the AER changes its policy preference, the AEC would strongly urge pursuing a price-based approach over a bottom-up approach. There are serious risks with using a bottom-up approach, in particular the AER's decision-making becoming politicised.

Methodology for Setting DMO 2

The AER has stated that its preferred approach is to use DMO 1 as a ‘starting point’ and then ‘adjust the DMO 1 price based on forecast changes in input costs’.¹ We view this as a sensible approach that will give retailers some certainty about what the future determination will look like, and reduce compliance costs with respect to re-marketing offers around the DMO. Customers on the DMO will also benefit through this greater predictability. Providing certainty to retailers and consumers is important in this early phase given the market is still adjusting to price regulation.

The AEC understands that some stakeholders are likely to reject this preferred approach in favour of using a bottom-up approach.² The Essential Services Commission has taken such an approach for setting the VDO in Victoria, however with a different policy objective: to set a ‘fairly priced offer’. We strongly caution against using such a model for the DMO. The cost stack methodology needed for a bottom-up creates unnecessary risks and is inconsistent with the clear policy objectives of the DMO.

Ensuring Prospective Retailers Have a Low Barrier to Entry

The AER states its ‘appropriate retailer benchmark is an efficient, prudent and risk adverse retailer with an established customer load’.³ This benchmark arguably highlights the tightrope the AER must walk when setting the DMO. In this case, the final condition of an ‘established customer load’ reflects the situation of active retailers, but at the same time, arguably creates a barrier to entry for prospective retailers, which incur significant costs in trying to acquire new customers.

Communicating the DMO to Customers

Following this position paper, the next stage of consultation will be the setting of a draft determination, and then the final determination. It is probable that a media release will accompany these determinations. In this event, it is important that the public message reflects the true purpose of the DMO, as described in the position paper: ‘the DMO is designed to act as a fall-back for those who are not engaged in the market, and not be a low-priced alternative to a market offer.’⁴

Customers should not be led to believe the DMO is the best or cheapest offer they can receive, as this is incorrect and may have the unintended consequence of encouraging customers to disengage once on the DMO.

Individual Cost Components

Our members will provide more detailed comments about factors relevant to determining the individual components of the cost stack. That notwithstanding, there are a number of high-level issues that should be considered when making the Draft Decision. These issues primarily result from a lack of reliable cost information at the time of setting the DMO, and the ability of the AER to forecast reasonable costs.

Environmental Costs

Acil Allen have recommended a market-based approach to determine costs associated with large-scale generation certificates (LGC). The AEC understands that some retailers prefer a contract-based approach to setting LGC prices given that a prudent and risk adverse retailer would have procured LGCs over time

¹ Australian Energy Regulator, Default Market Offer Price 2020-2021: Position Paper (‘Position Paper’), September 2019, p11-12.

² For example, this was the position of the Public Interest Advocacy Centre and Australian Council of Social Services in their submissions to the DMO 1 Position Paper last year.

³ Position Paper at 25.

⁴ Id at 10.

rather than merely at the end of the compliance period. We see merit in this approach and would welcome an opportunity to discuss with the AER about the most appropriate methodology going forward.

The AEC also notes that the South Australian government recently released a Directions Paper on the review of its Retailer Energy Efficiency Scheme (REES). This review asks what direction the REES should take after it ends in 2020. The outcome of this review should be monitored given it may influence environmental costs in South Australia.

Network Costs

The Position Paper notes that the AER ‘may not be able to incorporate the actual changes in annual tariffs’ into the DMO because the network tariffs will be approved after the Final Determination.⁵ This is a significant hurdle to setting an accurate DMO and will be a recurring problem each year if left unaddressed. The AEC proposes then that the DMO timetable should be revised so the AER can provide itself with the necessary time to use the final network tariffs when determining the DMO. Alternatively, the AER could push back the DMO commencement date (with a small adjustment for lost revenue to be made) so it can incorporate final network tariffs.

If a revised approach to setting network costs is rejected in favour of the current approach then the AEC urges the AER to err on the side of caution to avoid setting a price that is too low and places an unreasonable risk on retailers. The AEC would support indexing the draft network costs as a way to achieve this, taking into account the changes in network costs seen following the publication of DMO 1. As was seen in South Australia, the network prices rose significantly in 2019 yet DMO 1 continued to reflect the top down methodology undertaken in October 2018.

Upcoming Regulatory Reform

The energy market is going through a period of significant reform, which is making the wholesale market – particularly for standalone retailers – volatile. While the step change framework provides a useful method for capturing any material change in retail costs, the AER should be cautious not to set the ‘material’ threshold too high. Furthermore, when making this assessment, the cost of the regulatory initiatives for the DMO year should be considered collectively rather than as isolated reforms.

The AEC also notes that some regulatory initiatives, while not incurring large retail costs, may change the nature of the electricity retail market and how retailers recover their efficient costs. The AEMC’s proposed rule change to conditional discounting is one such regulatory initiative. If implemented, this rule change will likely change how retailers set and advertise their offers. This could impact the price of the market offers, and subsequently how the DMO is set.

Any questions about this submission should be addressed to Rhys Thomas, by email to Rhys.Thomas@energy.council.com.au or by telephone on (03) 9205 3111.

Yours sincerely,



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⁵ Position Paper at 36.