RESPONSE TO AER POSITION PAPER

Prepared for:

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Default Market Offer Price (2020-21)

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TABLE OF CONTENTS

1. INTRODUCTION

This report has been prepared by Etrog Consulting Pty Ltd for Queensland Council of Social Service (QCOSS). It responds to a Position Paper on the Default Market Offer (DMO) Price (2020-21) published by the AER on 19 September 2019.[1]

The AER has requested that submissions to its Position Paper should be received by 18 October 2019. This report has been developed in consultation with QCOSS with the understanding that QCOSS is intending to submit this report to the AER as a Companion Report to its own submission to the AER.

The remainder of this report is structured as follows:

- Section 2 provides background to the Position Paper and this response.
- Section 3 discusses the policy objectives for the DMO, and whether they have been achieved in DMO 1.
- Section 4 summarises our understanding of the three options for setting the DMO price that are proposed in the AER's Position Paper.
- Section 5 concludes with our commentary on the options, and our recommendation regarding which option the AER should follow.

1 Documentation on the calculation of the DMO for 2020-21 can be found on the AER website at https://www.aer.gov.au/retail-markets/retail-guidelines-reviews/retail-electricity-prices-review-determination-of-default-market-offer-prices-2020-21

2. BACKGROUND

The DMO came into effect on 1 July 2019. The DMO limits the price that retailers can charge electricity customers on default contracts known as standing offer contracts. A customer might be on a standing offer for various reasons, including the following:

- The customer has never taken up a market offer in the years since retail competition was extended to all customers.
- A customer may fall back onto a standing offer if they do not enter a new market contract when their existing market contract ends.
- A customer may specifically ask a retailer for a standing offer rather than a market offer, even though they have market offers available to them.
- A customer may move into premises where the electricity is already connected and not immediately contact a retailer. In those cases, the customer will be on a standing offer until they regularise their contractual position by contacting a retailer and moving to a market offer.
- A customer may be transferred to a retailer of last resort if their existing retailer fails before transferring its customers to another retailer.

The AER's role is to determine the maximum price that a retailer can charge a standing offer customer each year. The AER refers to this as the DMO price.

The AER's DMO price determination applies to small business and residential customers on flat rate tariffs in areas where there is no other retail price regulation – South Australia, New South Wales and south-east Queensland.

The DMO price for each area also acts as a 'reference price' for residential and small business offers in that area. When they are advertising or promoting offers, retailers must show the price of their offers in comparison to the DMO reference price. This aims to help customers more simply compare the price of different offers.

The *Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019* (Regulations) set out the legislative framework for the DMO.

In April 2019, the AER published its first DMO price determination, which set the DMO price for 1 July 2019 to 30 June 2020.[2] The AER refers to this as the DMO 1 determination. The AER's Position Paper is its first step in its process to determine DMO prices for the 2020-21 year. The AER refers to this as the DMO 2 determination.

Alongside its Position Paper, the AER also published a report by ACIL Allen Consulting on its approach to forecasting the wholesale and environmental costs for 2020-21.

2 Documentation on the calculation of the DMO for 2019-20 can be found on the AER website at https://www.aer.gov.au/retail-markets/retail-guidelines-reviews/retail-electricity-prices-review-determination-of-default-market-offer-prices

3. POLICY OBJECTIVES OF THE DMO

The AER sets out that the policy objectives of the DMO are to:

- Prevent retailers charging unjustifiably high standing offer prices;
- Allow retailers to recover their efficient costs of providing services, including a reasonable retail margin; and
- Not reduce incentives for competition, innovation and market participation by customers and retailers.

3.1. THE AER CLAIMS THAT DMO 1 MET THE POLICY OBJECTIVES OF THE DMO

The AER claims that it is satisfied that in its Final Determination the DMO price balanced the policy objectives:[3]

- *Preventing unjustifiably high standing offer prices* – The AER claims that the DMO 1 price achieved this outcome by being lower than nearly all retailers' standing offers, including those of the relevant local area retailer (LAR) in each distribution zone (that is, the retailer with the vast majority of standing offer customers).
- *Allowing retailers to recover their efficient costs* – The AER claims that this outcome was achieved as the DMO 1 price was well above the median market offer (the AER's proxy for a retailer's assumed efficient costs) in each distribution zone, which the AER considered was a reasonable indication of retailer's efficient costs.
- *Not reducing incentives for innovation, investment, competition and market participation by customers and retailers* – The AER claims that this outcome was achieved as the DMO 1 price was significantly higher than most market offers in each distribution zone, meaning customers on a DMO would have a strong incentive to shop around and switch.

3.2. ETROG CONSULTING COMMENTARY ON THE ACHIEVEMENT OR OTHERWISE OF POLICY OBJECTIVES IN DMO 1

It is the view of Etrog Consulting that the policy objectives may not have all been met in the manner in which the AER claims that they have been met. This section of our response to the AER's Position Paper considers each of the policy objectives in turn.

3.2.1. Preventing unjustifiably high standing offer prices

As stated above, the AER claims that the DMO 1 price achieved this outcome by being lower than nearly all retailers' standing offers, including those of the relevant local area retailer (LAR) in each distribution zone (that is, the retailer with the vast majority of standing offer customers).

Etrog Consulting contends that it is not convinced based on this evidence that the DMO 1 determination achieved the objective of *preventing unjustifiably high standing offer prices*. There are several reasons for this contention:

3 See the AER's Position Paper, section 1.3, pages 11-12

1. The achievement of lower standing offer prices in 2019-20 as against previous years is not an indicator that standing offer prices are not still unjustifiably high.
2. The AER has not defined what is an "unjustifiably high standing offer price", as against a "justifiably high standing offer price". Without such consideration, it is not possible to conclude whether the standing offer prices are or are not unjustifiably high.
3. The AER has stated, as quoted above: "*The DMO 1 price was well above the median market offer (the AER's proxy for a retailer's assumed efficient costs) in each distribution zone, which the AER considered was a reasonable indication of retailer's efficient costs*."

   We see no justification for the price of an essential service such as the supply of electricity to be well above efficient costs, and neither has the AER provided any such justification. Prices well above efficient costs are almost by definition unjustifiably high. There is thus an inherent contradiction in the Position Paper.

   The ACCC's Retail Electricity Pricing Inquiry (REPI) final report 'Restoring electricity affordability and Australia's competitive advantage' on which the DMO is based reported the following among other findings:[4]

   - The high tariffs associated with such standing offers are sometimes referred to as a 'loyalty tax' that is imposed on consumers who remain on, or end up on, a standing offer.
   - Average revenue for standing offer consumers was significantly higher than average revenue for market offer consumers.
   - The high price of standing offer bills outweighed the benefit of having access to a default offer with additional essential consumer protections.
   - The standing offer was no longer working as it was intended and was causing financial harm to consumers.

   The AER's finding that the DMO 1 price was well above efficient costs demonstrated that these findings of market failure by the ACCC remained unsolved with the implementation of DMO 1.

> The AER's own evidence that the DMO 1 price was well above efficient costs proves that DMO 1 does not meet the policy objective of preventing unjustifiably high standing offer prices.

3.2.2. Allowing retailers to recover their efficient costs

As stated above, the AER claims that this outcome was achieved as the DMO 1 price was well above the median market offer (the AER's proxy for a retailer's assumed efficient costs) in each distribution zone, which the AER considered was a reasonable indication of retailer's efficient costs.

4 See section 12 of the REPI report.

What this proves is that retailers have recovered well above efficient costs, rather than that they have recovered their efficient costs (and no more). This goes to the heart of the purpose of implementing the DMO.

Recommendation 30 of the ACCC's Retail Electricity Pricing Inquiry (REPI) final report 'Restoring electricity affordability and Australia's competitive advantage' on which the DMO is based stated:

> *The AER should be given the power to set the maximum price for the default offer in each jurisdiction. This price should be the efficient cost of operating in the region, including a reasonable margin as well as customer acquisition and retention costs.*

However, a later (December 2018) letter signed by Rod Sims as ACCC Chair then changed that, saying:

> *The ACCC does not consider that the AER should determine the efficient cost of supply in each jurisdiction or distribution zone, or that the AER should set the DMO at an 'efficient' level.*

This caused confusion in the calculation of DMO 1, which was reflected in several submissions to the AER's consultation process on the implementation of DMO 1.[5]

The AER's August 2019 report *Inquiry into the National Electricity Market* affirms[6] the original wording of recommendation 30, without any emendation. This should enable the AER to implement DMO 2 in accordance with recommendation 30, and not as re-interpreted in the implementation of DMO 1.

Customers on standing offers are largely customers who have never taken up a market offer in the years since retail competition was extended to all customers. These customers are showing considerable inertia and resistant to change. They have not been swayed by the marketing that entices them to switch to a market contract to save money. They may be price inelastic, or they may be in hardship and have some barrier to switching such as medical issues or lack of proficiency or lack of confidence in decision making that prohibits them from participating in the competitive market. Setting standing offer prices higher than the efficient cost of supply gives the incumbent retailer a pseudo-monopoly rent to benefit from these customers' inertia.

The DMO should allow retailers to recover their efficient costs, as set out in the ACCC's REPI recommendation 30, and confirmed as still being applicable in the AER's August 2019 inquiry report. The DMO should not allow retailers to recover well above their efficient costs. Allowing retailers to recover well above their efficient costs would undermine the intent of DMO to protect customers who are on standing offers from paying unjustifiably high prices.

5 This was reflected in submissions to the draft determination of DMO 1 from Etrog Consulting, PIAC, and others.

6 See page 127

3.2.3. Not reducing incentives for innovation, investment, competition and market participation by customers and retailers

As stated above, the AER claims that the DMO 1 price achieved this outcome because the DMO 1 price was significantly higher than most market offers in each distribution zone, meaning customers on a DMO would have a strong incentive to shop around and switch.

We concur that the DMO has not reduced incentives for innovation, investment, competition and market participation by customers and retailers. Our evidence is the market activity, advertising and marketing, market entry, energy retailer comparison sites and actual engagement of customers with electricity retailers, all of which continue apace.

This market activity is largely centred on and involves customers already on market offers who are engaged in the market. Those are the customers who are continuing to shop around and switch retailer. However, those were not the customers that the DMO was intended to help. The DMO was intended to assist customers not engaged. Prices that are significantly higher than most market offers in each distribution zone do not assist customers on the DMO.

> The AER must focus DMO 2 on assisting customers on the DMO, who for whatever reason are not moving to market offers, by ensuring that those customers do not have to pay prices that are significantly higher than market offers.

4. OPTIONS FOR CALCULATING THE DMO FOR 2020-21 AS SET OUT BY THE AER

The AER sets out three options for calculating DMO 2:

- Option 1: price based approach using DMO 1 (this is the AER's preferred approach);
- Option 2: top down market assessment;
- Option 3: detailed bottom up cost assessment.

Note: section 1 of the AER's Position Paper changes the order of options 2 and 3. In this response we are using the same numbering of options that is used in the AER's Position Paper other than section 1 of the Position Paper.

To explain the differences between the options and to analyse them, we use the same convention as the AER that the DMO comprises Network costs (N), Wholesale costs (W), Environmental costs (E) and Residual costs (R). R comprises retail costs and margins.

This section 4 summarises our understanding of the three options without commentary. Our commentary follows in the next report section (section 5).

4.1. OPTION 1

Under option 1, the AER would estimate the N, W and E costs that would have been applicable to DMO 1 in 2019-20. It would then subtract those from the DMO 1 price, to derive R for 2019-20.

The AER would estimate the N, W and E costs for DMO 2 in 2020-21. It would also adjust the R component from 2019-20 by CPI. It would then calculate the DMO 2 price for 2020-21 based on adding together:

- The estimated N, W and E costs for 2020-21
- The R component that was allowed in DMO 1, incremented by CPI.

This process for option 1 is illustrated in Figure 1 on page 21 of the AER's Position Paper. However, that figure refers to estimating the "proportion" of N, W and E costs in DMO 1, but in fact what will be estimated are the actual dollar values, not proportions.

The AER states:

> *As shown in Figure 1, we are calculating the change in costs from DMO 1 to DMO 2, rather than the absolute level of costs. However, in order to calculate the change, the cost assessments set out above will provide a cost stack of the above four cost components for DMO 1. We will then use the same methodology to forecast the changes in costs for DMO 2.*

In other words, under option 1 the AER is calculating the absolute level of costs for the N, W and E components, just not for the R component.

4.2. Option 2

Option 2 is a top down market offer based assessment. It would set the DMO price at a set percentage above the median market offer. However, the DMO price would apply to the year subsequent to the observed market offers, so further adjustment would likely be required based on year-on-year forecast changes of costs.

4.3. Option 3

Option 3 is similar to option 1, except that instead of adjusting the R component from option 1 for CPI, it will be estimated afresh for DMO 2.

Under option 1 the AER would calculate the DMO 2 price for 2020-21 based on adding together:

- The estimated N, W and E costs for 2020-21
- The R component that was allowed in DMO 1, incremented by CPI.

Under option 3, the AER would simply add together the estimated N, W, E and R costs for 2020-21.

5. ETROG CONSULTING VIEWS ON THE THREE OPTIONS

We have evaluated the three options proposed by the AER in the context of achieving the policy objectives set out in section 3 above.

5.1. OPTION 2

As stated above, option 2 is a top down market offer based assessment. It would set the DMO price at a set percentage above the median market offer. However, the DMO price would apply to the year subsequent to the observed market offers, so further adjustment would likely be required based on year-on-year forecast changes of costs.

We agree that option 2 should not be pursued. We agree with the reasons put forward by the AER against pursuing this option, including the following:

- There is a significant risk of retailers causing market distortions and gaming the offer spread in response to this methodology.
- At these early stages of the introduction the DMO price, retailers and consumers are still responding to the DMO. Therefore, we expect market offer prices to continue to change as the reforms bed in.
- The observed market offers for one year (in this case 2019-20) do not translate easily into pricing for the next year (2020-21). Price forecasts as required for 2020-21 under options 1 and 3 would still be necessary under option 2.

5.2. OPTION 1 AND OPTION 3

We have analysed option 1 and option 3 together, because they are very similar, differing only in how the R component is estimated in DMO 2, and the R component is the only issue we have with the AER's preferred option 1.

Option 1 estimates R in DMO 2 by adjusting R from DMO 1 by CPI. Option 3 estimates R directly, by estimating what the R component of costs should be in 2020-21.

5.2.1. Consideration of the AER's arguments for rejecting option 3

The AER's arguments for rejecting option 3 and our analysis of those arguments is as follows:

- Option 3 would calculate efficient costs, and according to the AER "the DMO is not aiming to identify efficient costs".

  As discussed in section 3 above, this is notwithstanding the fact that recommendation 30 of the ACCC's Retail Electricity Pricing Inquiry (REPI) final report 'Restoring electricity affordability and Australia's competitive advantage' on which the DMO is based stated:

  > *The AER should be given the power to set the maximum price for the default offer in each jurisdiction. This price should be the efficient cost of operating in the region, including a reasonable margin as well as customer acquisition and retention costs.*

Further, in the AER's current Position Paper, one of the policy objectives as quoted above is to allow retailers to recover their efficient costs of providing services, including a reasonable retail margin. As discussed in section 3 above, testing whether the retailers are recovering efficient costs requires identification of efficient costs. It is critical that in implementing DMO 2 the AER must identify efficient costs. Otherwise the AER cannot evaluate whether it is meeting its policy objectives, let alone actually meet them. The only way that the AER can evaluate whether the DMO is efficient is by calculating efficient costs, and that is best undertaken in a bottom up approach.

We recognise that the implementation of DMO 1 was under tight deadlines. It needed to be calculated quickly to come into effect, so there was insufficient time for AER to do proper bottom up calculation. It would be inappropriate to adjust DMO 1 by CPI as that just embeds a calculation approach which was not ideal in the first place. This year there is time to do a more robust job of estimating R, and that time should be used effectively.

- The AER states that it currently has no information gathering powers for the DMO price determination to use to determine the R costs.

  However, the AER then continues by stating that there are other sources of efficient R costs, including the ACCC and other regulators. There have in the past also been other estimates of retail costs that have been made by consultants, including estimates made by ACIL Allen who is the AER's current consultant,[7] KPMG[8] and others.[9]

  The AER also says in regard to its preferred option 1:

  > *Before reaching a decision on the DMO 2 price, we therefore plan to cross-check our DMO price against market offer prices and an indicative cost stack. This indicative cost stack will include an estimate of retailer costs. We will rely on publicly available retail costs benchmarks, taken by other regulators, such as Independent Competition and Regulatory Commission (ICRC), Queensland Competition Authority (QCA) and Essential Services Commission Victoria (ESCV). We will also rely on information provided by the ACCC through the course of their inquiry into the NEM. For example, the most recent ACCC report provided detailed estimates of the actual costs faced by retailers historically, such as a detailed breakdown of the retail cost component.*

7 See https://www.qca.org.au/getattachment/5591e73b-9dda-4780-9920-a30d6435d74b/ACIL-Allen-Regulated-retail-prices-for-2016-17-E.aspx

8 See https://www.ipart.nsw.gov.au/files/3b791e55-9dd3-454e-9ab3-9f2400f66cbd/Submission_-_Frontier_Economics_analysis_of_energy_costs_retail_costs_and_margins_-_draft_report_-_EnergyAustralia_-_George_Maltabarow.pdf – Appendix A

9 These consultants' reports are dated, but they are brought here to prove the case that there are methodologies that can be used to estimate retail costs. It is not sufficient for the AER to say that such analysis is beyond its capability.

In other words, the AER does have access to estimates of retail costs, and proposes to use that information to "cross-check" outputs from option 1. Under option 1, it is unclear what the AER will do with the results of its "cross-check". It will not necessarily be transparent.

Frontier Economics similarly recently benchmarked retail costs and margin in its advice to the Essential Services Commission on the Victorian Default Offer.[10]

> The AER can and should identify efficient costs for all cost components, and base DMO 2 on efficient costs, in order to meet its policy objectives.

5.2.2. Our views on increasing retail costs and margins by CPI each year

We see no justification for retail costs and margins to increase by CPI each year, especially as the AER is also recognising step changes due to changed business requirements. All businesses should increase productivity. Productivity is critical for the long-term competitiveness and profitability of any business.[11] This is not only in the competitive environment. The AER has itself recently recognised increased productivity in the electricity distributors, which are not subject to competition.[12] The need for increased productivity is clearly stronger in the competitive retailing sector than in the regulated network sector.

The AER's Position Paper states: "*The DMO is also not aiming to drive efficiencies in the retail operating costs*." While that may be true when looking at the DMO in a vacuum, the introduction of retail competition in energy markets was and still is intended to drive efficiencies in retail operating costs. It is through increased efficiencies that customers benefit from retail competition, rather than have regulated prices where the regulator determines productivity gains for retailers as has recently been done for electricity distributors.

The efficiencies that retailers manage to achieve would be applicable both to standard offers and market offers.

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10 See *Retail Costs and Margin,* a report for the ESC, Frontier Economics, 24 April 2019, available at https://www.esc.vic.gov.au/electricity-and-gas/prices-tariffs-and-benchmarks/victorian-default-offer

11 See for example https://www.aigroup.com.au/productivitycentreframe/pdf/productivitycentre/profit-from-your-productivity.pdf

12 See https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-our-approach-to-forecasting-opex-productivity-growth-for-electricity-distributors

5.2.3. Our views on including Customer Acquisition and Retention Costs (CARC) in the calculation of DMO

QCOSS stated in its December 2018 submission to the AER's Position Paper for DMO 1:

> *QCOSS' view is that customer acquisition and retention costs (CARC) should not be included in the DMO price. The DMO price is a cap on what is essentially the standing offer and is regarded as a safety net then CARC should not be included as there is no need to actively recruit and retain customer to a default offer. It is these customers' prerogative not to engage in the market and therefore they should not have to pay the costs of others who choose to engage with the market. People on standing offers and who do not shop around do not get the benefit of the activities relating to these costs.*

We also are aware that the ACCC recommendation 30 explicitly stated that CARC should be included in the DMO calculation. That does not diminish the validity of QCOSS' argument, which deserves further consideration.

5.3. Our recommended option for DMO 2

The AER should follow option 3. It should build a new cost stack for Network, Wholesale, Environmental and Retail costs and margins to establish DMO 2. This will establish efficient costs, as envisaged for the DMO based on recommendation 30 from the ACCC's Retail Electricity Pricing Inquiry (REPI) final report 'Restoring electricity affordability and Australia's competitive advantage' on which the DMO is based.