12 March 2020

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 2020-21 Draft Determination

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 Draft Determination on the development of a Default Market Offer price (DMO2) for retail electricity.

We strongly support the principle of a Default Price mechanism. As evidenced by the ACCC Retail Electricity Pricing Inquiry, many households continue to struggle to access the energy services they need at a fair and affordable price.

The Draft Determination demonstrates that 730,000 households and small businesses are being served by standing offers. PIAC remains concerned that the current DMO regulating these standing offers, and its proposed 20-21 adjustment, do not provide sufficient assurance that these people are paying a justifiable and fair price for these services. PIAC notes that DMO prices also act as a value reference for retail services more generally.

Effectiveness of the DMO

While the DMO improves price outcomes for a number of energy users, it is intentionally formulated to 'cap' prices well above the efficient cost of retail service. PIAC, therefore, remains doubtful that it promotes the interests of consumers in a manner that best achieves the National Energy Objective (NEO) and National Energy Retail Objective (NERO) as effectively as other approaches that are at the AER's discretion.

Failures of principle and process

PIAC considers that the reasoning behind the formulation of the initial DMO, the assessment of it, and the DMO2 proposed in the draft determination, contain inconsistencies and questionable assumptions. Specifically, PIAC highlights:

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- The Retail Electricity Pricing Inquiry recommendations, which form the basis of the DMO mechanism, asserted that standing offer prices were no longer fit for purpose and should be abolished and replaced with a default price mechanism preventing 'unjustifiable prices'. PIAC questions whether standing offers provide protections substantively beyond those commonly available in market offers (particularly considering the range of other recent reform measures), which do not involve any material cost premium to retailers. In PIAC's view, standing offers cannot be regarded as a 'premium' product.

- The initial DMO process had an objective of preventing 'unjustifiable' standing offer prices. The NEO and NERO require the NEM to provide efficiently operated and priced services to consumers. Unjustifiable prices could, therefore, be regarded as prices that are set materially above the efficient cost of service (including reasonable retail margin). Neither the initial DMO, nor DMO2 have been formulated to achieve this objective.

- The initial 'price based' formulation of the DMO recognised median market offers as a proxy for the efficient cost of service, yet used a calculation that included median standing offers. Where standing offers were recognised as 'unjustifiably high' this is inappropriate, and resulted in a DMO that provided no meaningful representation of efficient cost, value or 'justifiable' standing offer price. Without an explicit and objective rationale for deciding how far above efficient costs the DMO should be set, the DMO is an arbitrary price with no transparent relationship to actual cost to serve.

- The initial DMO used a 'price based' formulation on the rationale that it was impossible, or at least problematic, to estimate the components that would be required to undertake a 'cost based' formulation. The Victorian Default Offer (VDO), however, demonstrated that a reasonable estimation of cost components could be made and used to formulate a transparent default price that reasonably represented the efficient cost of service. PIAC notes that in determining the initial VDO, the median market offer at the time was considered, reinforcing that even when taking a price-based approach including median standing offers is inappropriate.

- Although estimation of costs was deemed impossible or impractical for the initial DMO formulation, the DMO2 adjustment proposes to use a forecast of changes to forward-looking costs. In employing this blend of approaches, the initial 'arbitrary' price – itself not representative of actual cost to serve - is now being upwardly adjusted according to cost estimates. To the extent the initial price was set above actual or efficient costs, this results in an updated price that is further above costs. In PIAC's view this does not meet the stated objectives of the DMO process.

- The AER has expressly assumed that the DMO must be set at a higher than efficient level in order to 'retain' an incentive for competition and engagement in the market. PIAC contends that this erroneously assumes that retailers have scope to price services above a fair and efficient cost for some consumers in order to offer competitive services to others. This is not in the interests of the consumers directly impacted by unjustifiable prices, and, in PIAC's view, is inaccurate: were a DMO to be set at a level approximating the efficient cost of service, including a more reasonable margin, it would still provide scope for innovation in service offerings, and scope for competition on service and price. Such a DMO would ensure that consumers engage where retailers compete to provide services of value. This would require retailers to either demonstrate a qualitative difference, improve efficiency to compete on price, or both. Regardless, it would require retailers to compete according to the objectives required in the NERO.

In PIAC's view, the AER has taken too narrow an interpretation of the objectives of default pricing, and the recommendations of the ACCC, and does not appropriately respond to the evidence provided by the ACCC in its Retail Electricity Pricing Inquiry and the demonstrated need for an effective default price.

PIAC again recommends that the AER reconsider its proposed approach to DMO, recognise the vital importance of a transparent and objective framework for default price setting, and adopt a cost-based approach more consistent with that employed in the formulation of the VDO.

The impact of default pricing on vulnerability

PIAC notes that the AER recently received a report it commissioned through the Consumer Policy Research Centre (CPRC)[1]. This report demonstrates the role of the retail market in either alleviating or increasing the potential vulnerability of all consumers, not merely those commonly identified as being subject to structural disadvantages such as income, disability or ill-health.

Where the market requires a high-level of informed engagement, on a constant basis, in order to ensure a fair or efficient price for an essential service, this is a material contributor to increased consumer vulnerability.

The DMO2 process represents a crucial opportunity to undertake a reform that addresses this. A DMO formulated transparently according to efficient costs, helps ensure all consumers are guaranteed a fair price for their essential energy, and that the retail energy market is playing its role in alleviating vulnerability rather than exacerbating it.

Continued engagement

PIAC would welcome the opportunity to continue to engage 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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1 Emma O'Neill, 'Exploring regulatory approaches to consumer vulnerability: a report for the Australian Energy Regulator', Consumer Policy Research Centre, 1 November 2019.