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Options Paper on 2022-23 methodology: Default Market Offer Price

The Australian Energy Council ('AEC') welcomes the opportunity to make a submission to the Australian Energy Regulator's ('AER') Options Paper on the *methodology to be adopted for the Default Market Offer Price 2022-2023 (DMO 4).* After three years of operation, the AEC agrees that it is timely to reassess the price setting methodology of the DMO, to ensure it continues to meet its policy objectives.

The AEC is the industry body representing 20 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 the high level design considerations raised in the options paper, rather than the preferred methodologies of individual members. Our members will provide more detailed views on the issues raised.

At a high level, the AEC considers that the AER's methodology in setting the DMO has to date been adequate in meeting its policy objectives. Whilst the AEC continues to believe that there are enhancements to the indexation approach to better enable the AER to compensate retailers for reasonably forecastable cost increases, overall, the indexation approach is effective in ensuring the DMO acts as a safety net for disengaged customers, without unreasonably impacting the benefits of the competitive retail market.

Retail costs, profit margin and DMO allowance

The Options Paper is seeking to identify a preferred approach to estimate retail costs, profit margin and DMO allowance. The AER has proposed three options which seek to identify these costs, while maintaining the policy objectives of the DMO. As noted above, the AEC considers the current indexation methodology is adequate to meet the DMO's objectives, and the options paper does not give any indication to suggest this is not the case. Given this, the AEC considers the AER should set a high threshold in this consultation process should a decision be made to move away from the current approach.

The AEC maintains that price regulation is an inherently risky process, with a particular risk placed on the vast majority of customers who have opted to enter into a market contract with a retailer of their choice. If the regulated price is set too low, at a level where retailers are unable to recover their efficient costs in delivering energy to their customers, the effect on the market can be chilling. The ACCC acknowledged this risk in its Retail Electricity Pricing Inquiry in its assessment of the low cost Basic Service Offer (BSO) under consideration in Victoria. The ACCC noted that it was *"concerned that implementing a BSO would lead to reduced innovation and act as a disincentive to retailers to adopt new technology or service models. Competition drives such incentives and provides benefits for consumers with new products and improved processes. The retail electricity market is undergoing substantial changes, providing many*

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opportunities for new and improved products and services to be delivered to consumers. It is therefore critical that this opportunity is not foreclosed." [1]

In recommending the DMO, the ACCC intentionally sought to avoid the risks caused by the BSO. "*The ACCC agrees with the AEMC's view that while the benefits of competition and price deregulation in the NEM have not materialised for a number of consumers, competition is clearly benefiting those who are engaging in the market and finding deals that suit their circumstances. We do not want to inhibit these consumers from achieving good outcomes… The default offer is unlikely to be one of the cheapest offers in the market, but will limit the ability of a retailer to price so far above cost that it detrimentally impacts on standing offer consumers."*[2]

The AEC considers that the benefits of the DMO have largely been delivered, with future benefits limited to minimising the risk that standing offer prices might return to higher than reasonable costs. Customers on the DMO today are significantly worse off than customers who seek to engage in the market, and the policy objectives of the DMO do not seek to set a price that customers should want to remain on. In that context, the AEC considers the benefits of seeking to identify a 'better' price setting methodology are low, with a much greater risk of getting the price wrong and impacting the policy objectives of the DMO during a period of significant change in the retail market.

Option 1: Estimating retail costs and a DMO allowance

Option 1 would require the AER to develop a methodology to identify efficient retail costs and then determine an appropriate DMO allowance to ensure that the DMO meets its policy objectives. The AEC considers the options presented by the AER to use ACCC retail price data as a means of identifying at retail costs at a high level would be workable.

However, our members have advised us that the retail cost data captured by the ACCC does not directly correlate to their own retail costs, in particular, when considering corporate overheads and shared costs. This creates a risk that needs to be resolved by the AER in developing a methodology to translate the ACCC collated costs to an efficient retailer costs for the purposes of the DMO. The AEC does not support an approach that would see the AER collect data directly from retailers to identify efficient costs. Retailers are already required to provide this data to many different regulators, and recreating this for the AER specifically would likely result in significant compliance costs for little gain.

Of greater concern to the AEC is the ability of the AER to set an appropriate DMO allowance. The DMO is unique in that it is not intended to perform the role of traditional price regulation that acts as a proxy for competition until such time as competition can act for itself. The DMO is intended to be ongoing irrespective of the level of competition in the market, as a means of ensuring that standing offer customers are not unreasonably disadvantaged by prices significantly above efficient costs.

Despite this, many consumer advocates seek to compare the DMO negatively against the Victorian Default Offer and other price regulation methodologies as allowing too high a margin for retailers with standing offer customers. This position represents a lack of understanding of the intent of the DMO, and more likely, highlights a lack of belief in some advocates that energy services should be offered through a competitive market at all. Despite the error of this position, the AEC is concerned that should the AER seek to identify an appropriate DMO allowance, this noise would be politicised, with the AER required to either determine an amount consumer advocates will say is too much, or lower the DMO allowance and impact the policy objectives. This does not seem a helpful argument to engage in, particularly given the decreasing number of customers the DMO impacts.

[1] ACCC, Retail Electricity Pricing Inquiry, June 2018
[2] Ibid

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Overall, the AEC does not consider option 1 provides any additional value over and above the current methodology.

Option 2: Continue indexation of the DMO residual

Option 2 represents the status quo approach. The AEC agrees with the AER's assessment of this approach as least risk as compared to the existing methodology of the DMO, and therefore should represent the starting point for considerations of an enhanced methodology. Broadly, the AEC considers the current DMO residual, with some minor amendments to factor in step changes that have occurred since 2018, would likely result in a DMO that continues to meet its policy objectives over the coming years.

However, the AEC notes that the factoring in of recent changes to retail costs in effect may require the AER to better understand the impact of cost changes more scientifically than its current data collection powers allow. Of material concern to the AEC is the impacts of a changing market since 2018 – namely, the progressing rollout of smart meters, changed expectations around debt management approaches (both during the COVID pandemic and likely beyond), and system change costs resulting from the significant number of interventions that have occurred in the retail market since the DMO's implementation. None of these costs are easily identifiable under the existing indexation approach, and there remains questions as to what is and what is not material when the DMO's policy objectives are considered.

Given this, the AEC considers a deep dive is required as part of this consultation to ascertain a reasonable approach to identifying these costs in an efficient manner. This approach would seek to identify what a material threshold for cost changes might look like, the ability of the AER to consider step changes collectively, and other factors that might impede a retailer to offer the DMO in a manner that ensures it meets its policy objectives.

Option 3: adjust the residual to reflect changes in retail costs using the ACCC data

As noted above, the AEC considers using the ACCC dataset as starting point for assessing the residual is a workable approach, and might resolve some of the issues seen in the status quo indexation model. Utilising an objective dataset also removes the risk of the AER needing to ascertain what data they should and shouldn't seek from retailers, and how to utilise that data.

However, as noted above, the ACCC dataset represents an average across the retail industry, and does not in itself represent the efficient costs of a representative retailer. This is a significant limitation of this approach, and will require the AER to undertake a process to determine how it will use the ACCC dataset for the upcoming DMO period in practice. While participant costs will vary significantly based on size and efficiency, the DMO must seek to pick a single number for the whole market. This risks smaller retailers who might be unable to achieve the economies of scale that larger retailers can being disproportionately impacted by lower tier 1 costs. For larger gentailers, consideration needs to be had about cost sharing and corporate overheads. For the purpose of this determination, the AER should consider that a retailer is separated from its generation arm, and assume that the benefits that come from a large customer base need to be tempered against higher corporate overheads.

The latency of the dataset will also require the AER to include costs that retailers incurred in a historical DMO period in a future decision. This is suboptimal but unavoidable, and provided the AER maintains that costs must be passed through even if they are no longer being incurred, the AEC accepts the approach as appropriate.

As a further consideration, the AEC considers that there is a risk of perverse incentives in the option 3 approach, in that retailers are discouraged from reducing their operating costs as those cost efficiencies would result in a lower DMO. The AEC considers this might be best resolved through the development of a reward sharing or incentive mechanism similar to that utilised in network regulation.

Preferred option

Overall, the AEC recommends the AER focus its efforts on enhancing option 2, as the least risk approach to the continued delivery of an effective DMO. While option 3 might have advantages, its relative costs as compared to the simplicity of retaining an option 2 style approach renders this approach less preferable than continuing with the status quo.

Duration of the DMO

The AEC does not have a strong preference on the length of the DMO period. Broadly, the AEC considers that the DMO is incompatible with a future two-sided retail market, and has encouraged the Commonwealth Government to review the function and efficacy of the DMO in 2024.

Given that, the AEC considers that a three year period might provide a useful opportunity to reassess the approach of any ongoing DMO to ensure that it continues to provide a functional protection for consumers in the post 2025 retail market. While the AEC considers that the case has not been made to suggest a change in DMO approach is required today, that may not be practical in 2025 and beyond, requiring reconsideration of a bottom up, cost stack approach.

Any questions about this submission should be addressed to me by email to ben.barnes@energy.council.com.au or by telephone on (03) 9205 3115.

Yours sincerely,

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