10 December 2018

Mark Feather
General Manager, Policy and Performance
Australian Energy Regulator

By email: DMO@aer.gov.au

Dear Mr Feather,

Submission to Default Market Offer Price 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 AER's position paper on the development of a Default Market Offer (DMO) price for retail electricity. PIAC strongly supports the need for significant reform to default retail pricing, and welcomes the recognition that, as it stands, the retail electricity market does not operate in the interests of consumers. The introduction of a DMO mechanism represents an opportunity to reshape the operation of the market to support better and more equitable outcomes for consumers in the delivery of an essential service.

The market implications of considering electricity as an essential service

Electricity is an essential service. The recent Thwaites review presented a guiding principle which should frame any considerations of the shape and structure of the retail electricity market, namely:

> 'Energy is an essential service and underpins our health and wellbeing, and our economic participation. As an essential service, consumers must purchase energy and must participate in the retail market even if they are not interested in the product and regardless of continued price rises. Energy must be accessible, affordable and reliable for all.
> Consumers are entitled to obtain easily understandable energy offers and enter into energy contracts that provide value for money and don't contain negative surprises.' [1]

Getting a fair deal in the current energy market relies upon a high degree of consumer understanding and engagement. Consumers are required to remain informed about the available choices in the market, regularly assess those choices and 'switch' within or between retailers on a regular basis. The failures of the market are well documented, with most consumers are paying above the lowest price for energy and many are paying above an efficient price.

[1] Thwaites, *Independent review into electricity and gas markets in Victoria*, page 51.

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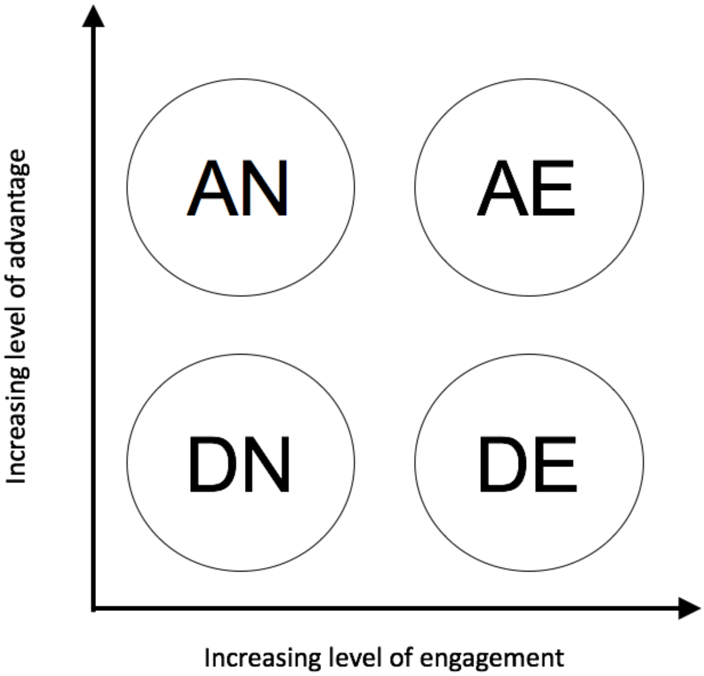

AN – Advantaged, not engaged
AE – Advantaged, engaged
DN – Disadvantaged, not engaged
DE – Disadvantaged, engaged

In this context PIAC considers that the current 'outcomes' for consumers are a function of the interaction between their level of engagement and their level of potential 'advantage', which can be expressed in 4 broad categories.

Advantaged/able, not engaged (AN)
This consumer cohort is disengaged from the energy market. While they do experience higher bills through suboptimal retail contracts, their potential socio-economic advantage means that they are often ignored in discussions regarding the operation of the competitive market and consumer outcomes, as they are considered to be able to be capable of dealing with the impacts of their lack of engagement. Increasingly however, evidence is showing that even consumers in middle incomes, are struggling with the cost of energy and are experiencing negative impacts as a result of their lack of engagement with the market[2]. PIAC considers the structure of the market framework and consumer protections are still relevant to this cohort, notwithstanding their current level of socio-economic advantage.

Disadvantaged/vulnerable, not engaged (DN)
This consumer cohort, who most closely match those often referred to as 'vulnerable consumers', consistently have the worst outcomes. The combination of energy market disengagement and relative socio-economic disadvantage means that these consumers are unable to take advantage of better market contracts from energy retailers. Market frameworks should support them having the opportunity to benefit from engagement where possible, but it is critical that supporting frameworks must not require them to be engaged in order to pay a fair price for access to an essential service. Most importantly, the goal should be to improve the relative level of 'advantage' (that is move people from the DN cohort to the AN cohort), while giving them the opportunity to move to the AE cohort but not obliging them to do so.

Advantaged/able, engaged (AE)
This energy consumer cohort are the only consumers able to operate as the current framework intends, and therefore only ones broadly getting good outcomes today. The combination of energy market engagement and relative socio-economic advantage means these consumers are more likely to be on favourable retail energy contracts, and choose (and can afford) to be adopters of energy technology such as solar PV, energy storage and demand management

2 Choice, *Consumer Pulse Report: July 2016*, page 8-9

systems. Competitive opportunities for these consumers should be encouraged, while recognising they are, by and large, the least at risk of disadvantage. PIAC considers all consumers should have the opportunity – but not an obligation – to move into this cohort. Importantly, the positive outcomes achieved by this cohort, are to some extent cross subsidised by the higher prices paid by those groups who are not engaged and able to negotiate better deals, particularly where 'loss-leading' contracts are involved.

Disadvantaged/vulnerable, engaged (DE)

While this cohort still requires similar support to the DN cohort, their potential and preference for engagement means that they are able to ameliorate some impacts of disadvantage through more active participation in the energy market. However, PIAC's recent report on disconnections demonstrates that the constant requirement to remain informed and engaged is a significant burden for a cohort that is often burdened by compounding and overlapping vulnerabilities[3]. Further, their potential disadvantage (even something as simple and fundamental as being a renter) means that the potential benefits of their engagement are limited. Accordingly, the goal for this group should be ensuring that the framework provides the same protections of access to a fair price, while giving them the choice and opportunities to benefit from competition in the same way that the AE cohort has. It is important that these consumers do not continue to be burdened with the risk of not engaging (and the ongoing cost of engagement), and that they have the protection of a fair price for an essential service.

The current, largely deregulated market framework operates upon the assumption that any negative consumer outcomes can be improved by facilitating greater consumer information and engagement. However, the independent review of electricity and gas in Victoria presented an alternative perspective, which reflects PIAC's own consumer framework, and suggests that the essential service nature of electricity requires another approach:

> 'the lack of consumer engagement in energy markets can be viewed as consumers simply acting as if energy was still a monopoly product. It is possible the essential service nature of energy is responsible for this: consumers cannot exit the energy market, they need to use energy, and the amount of energy they purchase stays the same no matter which retailer they are with.'[4]

This is fundamental to the consideration of a DMO, its intended role and the most suitable and efficient structure to fulfil that role. The key considerations in determining the role and objective of the DMO are that:

- electricity is an essential service, which all consumers have a right to access equitably and, for a fair price,
- overall benefit to consumers as a whole, be weighed against potential impacts for particularly consumer cohorts,
- competition is a mechanism intended to deliver consumer benefits, not an end in itself or an intrinsic good in and of itself,
- competition of any kind must be evaluated 'qualitatively' as well as quantitatively, and that a more effective competitive market may involve a smaller number of competitors, with the scope to compete on a range of service aspects instead of (and in addition to) price, and
- the 'choice to choose or not to choose', should be a fundamental right for consumers in an essential service market, such as electricity. Active participation should not be required to ensure a fair price.

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3 PIAC & UMR. Close to the Edge: A qualitative and quantitative study, November 2018. Pp 12-20

4 Thwaites, *Independent review into electricity and gas markets in Victoria*, page 38

PIAC accepts that any DMO that achieves such objectives will limit the ability of some retailers to continue with current business models, in particular those business models that today provide little or no discernible value for their customers. PIAC fundamentally rejects the notion that establishing a strong default mechanism that is designed to constrain consumer bills to a relatively efficient price is somehow anathema to market competition and innovation; to the contrary, a strong default mechanism places the incentive to innovate in a manner that will better serve customers though differentiation in service, rather than just price.

Establishing a Default Market Offer Price

In the context of the framework and objectives outlined above, the primary considerations to draw from the ACCC's recommendations relating to the DMO are:

- That the standing offer and standard retail contracts be abolished and replaced with a default market offer at or below the price set by the AER,
- That retailers are required to supply consumers under a DMO on request or where a consumer does not make an explicit choice of market offer,
- That the DMO price should be the *efficient*[5] cost of operating within the region, including a reasonable cost of customer acquisition and retention (CARC), and
- That AER should publish a reference bill amount for each distribution zone, using AER household benchmarks and the DMO price.

Customer Acquisition and Retention

In establishing a DMO mechanism for an essential service such as electricity, the consideration of what represents an 'efficient cost of operation' is fundamental. While the ACCC explicitly recommends that an allowance for 'reasonable CARC' be included in the formulation of a DMO, PIAC notes that there is no reliable means of determining a reasonable allowance for CARC that could be regarded as efficient. In its own final report, the ACCC sites a range of evidence to support this conclusion, including:

- That there is a positive correlation between 'switching rates' and an increase in CARC[6], suggesting that increased activity related to a small number of customers is simply loading more costs into retail businesses,
- That the retail cost to serve (CTS) and CARC have moved in opposite directions over the last 5 years, with average retail CTS per residential customer falling by $25 to $90, where the average CARC per customer has steadily increased by 20% to $48 over the same period[7]. While this seems a relatively small number, it is important to consider that this is averaged over all residential customers, and represents the cost of acquiring and retaining a relatively small proportion of 'desirable' customers who are churning (26% in Victoria and 19% in New South Wales),
- The difference between average CARC ($40 for 'big 3' retailers and $87 for other retailers) and CARC per acquired customer ($283 for 'big 3' retailers and $198 for other retailers)[8] illustrates the significant extent of effective cross subsidy as a result of costs imposed upon the majority of relatively static consumers for small number of 'acquired customers', and
- That retailers are engaging third party services that charge in excess of $200 per acquired customer[9]. This represents a substantial, unproductive cost added into the supply chain,

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5 Emphasis added

6 ACCC, Retail Electrcity Pricing Inquiry- Final Report, June 2018, pg.229

7 Ibid, pg.222

8 Ibid, pg.230

9 Ibid, pg.231

that is neither transparent, nor, because it can be smeared across the remaining customer base, subject to significant drivers of efficiency.

CARC are driven by decisions made by retailers making choices, for very opaque business-specific reasons, about which customers they believe to be desirable. It is difficult to argue this discretionary spending by retailers is a reasonable or efficient cost of business. PIAC contends that the only practical efficiency that could reasonably be applied to CARC, in the context of the formulation of a DMO, is to make no explicit allowance for it.

As an alternative, the formulation of an efficient price basis for the DMO should simply make allowance for efficient retail costs, and an additional 'fair' margin (which could be benchmarked and evenly applied across all jurisdictions). This would leave scope for the DMO price to allow retailer discretion to continue to 'spend' on CARC if they so choose, but not allow this to be unreasonably borne by consumers. More importantly it would introduce an efficiency incentive for any CARC incurred by retailers, something which does not currently exit. PIAC notes that this conclusion was supported by the ACT Independent Competition and Regulatory Commission[10], and the Independent Review into Victorian retail energy Markets.

Pricing approach

The AER proposes to apply a 'top down' approach to the formulation of the DMO price in each distribution zone, utilising the median market offers and median standing offers for benchmark household consumption, and selecting some point between these as an indication of an efficient price. PIAC appreciates that there are a number of pragmatic considerations, including short externally imposed timeframes and difficulty accessing sufficiently detailed and accurate market information, behind the decision to employ a top-down approach in this initial process. However, we have significant concerns with the intended approach and the assumptions underpinning it. Specifically:

- It is well established that standing offers are significantly 'overpriced' and, as such, do not bear any relationship to efficient costs. Utilising even the 'median' point of standing offers as an upper boundary for calculation of a proxy for an efficient price is likely to significantly over-estimate and inflate the resulting price. PIAC recommends that as this process will involve abolishing them, standing offers not be part of the consideration of an efficient price.
- The position paper assumes that available market offers in 'competitive markets' are likely to reflect retailers' efficient costs, and be a practical proxy for them. This assumption is flawed because:
    - it does not recognise the significant (and largely intentional) price dispersion that retailers create across their offers, often specifically to manipulate comparison tools (that is, offering multiple deals across a wide range that differ by a small and immaterial amount (such as $1) that would qualify as 'unique offers' under the proposed framework),
    - It depends on data that is not available, on how many consumers are on each deal. Retailers create a spread of offers, which range from significantly above efficient costs, to potentially below efficient costs. The efficiency of any particular offer, then, is not discrete and depends upon how many customers remain on a given deal relative to others that retailers offer, and
    - It does not recognise that market offers are expressed as inclusive of discounts. These offers are mostly dependent upon conditions that may or may not be met by consumers (particularly consumers experiencing various forms of payment difficulty who have trouble paying on time). This undermines the value of these 'headline'

[10] Independent Competition and Regulatory Commission (ICRC) 2017, Standing offer process for the supply of electricity to small customers from 1 July 2017, Report 6 of 2017, Final Report June 2017, p.28

prices as they are not necessarily a reflection of what consumers are actually paying. Additionally, the ACCC report and Independent report into Victorian retail markets also recognised that the quantum of the discounts that these deals involve do not relate to the efficient costs of meeting (or failing to meet) those conditions; for example, a 30% on-time payment discount is not related to the costs borne by the retailer should the customer not pay on time.

PIAC accepts that there is a time imperative in relation to the current process that is likely to make a 'top down' approach a matter of pragmatic necessity. However, bearing in mind the concerns raised, PIAC recommends that the flaws of this approach be explicitly recognised as part of this process, and that an initial 'top down' method be augmented by the following:

- That standing offers not be part of the top-down consideration at all,
- That market offers be utilised as the only basis for calculation of an indicative 'efficient price',
- That the market offers used be expressed including all discounts, and
- That the resulting median of all available market offers (including all discounts) be tested against a desktop estimation of an efficient or fair price (such as that proposed in the ACOSS submission to this process), that could be calculated by adding:
    - Wholesale energy costs – this can be calculated by applying the premium of wholesale energy costs over wholesale spot prices that was observed in the AEMC's most recent price trends reports to a forecast of wholesale spot prices for 2018/19 that is based on ASXEnergy swap prices for 2018/19.
    - Costs of complying the Large-scale Renewable Energy Target (LRET) and Small-scale Renewable Energy Scheme (SRES) – which can be based on retailer's percentage obligations for 2018/19 and observed prices for Large-scale Generation Certificates (LGCs) and Small-scale Technology Certificates (STCs).
    - Network tariffs – which can be based on published network use of system (NUOS) tariffs for each distribution area in the NEM.
    - Network losses - based on published loss factors.
    - Market fees, ancillary services costs and costs of complying with any relevant jurisdictional schemes - based on the AEMC's most recent prices trends reports.
    - Retail operating costs, and the retail margin, can be based on recent regulatory allowances.
        - The allowance for retail operating costs based on retail operating costs from IPART's 2013 review of regulated retail prices for 2013 to 2016, or ACIL Allen's analysis for the Queensland Competition Authority for 2015/6, or similar work, adjusting for inflation to 2018/19.
        - The allowance for the retail margin: This retail margin is from IPART's 2013 review of regulated retail prices for 2013 to 2016; it reflects a regulated allowance rather than an estimate of the retail margin that retailers are actually earning (as reported by the ACCC[11]).
        - No specific allowance for CARC, and
- That this process involves an explicit commitment that subsequent processes for determining the DMO price will be carried out using a 'bottom up' approach, that has more scope for accuracy.

Specifying the DMO

[11] ACCC, Retail Electricity Pricing Inquiry- Final Report, June 2018, pp.145-147

PIAC recommends that the DMO and reference bill be expressed in both dollar terms for bill and as a c/kWh.

Expressing the DMO as a quarterly or annual bill (based on a single, or ideally several benchmark consumption points) will enable people to compare between offers.

Expressing the DMO also in c/kwh, may also provide a means for consumers to better estimate what their total bill might be at different times of the year (depending on their climate zone), and also to adjust for any potential differences in the way that different retail offers may split between fixed and usage charges.

Addressing the risks

Critics of a default offer mechanism often cite the risk that such a mechanism will encourage consumer inertia. PIAC agrees that there is a likelihood that a significant proportion of consumers (any of the vast majority who regard electricity as an essential service for which they simply want to pay a fair price) may be encouraged to remain on the default offer. As set out in our framework for understanding consumers, PIAC contends that should be regarded as a positive outcome for all consumers if:

- The default price is set as close to an efficient price as possible, to ensure that those consumers who remain on it, do so in the knowledge that they are paying a 'fair' price for their essential access to electricity.

  PIAC recommends against regarding only to protect against the most egregious price impacts. Such an approach would have limited impact upon the large number of consumers who regard energy as an essential service, and would see many of them potentially remain on a default offer under the false assumption that they were being protected by a fair price. Such an approach would still allow for the continuation of a significant 'opaque' internal cross-subsidy between retail customers and would do little to address the significant detrimental impacts currently being experienced by many consumers.

- There is recognition that it is not merely 'standing offers' which are currently problematic, and that many consumers who currently appear to be on 'market offers' may still be on contracts which are priced significantly beyond any reasonable point of efficiency. The common retail practice of long or 'evergreen' retail contracts, in combination with 'benefit' periods which expire within the term of the contract, means that many consumers who appear to be, or assume they are on, a market offer, may be subject to conditions similar to those of a standing offer (without actually defaulting to a standing offer and being captured in those figures).

  Accordingly, the provisions of any DMO should explicitly state that the DMO applies not only in all conditions where a consumer currently defaults to a standing offer, but in all conditions where the benefits of the offer that a consumer explicitly consented to, expire. This would address the significant confusion currently experienced by many consumers, while providing retailers with a further incentive to engage their customers.

- The choice to engage in the competitive market is genuinely retained as a choice, rather than a requirement. Where consumers are guaranteed a 'fair' price for electricity, they are able to engage in the retail market as and when they choose (similar to any other competitive market). This provides retailers with a strong incentive to innovate and create services and offers which are likely to draw consumers attention.

  Because 'fair' price is guaranteed, it is true that there may be more limited scope for price-only competition, though it will still be possible (with below cost honeymoon offers, 'all-you-can-eat' deals, bundling, peak demand rebate deals, etc). Importantly, the burden of risk and cost for engagement will be more evenly shared between consumers and retailers.

Continued engagement

PIAC would welcome the opportunity to meet with the AER and other stakeholders to discuss these issues in more depth, and looks forward to providing further detail on the issues explored in this submission. For further engagement please contact Douglas McCloskey.

Yours sincerely,

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