

18 October, 2019



Mr Mark Feather
General Manager, Policy and Performance
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Mr. Feather

Default Market Offer (DMO) Price 2020-21 Position Paper

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit legal centre based in New South Wales. Established in 1982, PIAC tackles systemic issues that have a significant impact upon people who are marginalised and facing disadvantage. We ensure basic rights are enjoyed across the community through litigation, public policy development, communication and training. The Energy + Water Consumers' Advocacy Program represents the interests of low-income and other residential consumers, developing policy and advocating in energy and water markets.

PIAC welcomes the opportunity to respond to the Australian Energy Regulators (AER) position paper on the Default Market Offer Price 2020-21.

PIAC disagrees with the AERs assertion in the Position Paper (the Paper) that the initial iteration of the DMO achieved its intended objectives. We contend that the DMO has failed to deliver its intent, and is based on a number of flawed assumptions that have ensured the retail market does not operate in the interests of consumers. This has left many consumers still being charged too much for an essential service.

PIAC is concerned that if DMO2 is built upon the flawed foundation of the initial DMO it will compound existing failures and lock inefficiency into retail pricing. We strongly recommend the AER reconsider the proposed option for calculating DMO2, reassess the intent of default pricing, and look at ways the stated objectives can be better realised in the long-term interests of consumers. PIAC considers Option 3 – a cost-based approach to determining DMO2 – is preferable.

Recommendation

PIAC recommends that the AER undertake a more thorough re-assessment of the intent and objectives of the DMO, including a more detailed examination of the impact of the DMO on actual retail bills, as part of a DMO2 determination process utilising a cost-based approach.

Level 5, 175 Liverpool St
Sydney NSW 2000
Phone: 61 2 8898 6500
Fax: 61 2 8898 6555
www.piac.asn.au
ABN: 77 002 773 524

Assessment against DMO objectives

The Paper asserts that the initial DMO (DMO1) achieved its objectives. PIAC disagrees and contends that in determining DMO2, the AER should undertake a comprehensive reassessment of the intent and objectives of the DMO.

Defining Unjustifiable

A key objective, and arguably the fundamental intent, of the DMO is to prevent the charging of 'unjustifiably high' standing offer prices. Where standing offers operate as a form of default and crucial reference price, PIAC strongly supports this objective. However, we disagree that this intent has been correctly applied in the development of the DMO, and do not consider that the Paper has sufficiently assessed the impact of DMO1 against the intent and objectives.

As we argued in our submissions to the initial DMO consultation process, 'unjustifiable' is a subjective term. Accordingly, it is crucial that the DMO process commences with a clearer 'problem definition' and an explicit statement of the reasoning behind what the AER regards as unjustifiable standing offer prices.

Without this, it is impossible to assess the performance of the DMO, and conclude that the objective of preventing 'unjustifiable standing offer prices' has been achieved. PIAC strongly recommends the AER adopt an approach similar to that used by the Victorian Essential Services Commission (ESC) to calculate the Victorian Default Offer (VDO). The VDO methodology uses efficient costs as a reasonable, objective and transparent indicator for unjustifiable standing offer prices. PIAC regards this as particularly important where the DMO also serves as the basis for the reference price, and is a crucial element of information for consumer choice.

Regardless of whether the AER agrees with this particular perspective on what is unjustifiable, transparent monitoring and assessment requires an explicit definition and reasoning to be stated as part of the DMO setting process.

The application and extent of efficiency

Efficiency is a key measure of the 'long term interests of consumers' and PIAC strongly supports embedding efficient cost recovery into each link in the energy supply chain. Accordingly, PIAC supports the objective that a DMO allow the recovery of efficient retail costs including reasonable retail margins. However, this objective was not achieved by the initial DMO formulation. In fact, in its final determination of DMO1, the AER was explicit that the DMO would intentionally not represent an efficient retail price¹.

We consider that the objective was formulated to guarantee that retailers recover 'at least' their efficient costs, and when read in conjunction with the first objective – to prevent unjustifiably high standing offer prices – this objective should lead to a DMO set at a level of efficient cost recovery. PIAC regards the decision to set DMO1 above the level of efficient cost recovery as a failure. Accordingly, we consider that DMO1 did not achieve either of the first two policy objectives.

The VDO, implemented in parallel to the DMO, used a formula that includes 'efficient costs'. This incorporated a reasonable allowance for benchmarked retail costs, benchmarked Customer acquisition and retention costs (CARC) and retail margin. It was not intended to

¹ AER 'Default Market Offer 2019-20: Final Determination'. April 2019, 30.

indicate a 'lowest cost' price, and it left considerable room for lower cost offers. The VDO has achieved much greater standing offer reductions than the AER's DMO. PIAC contends that this difference is a reasonable indicator of the unreasonable premium above efficient costs allowed by the DMO.

This indicates that the DMO has not met its objective to allow for the recovery of 'efficient costs', and as the basis of the reference price, does not serve as a meaningful market indicator for consumers.

Incentives and market participation

Active, meaningful competition and the ability for consumers to engage effectively in the market is a priority for the retail energy market. PIAC supports the objective that the DMO not negatively impact incentives for retailers or consumers to participate effectively in the retail electricity market, for the benefit of consumers. However, we reiterate our disagreement with the application of this principle in the AER's formulation of the DMO.

Throughout the determination of DMO1, the AER applied an assumption that retailers must have 'positive incentives' and consumers must have 'negative incentives' to act. PIAC considers these assumptions to be flawed and inappropriate. Specifically:

- Incentives for retailers are assumed to require retailers to be able to charge a significant proportion of consumers above an efficient price, on the basis that this provides scope for them to offer other consumers lower prices, and to develop and employ innovative products. This assumes that retailers need a 'positive' incentive, where they benefit financially in advance of any action that is intended to be incentivised, and where they do not bear any direct cost or risk of not engaging in that behaviour.

PIAC contends this assumption entrenches inertia, as it allows retailers to 'benefit' from inefficient pricing, regardless of whether they innovate or compete. This leaves the potential for some consumers to benefit (and the quantum of that benefit) up to retailers, with no transparent mechanism incentivising efficiency. We regard this as inappropriate in the provision of an essential service, particularly one that is largely homogenous.

- Consumers are considered to be incentivised by a requirement to mitigate losses. It is assumed they will become more active in the market if they face penalties for not doing so. This is predicated on the following two faulty assumptions:
 - Consumers are driven by 'negative incentives' based on a guaranteed penalty and the possibility of a future benefit if the desired behaviour is undertaken. PIAC considers this is inappropriate in the delivery of an essential service such as electricity, where consumers do not have the option not to purchase, and do not have an effective indicator of the 'fair value' of retail services.
 - Participation enables consumers to secure a better priced deal through navigating the competitive market. Research undertaken by the Victoria Energy Policy Centre illustrates that this is not the case. Examining nearly 50,000 actual bills, the research demonstrated that the price difference for consumers who switched recently and those who did not, was negligible². The conclusion drawn was that consumers are

² Victoria Energy Policy Centre. 'Do Victoria's households leave less money on the table when they switch electricity retailers?' September 2019.

not able to effectively mitigate their losses or impose efficiency on retailers through participation in the market.

On this basis, PIAC considers that the current DMO has not fulfilled its objective to maintain effective incentives. The result is that consumers bear the bulk of the cost and 'risk' of ineffective market competition. They are penalised for not 'participating', while unable to consistently impose competitive efficiency when they do.

PIAC reiterates that a DMO reflecting the efficient cost of retail services operates as a more 'symmetrical' market incentive for both consumers and retailers. Such a DMO would more clearly signal retail cost efficiency, and better align the interests of retailers with the long-term interests of consumers. An efficient cost based DMO would:

- Give retailers an incentive to improve the efficiency of all of their service offerings. Under an efficient cost DMO retailers are discouraged from 'loss-leading' price discounting, a behaviour that has been shown to be demonstrably inequitable, inefficient and one that loads unproductive costs into retail operations. In an environment where 'price only' competition is less viable, retailers are incentivised to develop new service offerings to entice consumers. An efficient price DMO leaves a productive margin for retailers and aligns improved retail business growth and profitability with improved efficiency. Importantly, it introduces an ongoing mechanism for improved productivity and efficiency and does not reward inefficient pricing or business practice.
- Incentivise consumers to choose the market participation that best suits their needs. With a clearer understanding of the efficient cost of retail electricity services through the DMO, consumers are better able to choose between offers. Crucially, it becomes a 'positive incentive', ensuring that consumers pay a 'fair' price, and can exercise choice where it is in their interests to do so. This may include choosing premium price offers where retailers demonstrate the additional value to consumers.

PIAC strongly recommends that the AER re-evaluate the role of the DMO in aligning effective competition incentives in the retail electricity market, and implement a DMO2 that more closely represents the efficient cost of retail services.

Recommended approach to DMO2

The AER has proposed an approach that 'updates' DMO1 with adjustments to retail cost inputs. PIAC strongly disagrees with this approach. As outlined above, we consider DMO1 to have failed, and to be fundamentally flawed. The AER's preferred approach to DMO2 proposes only to 'adjust' for changes in retail input costs, not to re-evaluate costs as a whole. We regard this as a 'worst of both worlds' option.

PIAC sees the review processes being undertaken concurrently by the Victorian ESC and the AER as an opportunity to address flaws in the initial DMO mechanism. The results outlined by the ESC support PIAC's view that an efficient cost-based formulation of a default price more effectively delivers good consumer outcomes. PIAC contends the ESC VDO more effectively meets the stated objectives and intent of the DMO, and addresses the flaws and concerns we have raised in this submission and our previous submissions to the initial DMO process. Adopting an approach more consistent with the ESC would improve consistency across the retail electricity market, and improve transparency and simplicity for retailers operating in multiple jurisdictions. PIAC recommends Option 3 in the Paper be pursued, with an explicit objective to align with the VDO to the greatest extent possible.

Continued engagement

PIAC would welcome the opportunity to meet with the AER and other stakeholders to provide further input and discuss these issues in more depth.

Yours sincerely,

Douglas McCloskey

Policy Officer, Energy and Water
Public Interest Advocacy Centre

Direct phone: +61 2 8898 6534
E-mail: dmcloskey@piac.asn.au

Craig Memery

Policy Team Leader, Energy and Water
Public Interest Advocacy Centre

Direct phone: +61 2 8898 6522
E-mail: cmemery@piac.asn.au