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22 March 2019

The Hon Josh Frydenberg MP
Treasurer

The Hon Angus Taylor MP
Minister for Energy

Parliament House
CANBERRA ACT 2600

By email: Josh.Frydenberg.MP@aph.gov.au
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Dear Treasurer and Minister

Thank you for your letter on 12 February 2019 clarifying the application of the default market offer (DMO) framework to Victoria. In that letter you requested that we provide you with advice on the protections for consumers under the Victorian Default Offer (VDO).

The Essential Services Commission of Victoria (ESC) published its draft advice on the VDO to the Victorian Government on 8 March 2019, with a final recommendation expected by 3 May 2019. The VDO framework is intended to apply from 1 July 2019.

Please see the following attachment, which summarises the key aspects of ESC's draft advice and the expected outcomes under the VDO.

I would be happy to discuss any questions you may have.

Yours sincerely

Paula Conboy
Chair
Australian Energy Regulator

Sent by email on: 22.03.2019

ATTACHMENT: Summary of ESC Victorian Default Offer draft advice

The ESC released its draft advice on the VDO on 8 March 2019. Submissions on the draft advice are due 4 April 2019.

The ESC's approach in its draft advice appears to meet the stated policy objective of the VDO. The ESC has set a 'fair' default price to apply to customers on standing offers, based on the efficient costs of running a retail electricity business. In doing so, the ESC has had regard to cost estimation approaches used by other economic regulators and formulated its approach in response to stakeholder submissions and other consultation mechanisms.

We note that the ESC is still in its consultation phase on the proposed VDO, with the final recommendation due by 3 May 2019.[1] Accordingly, the ESC's final recommendation will depend on the further information it receives as part of its current consultation process.

Context

The Australian Competition and Consumer Commission (ACCC) Retail Electricity Pricing Inquiry (REPI) conducted during 2017-18 found that energy affordability remains a critical issue for Australians. It noted that:

- Residential customer prices have increased by around 56 per cent in real terms from 2007-08 to 2017-18, with a real increase in bills of around 35 per cent over the same period.[2]
- The proportion of household disposal income spent on electricity, in most NEM areas in 2016, was around five times greater for the lowest income quintile than for the highest income quintile.[3]
- The gap between a retailer's standing offer and its lowest priced market offer has widened since 2014. For instance, the difference between standing and market offers in the AusNet Services distribution network in Victoria increased from $304 in 2014 to $569 in 2018, on an average bill.[4]

In the REPI final report, the ACCC noted that standing offers, which were originally intended as a default protection for consumers who were not engaged in the market, were unjustifiably high and have been used by retailers as a high priced benchmark from which their advertised market offers are derived. The ACCC found that the standing offer is no longer working as it was intended and is causing financial harm to consumers.

Terms of Reference for the VDO

On 18 December 2018, the ESC received terms of reference from the Victorian Government to advise on the VDO.

[1] ESC, *Victorian Default Offer to apply from 1 July 2019, Draft advice*, 8 March 2019, p. 7.
[2] ACCC, *Restoring electricity affordability and Australia's competitive advantage, Retail Electricity Pricing Inquiry—Final Report*, June 2018, p. 5.
[3] ACCC, Retail Electricity Inquiry—*Preliminary Report*, 22 September 2017, p. 14.
[4] ACCC, Restoring electricity affordability and Australia's competitive advantage, *Retail Electricity Pricing Inquiry—Final Report*, June 2018, p. 242.

The VDO is intended to limit the prices charged to residential and small business customers on standing offer contracts in Victoria.

The terms of reference requested the ESC to develop a methodology for determining a VDO that will:

- be offered unconditionally by each licensed electricity retailer to all residential and small business customers, including those who export power under feed-in tariffs
- be the price that a retailer can charge under the VDO arrangements and is to be established as the basis for retail discounts
- adopt the terms and conditions for standard retail contracts, and
- be based on current marketing standards and practices.[5]

The terms of reference also set out some further detail about how the VDO should be determined. The VDO should:

- be set for each distribution zone
- be based on the efficient cost to run a retail business
- include an allowance for a maximum retail profit margin
- include a modest allowance for customer acquisition and retention costs; and
- not include an allowance for headroom.[6]

The ESC's draft advice notes the following on the intended purpose of the VDO:

> *Our terms of reference, and subsequent statements from the Premier and Minister for Energy, make clear that the purpose of the VDO is to provide customers with universal access to a "fair" price.*
>
> *There is no single definition of fairness. It is generally dependent on the context within which it is used. In the context of the Victorian retail electricity market (as described above), we assume that a fair price is intended to reflect the price that a loyal customer could expect to pay if this market operated like other normally competitive markets. That is, prices reflect the efficient costs of delivering services to different customers. Our terms of reference reflect this expectation when they state that the VDO should be "based on the efficient cost to run a retail business" and no allowance should be made for "headroom" (where "headroom" means a provision that is not related to (efficient) costs).*[7]

Price methodology

The ESC has used a cost-based approach to determine the VDO. This reflects its objective of estimating the efficient costs of an electricity retailer.[8] In summary:

- Wholesale and environmental costs are based on observed market costs.
- Network costs are a straight pass-through (the initial VDO only applies for six months, so no estimation of change in network costs was required).

[5] ESC, *Victorian Default Offer to apply from 1 July 2019, Draft advice*, 8 March 2019, p. 6.
[6] ESC, *Victorian Default Offer to apply from 1 July 2019*, Draft advice, 8 March 2019, p. 6.
[7] ESC, *Victorian Default Offer to apply from 1 July 2019, Draft advice*, 8 March 2019, p. iii.
[8] ESC, *Victorian Default Offer to apply from 1 July 2019, Draft advice*, 8 March 2019, p. 16.

- Retail operating costs (including customer acquisition and retention costs) are based on a benchmarking approach, using published ACCC data, and information from annual reports and other regulatory decisions.
- Retail margins are based on a benchmark of other regulatory decisions.

The VDO is established as a tariff (with supply and usage charges determined by the ESC) that retailers must adopt for all standing offer customers.[9]

Coverage

As noted above, the VDO applies to residential and small business customers.

For residential customers, the VDO price has been set as flat rate and controlled load tariffs. For small business customers, the VDO price has been set as a flat rate tariff. These tariffs reflect the type of tariff that the majority of residential and small business standing offer customers are likely to be on.[10]

The VDO will be also be available to customers with solar photovoltaic systems.

Retailers will continue to have flexibility to offer customers different prices to the VDO (both higher and lower), through market offers.

Pricing outcomes under the VDO

Under the proposed VDO prices in its draft advice:

- Typical residential customers on standing offers and using 4000 kWh of electricity per year will see their annual electricity bills reduce by between $390 and $520, when compared with the median standing offer in their distribution zone.
- Small business customers on standing offers and using 20 000 kWh of electricity per year will see their annual electricity bills reduce by around $1830 to $2300, when compared with the median standing offer in their distribution zone.[11]

Difference in objectives between the VDO and DMO

Both the DMO and VDO will act to limit retail electricity prices for residential and small business customers on standing offers. However, the objectives of the DMO and VDO differ. The ESC's draft advice explicitly recognises the difference in objectives:

> *While the VDO is described in terms of “fairness”, the DMO is described as a “fall-back position” or a “cap…to limit the ‘loyalty tax’.” These terms suggest the DMO is not intended to be as profound an intervention as the VDO.*[12]
>
> …
>
> *While we note that there are some similarities between our work on the VDO and the AER’s work on the DMO, there are significant differences in the objectives of each pricing mechanism.*[13]

As highlighted in the AER's DMO draft determination, the DMO is intended to serve two main purposes:

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[9] ESC, *Victorian Default Offer to apply from 1 July 2019, Draft advice*, 8 March 2019, p. 73.
[10] ESC, *Victorian Default Offer to apply from 1 July 2019, Draft advice*, 8 March 2019, p. 30.
[11] ESC, *Victorian Default Offer to apply from 1 July 2019, Draft advice*, 8 March 2019, p. 76.
[12] ESC, *Victorian Default Offer to apply from 1 July 2019, Draft advice*, 8 March 2019, p. iv.
[13] ESC, *Victorian Default Offer to apply from 1 July 2019, Draft advice*, 8 March 2019, p. 18.

- It will act as a cap on the price of default offers to limit the 'loyalty tax' that is levied on disengaged consumers
- It will be used to set a reference bill amount which all advertised discounts must be calculated from.

The DMO aims to establish a price that carefully balances the need to reduce the unjustifiably high level of standing offer prices for consumers who are not engaged in the market, while still providing consumers and retailers with incentives to participate in the market and allowing retailers to recover their efficient costs in servicing customers. This requires the DMO to be set at a level sufficiently above efficient market offers.

The ACCC's submission to the AER position paper highlighted the importance of the DMO price being set sufficiently above 'efficient' market offers to allow scope for retailers to continue to compete, and for the benefits of retail competition to be retained:

> *The level at which the DMO is set is critical in ensuring that these measures work to improve competition, rather than risk stifling it.*
>
> *The ACCC does not want the DMO to become a viable alternative for engaged consumers that can find good deals. Engaged consumers drive efficiency and innovation in the electricity sector by responding to new offerings from retailers. Losing this engagement would result in less effective retail competition and is unlikely to be in the long-term interest of consumers.*[14]

The DMO is not intended to be the lowest price, or close to the lowest price in the market. Rather, its purpose is to act as a fall-back position for those not engaged in the market or for those that require its additional protections. As such, it is not intended that many customers should be choosing the DMO as the preferred (lowest cost) offer available to them:

> *The default offer should not exist to be the lowest price, or close to the lowest price in the market. … It must be set above the price for competitive market offers to avoid incentivising consumer disengagement. … The default offer should not exist to be a price accessed by most, if not all, consumers in the market.*[15]

In comparison to this approach, the VDO is intended to provide customers with 'universal access to a "fair" price'.[16] While this objective will achieve a similar outcome to the first stated objective of the DMO—disengaged customers not being subject to significantly higher prices than other customers—the policy position on the intended level of the default price is a key difference between the frameworks.

The ESC has set the VDO based on 'the efficient cost to run a retail business', with no allowance for 'headroom'.[17] This approach is expected to result in a default price under the VDO that is closer to the level of retailers' current market offers than under the DMO.

In making its recommendations on the DMO, the ACCC noted the importance in minimising any impact from the default price on competition, particularly in a transitioning energy market:

> *The retail electricity market is undergoing substantial changes, providing many opportunities for new and improved products and services to be delivered to consumers. It is therefore critical that this opportunity is not foreclosed.*[18]

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[14] ACCC, *Submission to the AER's position paper on the Default Market Offer price*, December 2018, p. 2.
[15] ACCC, *Restoring electricity affordability and Australia's competitive advantage, Retail Electricity Pricing Inquiry—Final Report*, June 2018, p. 249.
[16] ESC, *Victorian Default Offer to apply from 1 July 2019, Draft advice*, 8 March 2019, p. iii.
[17] ESC, *Victorian Default Offer to apply from 1 July 2019, Draft advice*, 8 March 2019, p. iii.

These different policy objectives lead to different pricing outcomes under the DMO and VDO. In the ESC's draft advice, the VDO is set at around the median market offer observed. In contrast, the AER's DMO draft determination sets the DMO at the midpoint between the median standing offer and median market offer.[19]

[18] ACCC, *Restoring electricity affordability and Australia's competitive advantage, Retail Electricity Pricing Inquiry—Final Report*, June 2018, p. 250.

[19] The ESC estimates that the VDO would be on average $200 lower than a notional residential DMO price, or $1000 lower for small business customers. It also notes that the AER's and ESC's different pricing approaches would lead to similar monetary outcomes if the same policy objective was being pursued. See: ESC, *Victorian Default Offer to apply from 1 July 2019, Draft advice*, 8 March 2019, p. iv.