



# **DRAFT DETERMINATION**

## **Default Market Offer Price**

February 2019

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## Invitation for submissions

Interested parties are invited to make submissions on this draft determination by **Wednesday, 20 March 2019**.

We will consider and respond to all submissions received by that date in our final determination.

Submissions should be sent to: [DMO@aer.gov.au](mailto:DMO@aer.gov.au)

Alternatively, submissions can be sent to:

Mark Feather  
General Manager, Policy and Performance  
Australian Energy Regulator  
GPO Box 520  
Melbourne VIC 3001

Submissions should be in PDF, Microsoft Word or another text readable document format.

We prefer that all submissions be publicly available to facilitate an informed and transparent consultative process. Submissions will be treated as public documents unless otherwise requested. Parties wishing to submit confidential information should:

1. clearly identify the information that is the subject of the confidentiality claim
2. provide a non-confidential version of the submission in a form suitable for publication.

All non-confidential submissions will be placed on our website. For further information regarding our use and disclosure of information provided to us, see the ACCC/AER Information Policy (June 2014), which is available on our website.<sup>1</sup>

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<sup>1</sup> <https://www.aer.gov.au/publications/corporate-documents/accc-and-aer-information-policy-collection-and-disclosure-of-information>

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## Shortened forms

Shortened form	Extended form
ABCB	Australian Building Codes Board
ACCC	Australian Competition and Consumer Commission
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
CARC	Customer acquisition and retention costs
CL	Controlled Load
COAG EC	Council of Australian Governments Energy Council
DMO	Default market offer
DNSP	Distribution Network Service Provider
EBRIN	Economic Benchmarking regulatory information notice
ECA	Energy Consumers Australia
EME	Energy Made Easy
FIT	Feed-in Tariff
kWh	Kilowatt Hours
kVa	Kilovolt Amperes
LAR	Local Area Retailer
LRET	Large-scale Renewable Energy Target
NEM	National Electricity Market
NER	National Electricity Rules
NERL	National Energy Retail Law
NERR	National Energy Retail Rules
NGL	National Gas Law
NUoS	Network use of system
QCA	Queensland Competition Authority

REPI	Retail Electricity Pricing Inquiry
SME	Small and medium-sized business customers (enterprises)
SRET	Small-scale Renewable Energy Target
ToU	Time of Use
UTP	(Queensland) Uniform Tariff Policy
VDO	Victorian Default Offer

# 1 Summary

This is our draft determination for retail electricity default market offer (DMO) prices that, should the *Competition and Consumer (Industry Code—Electricity Retail) Regulations 2019* (the draft Code) be made, will apply in network distribution zones where there is no retail price regulation.

In the final report of its Retail Electricity Pricing Inquiry (REPI), the Australian Competition and Consumer Commission (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.

The ACCC recommended that in non-price regulated jurisdictions, the standing offer and standard retail contract should be abolished and replaced with a default offer. Designated retailers, as defined in the National Energy Retail Law (NERL), should be required to supply electricity to consumers under a default offer on request, or in circumstances where the consumer otherwise does not take up a market offer.

The ACCC further recommended that the Australian Energy Regulator (AER) be given the power to set the maximum price for the default offer in each jurisdiction.

The ACCC noted that the default offer price will have two benefits:

- 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 discounts must be calculated from.

On 22 October 2018, the Commonwealth Treasurer and Minister for Energy wrote to us requesting we develop a mechanism for DMO prices and a reference bill by 30 April 2019, in time for the Government to implement them by 1 July 2019.<sup>2</sup>

As the first step in developing DMO prices, we published a Position Paper in November 2018. The Position Paper outlined preliminary positions for how we would determine DMO prices and included a number of questions for stakeholder input. We also held a public forum in December 2018 to discuss the issues raised in the Position Paper. We received 31 submissions to the Position Paper. We have had regard to these submissions, as well as feedback provided at our 5 December 2018 DMO public forum, in formulating this draft determination.

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<sup>2</sup> The Hon Josh Frydenberg, Treasurer, and the Hon Angus Taylor, Minister for Energy, *Letter to the AER*, 22 October 2018.



We have made this draft determination in accordance with the draft Code.

In making this draft determination we have had to carefully balance a number of important policy objectives. As a starting point, we have had regard to the need to reduce the unjustifiably high level of standing offer prices for consumers who are not engaged in the market. This is the key reason for the introduction of a DMO.

At the same time, we have sought to set DMO prices at a level that provides consumers and retailers with incentives to participate in the market, while allowing retailers to recover their efficient costs in servicing customers. The ACCC stated the default offer should not exist to be the lowest price, or close to the lowest price in the market. 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. We consider that these factors are important in facilitating competition, efficient investment, and innovation in retail markets.

As proposed in our Position Paper, we have used a price-based top-down approach for determining DMO prices. This method uses publicly available price information. We have also had regard to the forecast changes in key cost inputs, such as network charges and wholesale energy costs, for the 2019-20 period.

Our draft determination position is that the DMO price for each distribution zone will be set at the mid-point (50th percentile) of the range between the median market offer and median standing offer, based on generally available offers in October 2018.

We consider this approach meets all the relevant policy objectives for the introduction of the DMO and criteria set out in the draft Code.

The resulting draft determination DMO prices are set out in Table 1 below.

**Table 1: Draft Determination Default Market Offer prices – 1 July 2019**

Distribution zone	Residential Flat Rate	Residential Flat Rate with Controlled Load (30% CL usage)	Small Business Flat Rate
Ausgrid	\$1,441 for 3,800 kWh p.a.	\$2,063 for 6,800 kWh p.a.	\$7,266 for 20,000 kWh p.a.
<i>Median saving<sup>#</sup></i>	\$122	\$195	\$937
Endeavour Energy	\$1,720 for 4,900 kWh p.a.	\$2,144 for 7,400 kWh p.a.	\$6,167 for 20,000 kWh p.a.
<i>Median saving<sup>#</sup></i>	\$174	\$200	\$578
Energex	\$1,572 for 4,600 kWh p.a.	\$1,928 for 6,300 kWh p.a.	\$5,972 for 20,000 kWh p.a.
<i>Median saving<sup>#</sup></i>	\$115	\$168	\$453
Essential Energy	\$1,924 for 4,600 kWh p.a.	\$2,330 for 6,600 kWh p.a.	\$7,940 for 20,000 kWh p.a.
<i>Median saving<sup>#</sup></i>	\$146	\$176	\$745
SA Power Networks	\$1,943 for 4,000 kWh p.a.	\$2,420 for 6,000 kWh p.a.	\$9,014 for 20,000 kWh p.a.
<i>Median saving<sup>#</sup></i>	\$169	\$218	\$790

# Median saving is the difference in the median standing offer and the default market offer in that distribution zone, at that consumption level.

This draft determination, if adopted, would lead to reductions in median standing offer prices in all distribution zones ranging between:

- \$115 in Energex's zone and \$174 in Endeavour Energy's zone for residential customers on a flat rate tariff.
- \$168 in Energex's zone and \$218 in SA Power Network's (SAPN) zone for residential customers on flat rate tariffs with controlled load.
- \$453 in Energex's zone and \$937 in Ausgrid's zone for small business customers on a flat rate tariff.

We note that the DMO prices outlined above are an indicative price based on an assumed benchmark consumption level, and are not a 'maximum bill'. For an individual customer, their actual bill will vary depending on how much electricity they use, their distribution zone, and how their retailer has set the fixed and variable charges on their standing offer.

In accordance with the draft Code, we have specified DMO prices as annual price amounts, based on benchmark consumption levels, rather than as fixed and variable charges. Under the draft Code retailers must structure prices to not exceed the DMO annual price for the stated benchmark consumption level.

Our benchmark consumption levels for residential consumers in each distribution zone are derived from 2018 data provided by the network distribution businesses. The benchmark consumption level for small businesses is based on research conducted by Energy Consumers Australia. Our methodology for calculating these benchmarks is discussed in detail in chapter 4.

We consider that presenting the DMO price as an annual price is easier for customers to understand, and facilitates easier comparison than individual tariff components. It also provides retailers with flexibility to translate the annual amount into different tariff structures. Different retailers will have different tariff components of supply charges and usage charges. However, our expectation is that retailers, in formulating tariffs that are consistent with the policy intent, will take reasonable steps to ensure that customers will not be worse off under a DMO price tariff compared to what they are currently paying. In practice, we expect retailers should:

- maintain any relevant standing offer prices that are below the DMO price level at those current levels
- maintain any discounts offered to relevant standing offer customers where these result in a price lower than the DMO price.
- not increase relevant standing offer customers' fixed and variable tariff component prices

We intend to monitor the impact of DMO prices on the market. This will include monitoring changes retailers make to their standing and market offer prices.

As the draft Code is being made as an industry code under Part IVB of *the Competition and Consumer Act (2010)*, enforcement of its provisions would be the responsibility of the ACCC.

In addition to setting DMO prices, the Minister and Treasurer's letter requested we develop a mechanism for a reference bill. A reference bill would function as a benchmark comparison point, against which consumers could compare the relative price of different offers.

Given that the DMO price will be specified as annual dollar amount, the DMO price for each distribution zone will also function as the reference bill price for that zone.

The draft Code gives effect to the reference bill by requiring retailers to calculate their offers in relation to the AER's total annual price (that is, the DMO price) for a distribution zone.<sup>3</sup>

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<sup>3</sup> Draft Code, s 11,s 12.

## Next steps

This draft determination is one of the key steps in making our final determination. The final determination will be released no later than 30 April 2019.

Before that, stakeholders will have the opportunity to make submissions to us on our draft determination. Following receipt of submissions, we will then make our final determination taking into account submissions and any other relevant information.

Table 2 lists the key dates and consultation deadlines for the process.

We will publish details of all consultation steps and any public submissions received on our website.

To make a written submission please email: [DMO@aer.gov.au](mailto:DMO@aer.gov.au)

**Table 2: Key dates and consultation deadlines**

Stage	Timing
Publish draft determination	23 February 2019
Consultation on draft determination	Submissions due 20 March 2019
Issue final determination	30 April 2019

## Structure of this draft determination

- **Chapter 2** outlines the background and policy objectives for implementing DMO prices and proposed legislative framework
- **Chapter 3** sets out our annual price determination for DMO prices
- **Chapter 4** sets out our annual usage determination
- **Appendix 1** – Ministerial letter requesting AER commence work to develop DMO prices
- **Appendix 2** – List of stakeholder submissions to the AER's *DMO prices Position Paper*
- **Appendix 3** – List of annual bill calculation assumptions
- **Appendix 4** – Standing and market offer analysis for each distribution zone
- **Appendix 5** – Forecast changes in cost components
- **Appendix 6** – Time of Use assumptions

## 2 Background

The AER is the independent regulator for Australia's national energy market.

Our functions include regulating electricity networks and covered gas pipelines, in all jurisdictions except Western Australia. We enforce the laws for the National Electricity Market (NEM) and spot gas markets in southern and eastern Australia. We monitor and report on the conduct of market participants and the effectiveness of competition.

We protect the interests of household and small business consumers by enforcing the NERL. Our retail energy market functions cover New South Wales, South Australia, Tasmania, the ACT and Queensland.

Our goals include driving effective competition where this is feasible, providing effective regulation where competition is not feasible, and equipping consumers to participate effectively in the market.

This is our draft determination for DMO prices that, should the draft Code be made, will apply in distribution zones where there is no retail price regulation.

This is the first time we have made a determination on DMO prices for residential and small business customers as recommended by the ACCC in its REPI final report and requested by the Commonwealth Government.

In making this draft determination we have had regard to the policy intent as reflected in:

- The Treasurer and Minister for Energy's request in their 22 October 2018 letter to the AER (included as **Appendix 1**)
- The ACCC's REPI final report, in particular recommendations 30, 32, 49 and 50, and the related commentary.

(collectively referred to throughout this document as the 'policy intent').

We have also had regard to:

- Submissions received in response to our Position Paper.<sup>4</sup> A list of submissions is included in **Appendix 2**.
- Discussions and stakeholder feedback from our public forum. This was held in Sydney on 5 December 2018. Around 50 stakeholders attended, including retailers, consumer representatives, consultants and ombudsmen. Key themes and issues raised included:
  - General agreement that the proposed top-down pricing methodology was appropriate for the first DMO price determination

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<sup>4</sup> AER, *Default Market Offer (DMO) prices Position Paper*, November 2018.

- Determination of DMO prices in future years, and issues associated with the potential need to transition between different pricing approaches
  - The importance of a safety net for vulnerable customers
  - Application of the DMO to customers on particular tariff types, including flexible tariffs and demand tariffs
  - The value of a DMO given standing offer customer numbers are declining
  - The potential negative impacts of a DMO on competition, innovation and efficient investment
  - If DMO prices are presented as an annual bill, the impacts this may have on customers' whose usage profile is different to the average used to set DMO prices
  - General support for the concept of a reference bill as a mechanism to assist customers compare offers on a 'like for like' basis and as a means to promote competition between retailers.
- The draft Code
  - Any other relevant information.

## 2.1 The Commonwealth Government's request

On 22 October 2018, the Commonwealth Treasurer and Minister for Energy requested that:<sup>5</sup>

*...the AER commence work immediately on developing a mechanism for determining the price of the default market offer, consistent with the ACCC's recommendations. As part of this, we ask that the AER also develop a mechanism for determining a reference bill for each network distribution region, from which headline discounts can be calculated, in accordance with ACCC Recommendations 32 and 50.*

*We ask that the AER's final determination for 1 July 2019 default offer prices and the reference bill be publicly released by 30 April 2019, to bring about price reductions for residential and small business consumers.*

The letter of request is included as **Appendix 1** and also published on our website.<sup>6</sup>

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<sup>5</sup> The Hon Josh Frydenberg, Treasurer and the Hon Angus Taylor, Minister for Energy, *Letter to the AER*, 22 October 2018.

<sup>6</sup> Available at: <https://www.aer.gov.au/system/files/Letter%20to%20the%20AER%20Chair%20-%20default%20pricing.pdf>

## 2.2 What is the Default Market Offer?

Currently, the NERL and the National Energy Retail Rules (NERR) include a framework under which all retailers are required to provide services to residential and small business customers under a standard retail contract if the small customer does not otherwise accept a market offer.<sup>7</sup> Retailers must publish, on their websites, a standard retail contract for all distribution zones in NEM regions that they operate in.<sup>8</sup> Retailers' standard retail contracts must adopt the model terms and conditions set out in the NERR.<sup>9</sup> As summarised in the ACCC's REPI final report:<sup>10</sup>

*Governments retained standing offers after price regulation was removed to provide a safety net for consumers who had not engaged in the market, or for consumers who face barriers to accessing a market offer due to credit issues or other reasons. The standing offer was also used as a default offer for consumers who are switched following a retailer of last resort event. Given the role of a standing offer as a default safety net offer, the standard retail contract includes some additional consumer protections that are not required in all market retail contracts, such as access to paper billing, minimum periods before bill payment is due, a set period for reminder notices, and no more than one price change every six months.*

In non-price regulated jurisdictions, retailers are currently free to determine the prices of their standard offers subject to these terms and conditions.

The DMO is intended to be a service, which all retailers in a non-price regulated distribution zone are obliged to offer customers that do not otherwise take up a market offer for the provision of electricity retail services. That is, it is to replace retailer-set standing offer.

The proposed July 2019 implementation of the DMO under the draft Code will incorporate the current standing offer framework in the NERL, including the standard retail contract. The new feature compared to the current standing offer framework is the introduction of a maximum default offer price for relevant standing offers.

We refer to the maximum price for standing offers as the 'DMO price'.

After establishing the initial legislative framework for the DMO, the Commonwealth Government has indicated that it will seek Council of Australian Governments (COAG) Energy Council support to replace the standing offer framework in the NERL with a new default market offer including the remaining parts of the ACCC's recommendations. This would result in further changes to features of the framework such as terms and conditions in the standard retail contract.

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<sup>7</sup> NERL, s. 22(1); NERR, r. 16.

<sup>8</sup> NERL, s. 25(1).

<sup>9</sup> NERL, s. 25.

<sup>10</sup> ACCC, *Retail Electricity Pricing Inquiry - Final Report*, June 2018, p. 240.

## 2.3 ACCC Recommendations

In making its request to the AER, the Commonwealth Government referred specifically to recommendations 30, 32, 49 and 50 from the ACCC REPI final report. These recommendations are summarised in Table 3.

**Table 3: REPI recommendations relating to the default market offer and reference bill**

Number	Recommendation
30	<p>In non-price regulated jurisdictions, the standing offer and standard retail contract should be abolished and replaced with a default market offer at or below the price set by the AER.</p> <ul style="list-style-type: none"><li>• Designated retailers, as defined in the NERL, should be required to supply electricity to consumers under a default offer on request, or in circumstances where the consumer otherwise doesn't take up a market offer</li><li>• The default offer should contain simple pricing, minimum payment periods, and access to bill smoothing and paper bills</li><li>• 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.</li><li>• The default offer should be used by retailers in all circumstances where a standing offer is currently used. This includes circumstances where a consumer has moved into a premises but has not contacted the retailer, where a consumer has not selected a market offer before the expiry of a market contract, and where a consumer is switched through a retailer of last resort event.</li></ul>
32	<p>If a retailer chooses to advertise using a headline discount claim it must calculate the discount from the reference bill amount published by the AER.</p> <ul style="list-style-type: none"><li>• The AER should publish a reference bill amount for each distribution zone using AER bill benchmarks for medium (2–3 person) households and the price set by the AER for default offers (recommendation 30).</li><li>• Retailers must calculate all discounts off the reference bill, including win-back and retention offers that have discounts attached to them</li><li>• Headline discounts in advertising must only include guaranteed (unconditional) discounts.</li></ul>



49	The ACCC's recommendation to abolish the standing offer and replace it with a 'default offer' at or below a price set by the AER (recommendation 30) should be extended to all generally available offers including offers for Small and Medium Enterprise customers.
50	The ACCC's recommendation that all discounts must be calculated from a reference bill amount set by the AER (recommendation 32) should be extended to all generally available offers including offers for SME customers. The AER should develop a process for determining a benchmark for representative usage levels for an average SME customer. Similarly, restricting conditional discounts to the reasonable savings that a retailer expects to make if a consumer satisfies the conditions (recommendation 33) should also apply to offers for small business.

Source: ACCC, Retail Electricity Pricing Inquiry- Final Report, June 2018, pp. xvii-xxv

These recommendations were designed to address two key issues, described in the ACCC's REPI final report as follows:<sup>11</sup>

- In non-price regulated jurisdictions, the standing offer and standard retail contract are no longer fit for purpose. The standard retail contract is not operating as an effective default offer, nor is it delivering essential consumer protections that justify the high price of the offer.
- In recent times, standing offer prices have often been set at a high level to enable retailers to advertise high headline discounts for market offers.

## 2.4 ACCC Commentary on the DMO price

The ACCC's REPI final report stated the DMO price should not be the lowest price in the market, but should reflect the operating costs of an efficient retailer, including a reasonable retail margin and customer acquisition and retention costs (CARC). DMO prices should fall somewhere between current standing offer prices and current market offers.

It was also clear to differentiate the purpose of a DMO price from retail price regulation in areas where there is limited retail competition:

*The default offer should not exist to be a price accessed by most, if not all, consumers in the market. In NEM regions where there is little competition (that is, in Tasmania, regional Queensland and the ACT, and most consumers are on the standing offer) it is appropriate for the regulated price to include little or no CARC. In contrast, in NEM regions where the majority of consumers are on competitive market offers, the*

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<sup>11</sup> ACCC, Retail Pricing Inquiry – Final Report, June 2018, p. 240.

*default offer price should be set at a higher level. To do otherwise would ignore the costs of customer acquisition being incurred by retailers and would discourage consumer participation and risk significantly increasing consumer disengagement.*<sup>12</sup>

It also identified that:

*...the ACCC considers that the AER should calculate the default offer price in each distribution zone based on the efficient costs of operating in each jurisdiction, including the costs of supplying an offer with additional consumer protections, such as paper billing and bill smoothing. This should include a reasonable margin as well as an allowance for CARC.*<sup>13</sup>

## 2.5 Who will this affect?

The DMO price will affect residential and small business customers currently on standing offers in distribution zones where there is not already price regulation, and whose standing offer is of a tariff type for which we determine a DMO price.

### *Customers on standing offers*

The DMO price will limit the prices charged to current and future standing offer customers but not to customers on market offers. The key policy objective of the DMO price is to mitigate the impact of unjustifiably high prices for standing offer customers while allowing scope for continued competition in market offers.

The majority of standing offer customers are customers of the Tier 1 retailers (AGL, EnergyAustralia and Origin Energy).<sup>14</sup>

More specifically, the local area retailer (LAR) in each distribution zone has the highest proportion of customers on standing offers.<sup>15</sup>

The LAR (always a Tier 1 retailer) is the retailer that acquired the region's customer base at the time of retail market privatisation.<sup>16</sup>

AEMC analysis of retailer data shows that on average in each distribution zone:

- 22 per cent of the LAR's customers are on standing offers
- Only 3 per cent of non-LAR customers are on standing offers, including other Tier 1 retailers.<sup>17</sup>

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<sup>12</sup> ACCC, *Retail Electricity Pricing Inquiry - Final Report*, June 2018, p. 249.

<sup>13</sup> ACCC, *Retail Electricity Pricing Inquiry - Final Report*, June 2018, p. 249.

<sup>14</sup> ACCC, *Retail Electricity Pricing Inquiry - Final Report*, June 2018, pp. 141, 241–242; AER, *Annual report on compliance and performance of the retail energy market 2017-18*, pp. 29-30.

<sup>15</sup> AEMC, *Advice to COAG Energy Council: Customer and competition impacts of a default offer*, 20 December 2018, pp. 14-15.

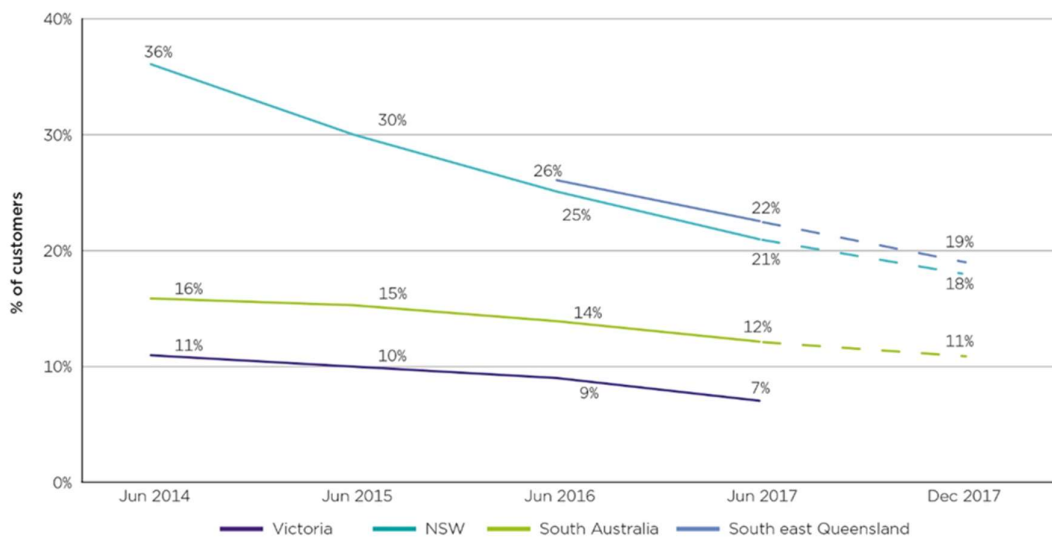
<sup>16</sup> We note that while AGL and Origin acquired the Energex customer base, Origin is the formally designated LAR under the NERL.

The AEMC and ACCC identified that customers on standing offers will be customers who:

- have not taken up a market offer since the introduction of competition in that jurisdiction – these will be customers of the LAR
- are supplied under a retailer's 'obligation to supply' obligations (for example, if a poor credit history means other retailers will not supply them)<sup>18</sup>
- have moved into a premises and receive supply from the existing retailer supplying the premises<sup>19</sup>, but are yet to make contact with the retailer
- have defaulted to a standing offer following the expiry of a market contract.<sup>20</sup>

Figure 1 sets out the trend and proportions of standing offer customers by distribution zone.

**Figure 1: Residential customers on standing offers in non-price regulated areas, 2014–17**



Source: ACCC, Retail Electricity Pricing Inquiry- Final Report, June 2018, p. 240

While the number of customers on standing offers has reduced over time, a significant proportion are still not accessing more competitive market offers. AEMC analysis of

<sup>17</sup> AEMC, *Advice to COAG Energy Council: Customer and competition impacts of a default offer*, 20 December 2018, pp. 14-15.

<sup>18</sup> Unlike other retailers, under s22 of the NERL LARs cannot refuse to supply customers.

<sup>19</sup> AEMC, *Advice to COAG Energy Council: Customer and competition impacts of a default offer*, 20 December 2018, p. 15.

<sup>20</sup> We note that under the draft Code the DMO price will not apply customers who are on 'evergreen' ongoing market contracts where discounts have expired, and who in practice are paying a retailer's standing offer prices.

this inertia suggests that the reasons for not switching might depend on factors such as:<sup>21</sup>

- customer awareness of the different types of offers available to them and the ability to switch providers.
- whether customers actively investigate offers, and how they behave once they have investigated offers.
- the ability of customers to compare offers given the information that is available to them through private and government websites.<sup>22</sup>

Under the NERL retailers are also able to switch a consumer, without their explicit informed consent, to a standard retail contract in circumstances where the consumer has not chosen a new market contract prior to the expiry of their current one, or is switched through a retailer of last resort event.<sup>23</sup>

The draft Code requires retailers not charge a standing offer customer more than the DMO price for their distribution and tariff type (based on the relevant consumption benchmark). In practice, this means retailers would have to reduce the prices of relevant existing standing offer customers who are paying more than the DMO price.

Importantly, the ACCC noted there is a small cohort of consumers who cannot access a market offer. This could be due to there being limited market offers where they live (for example in rural areas), or that retailers do not wish to serve them due to poor credit history.<sup>24</sup> The AEMC also highlighted that reasons for not switching may differ between customers and classes of customers.

In its recent advice to COAG Energy Council on the impacts of the DMO, the AEMC forecast reductions in customers on standing offers further to those presented in Figure 1 above. The AEMC reported the number of customers on standing offers in South Australia to be under ten per cent and in New South Wales and South East Queensland to be approximately 14 per cent, as at December 2017.<sup>25</sup> The AEMC considered that based on current trends, all jurisdictions are likely to have fewer than 10 per cent of residential customers on standing offers within the next two years.<sup>26</sup>

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<sup>21</sup> AEMC, *2017 Retail Electricity Competition Review*, July 2017, p. 73.

<sup>22</sup> The AER is undertaking a range of work to facilitate easier comparison of energy offers, including through improvements to its Energy Made Easy website, and the recent review of our Retail Pricing Information Guidelines.

<sup>23</sup> NERL, ss. 38(1), 54(2), 140(1).

<sup>24</sup> ACCC, *Retail Electricity Pricing Inquiry - Final Report*, June 2018, p. 247.

<sup>25</sup> AEMC, *Advice to COAG Energy Council: Customer and competition impacts of a default offer*, 20 December 2018, p. 13.

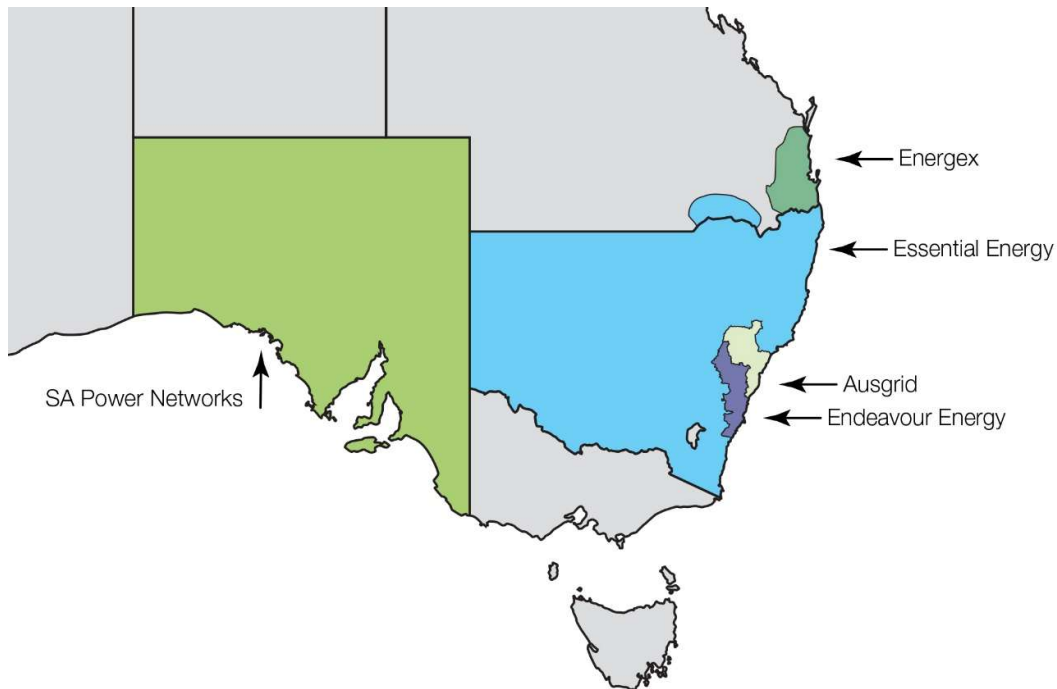
<sup>26</sup> AEMC, *Advice to COAG Energy Council: Customer and competition impacts of a default offer*, 20 December 2018, p. ii.

### *Customers in distribution zones with deregulated prices*

Under the draft Code, DMO prices would apply in distribution zones that are not subject to price regulation by jurisdictional regulators.<sup>27</sup> These distribution zones are in the following areas:

- New South Wales
- South Australia
- South-East Queensland

**Figure 2: Distribution zones with deregulated prices**



The jurisdictions where we will not determine a DMO price are:

- The Australian Capital Territory – The Independent Competition and Regulatory Commission currently regulates the price for the supply of electricity to small customers in the ACT purchased from ActewAGL Retail under regulated tariffs.<sup>28</sup>

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<sup>27</sup> Section 8 of the draft Code specifies that the instrument would not apply in a distribution region if any standing offer prices, or maximum standing offer prices, for supplying electricity in the year in the region to a small customer are set by or under a law of a State or Territory.

<sup>28</sup> See: <https://www.icrc.act.gov.au/energy/electricity/>

- The Northern Territory – The Northern Territory Government regulates retail electricity tariffs and charges, via an Electricity Pricing Order issued by the Regulatory Minister. This pricing order applies to contestable customers using less than 750 MWh per annum.<sup>29</sup>
- Queensland (except for South-East Queensland) – Standing offer retail prices in Ergon's distribution zone are regulated under the Queensland Government's Uniform Tariff Policy (UTP) by Queensland Competition Authority (QCA).<sup>30</sup>
- Tasmania – The Tasmanian Economic Regulator approves the maximum prices that a Regulated Offer Retailer can charge its regulated customers.<sup>31</sup>
- Western Australia – The Western Australian Government regulates Synergy's and Horizon Power's (main retailers) electricity prices through its Uniform Tariff Policy.<sup>32</sup>
- Victoria – The Victorian Government has issued terms of reference for ESCV to develop a methodology to calculate a Victorian Default Offer (VDO) for small electricity customers, by 3 May 2019.<sup>33</sup> The VDO would be implemented from 1 July 2019.

## 2.6 Tariff types for which we determine a DMO price

As noted earlier, the NERL requires retailers to supply customers under a standing offer in certain circumstances. This requires that all retailers have at least one standing offer available in each distribution zone in which they participate. In practice, retailers typically offer numerous different standing offers for residential and small business customers within a distribution zone. The differences between these offers reflects the range of different tariff structures, with retailers typically mirroring the network tariff structure applied to a customer.

Table 4 shows the different standing offer tariff types that a retailer in a particular distribution zone might offer residential customers.

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<sup>29</sup> See: <http://www.utilicom.nt.gov.au/electricity/Pages/default.aspx>

<sup>30</sup> See: <https://www.dews.qld.gov.au/electricity/regulation>

<sup>31</sup> See: <https://www.economicregulator.tas.gov.au/electricity>

<sup>32</sup> See: <https://www.treasury.wa.gov.au/Public-Utilities-Office/Household-energy-pricing/Electricity-pricing/>

<sup>33</sup> See: <https://www.esc.vic.gov.au/taxonomy/term/14>

**Table 4: Indicative tariff types**

Tariff type	Description
Flat rate	A flat rate tariff includes a fixed daily supply charge, and a variable charge reflecting the volume (in kilowatt hours [kWh]) of electricity consumed. Usage charges do not vary by time of day, but may change based on overall consumption in a period (block tariffs) or the time of the year (seasonal tariffs).
Controlled load	A controlled load tariff is an additional charge element (potentially including both fixed and variable components) for a separately metered part of a customer's load (for appliances such as electric hot water storage systems or slab or underfloor heating). A controlled load tariff is generally a lower rate as these appliances operate during off-peak hours (usually overnight). Some tariffs incorporate multiple controlled load components.
Time of use	Time of use (ToU) pricing applies different charges to electricity usage (in kWh) at different times of the day (or week). Days are commonly split into peak and off-peak (and sometimes shoulder) periods. Peak periods are intended to correspond to the times the network faces high demand, but in practice are wide periods that cover much of the day. These tariffs also include a fixed daily supply charge.
Demand	In contrast to both flat rate and ToU pricing, which are based on kWh usage, a demand tariff differs in that it is based on the maximum point in time demand (in kilowatts [kW] or kilovolt amperes [kVa]) of a customer during pre-defined 'peak windows'. The windows are set by reference to the usual peak network demand. A customer's demand charge is reset after a defined period (for example, a month). Usage outside of the relevant pre-defined period does not contribute to the demand charge component (although usage charges and fixed charges may still apply).

Under the draft Code, we are required to determine DMO prices for residential customers on:

- A flat rate usage tariff
- A controlled load tariff.<sup>34</sup>

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<sup>34</sup> Draft Code, sections 6 and 14(1)(b).

Under the draft Code, we are required to determine DMO prices for small business customers on:

- A flat rate usage tariff.<sup>35</sup>

As noted in our Position Paper, these tariffs reflect the type of tariff that the majority of residential and small business standing offer customers are likely to be on.

A number of stakeholders provided submissions to our Position Paper on the issue of what tariff types should be subject to a DMO price.<sup>36</sup> Given the draft Code now prescribes what tariffs types will be subject to a DMO price, we are proceeding on the basis that this is an issue that is beyond our discretion.

## 2.7 Related policy processes

At the COAG Energy Council meeting of 26 October 2018, Ministers agreed:<sup>37</sup>

- on the need to develop a reference point/comparison rate against which all offers could be measured, for consideration at the December Council meeting.<sup>38</sup>
- that the AEMC undertake work on the impacts of the Commonwealth's proposed DMO on competition issues and customer impacts.

The AEMC published its advice to COAG Energy Council on the competition and price impacts of a DMO on its website on 20 December 2018.<sup>39</sup>

At the COAG Energy Council meeting of 19 December 2018, Ministers agreed:<sup>40</sup>

- to the adoption of a reference bill by 1 July 2019, as proposed in the ACCC's Retail Electricity Pricing Inquiry, in network regions that do not have a regulated standing offer price.
- the AER will jointly determine the price with the affected jurisdictions.
- to commence work on a reference bill against which customers can compare other offers by preparing any necessary changes to support the design and enforcement of the measure, and potentially enacting the reference bill through Commonwealth law to ensuring its implementation by 1 July 2019.

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<sup>35</sup> Draft Code, sections 6 and 14(1)(b).

<sup>36</sup> Origin, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 4; EnergyAustralia, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 4; ERM Power, *Submission to AER on Default Market Offer Position Paper*, 7 December, pp. 1-2; AGL, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 5; EWOSA, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 1; St Vincent de Paul Society and SACOSS, *Submission to Default Market Offer Position Paper*, 6 December 2018, pp. 1-3.

<sup>37</sup> COAG Energy Council, *20th Energy Council Ministerial Meeting Communique*, 26 October 2018.

<sup>38</sup> Western Australia, Victoria, Tasmania and the Northern Territory noted that this would not apply in their jurisdictions.

<sup>39</sup> See: <https://www.aemc.gov.au/market-reviews-advice/advice-coag-energy-council-default-offer>

<sup>40</sup> COAG Energy Council, *21st Energy Council Ministerial Meeting Communique*, 19 December 2018.



We note that the concept of a reference bill has also been referred to as a 'comparison price' or 'reference price'. A key difference between COAG Energy Council's reference bill proposal and a reference bill based on DMO prices is that COAG Energy Council's reference bill would not be a maximum cap on standing offers prices, whereas the DMO price reference bill would be a cap.

A number of stakeholders in response to our Position Paper raised the issue of whether a DMO and/or reference bill should be implemented at all.

Public Interest Advocacy Centre (PIAC) supported the introduction of a DMO. It considered that a strong default mechanism provides incentives for retailers to innovate in a manner that will better serve customers through differentiation in service, rather than just price.<sup>41</sup>

Customer groups generally supported the implementation of a DMO alongside the establishment of a reference price or comparison rate.

- Energy and Water Ombudsman SA (EWOSA), St Vincent de Paul Society and South Australian Council of Social Service (SACOSS) supported the DMO for residential customers as it has the potential to improve outcomes for disengaged customers.<sup>42</sup> However, St Vincent de Paul Society and SACOSS raised concerns with the interaction of DMO with other market reforms such as a reference bill. They submitted that the DMO should be implemented alongside other REPI recommendations.<sup>43</sup>
- National Seniors Australia (NSA) submitted that seniors generally have a low level of digital literacy and therefore struggle to engage in the electricity retail market. NSA stated that this demographic should not be penalised as a result of this.<sup>44</sup>
- National Farmers Federation (NFF) raised the need for simplicity in how prices are communicated.<sup>45</sup>
- CHOICE supported a 'safe default offer' (i.e. an affordable capped price, available to everyone, free from excessive marketing costs, a safety net).<sup>46</sup> CHOICE was supportive of a reference bill and considered that reference bills will play a key role in helping consumers compare offers.<sup>47</sup>

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<sup>41</sup> PIAC, *Submission to Default Market Offer Position Paper*, 10 December 2018, p. 7.

<sup>42</sup> EWOSA, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 1; St Vincent de Paul Society and SACOSS, *Submission to Default Market Offer Position Paper*, 6 December 2018, pp. 1-3.

<sup>43</sup> St Vincent de Paul Society and SACOSS, *Submission to Default Market Offer Position Paper*, 6 December 2018, p. 1.

<sup>44</sup> National Seniors Australia, *Submission to Default Market Offer Position Paper*, 7 December 2018, pp. 1-2.

<sup>45</sup> National Farmers Federation, *RE: Australian Energy Regulator's Position Paper on Default Market Offer Price*, 5 December 2018, pp. 2-3.

<sup>46</sup> CHOICE, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 2.

<sup>47</sup> CHOICE, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 9.

Australian Energy Council<sup>48</sup> and the majority of retailers<sup>49</sup> opposed the DMO, submitting it would have significant impacts on competition and customer engagement. Retailers noted customers may have a perception that the DMO will be a 'regulator approved' price, which may reduce engagement. Retailers considered a non-cap reference price for calculating discounts instead of a regulated price would deliver benefits with a reduced risk of regulatory error.<sup>50</sup>

In addition, AGL highlighted that disengaged consumers are a small and reducing number of customers, with:<sup>51</sup>

- changes to the regulatory framework introduced to ensure that this number continues to decrease; and
- AGL, and other retailers, having introduced significant pricing changes to minimise the impact of standing offer prices on many these customers.<sup>52</sup>

Alinta Energy submitted that it does not support price regulation in any form. Alinta Energy stated that the policy objectives of the DMO price can be achieved through alternative approaches that allow retailers to manage price risk. Alinta Energy proposed a methodology that allows a maximum allowable percentage between the market offer and the equivalent standing offer price.<sup>53</sup>

The South Australian Government was concerned that introducing a DMO, which it considered is effectively re-introducing retail price regulation, may adversely impact smaller retailers and therefore retail competition. The South Australian Government submitted it is willing to consider options such as a form of reference price which establishes a base that all offers can be measured against, but without a maximum price being set by the AER.<sup>54</sup>

The South Australian Government also noted the recent COAG Energy Council meeting where it was agreed the AEMC should undertake work on the impacts of the

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<sup>48</sup> AEC, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, pp. 1-2.

<sup>49</sup> AGL, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, pp. 1-2; Alinta, *Submission to AER on Default Market Offer Position Paper*, 7 December 2017, pp. 1-3; Origin, *Submission to the AER: Default Market Offer Price*, 7 December 2018, pp. 1-2; Simply, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, pp. 1-2; Powershop, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 1; LPE, *Submission to AER on Default Market Offer Position Paper*, 6 December 2018, p. 1

<sup>50</sup> AGL, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, pp. 1-2; Origin, *Submission to the AER: Default Market Offer Price*, pp. 1-2; Simply Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, pp. 1-2; Powershop, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 1; EnergyAustralia, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, pp. 1-4.

<sup>51</sup> AGL, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, pp. 1-2.

<sup>52</sup> AGL, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 6.

<sup>53</sup> Alinta Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, pp. 1-3.

<sup>54</sup> SA Minister for Energy and Mining, *Submission to AER on Default Market Offer Position Paper*, 14 December 2018, pp. 1-3.

proposed DMO on competition and customers. It noted the importance of ensuring any reforms do not result in a reduction of attractive market offers available to customers.<sup>55</sup>

While we recognise the concerns raised by consumers and retailers about the implementation of a DMO, we note that this is a policy decision that rests with the Government through the draft Code.

Nevertheless, as part of making this draft determination, we have been mindful of the risks and potential issues with the introduction of a DMO, as identified by stakeholders. This information has been relevant in us exercising our judgement in balancing the objective to address unjustifiably high standing offer prices in a manner that does not compromise competition, efficient investment and customer engagement. These considerations are set out in chapter 3.

The draft Code gives effect to the reference bill by requiring retailers to describe their prices in relation to the AER's total annual price (that is, the DMO price) for a distribution zone.<sup>56</sup>

## **2.8 Retailer announcements on standing offer discounts**

A number of retailers have recently made announcements in relation to discounts off their standing offers prices. These discounts took effect from 1 January 2019 and are outlined in Table 5 below.

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<sup>55</sup> SA Minister for Energy and Mining, *Submission to AER on Default Market Offer Position Paper*, 14 December 2018, pp. 1-3.

<sup>56</sup> Draft Code, s 11.

**Table 5: Retailer announcements effective 1 January 2019**

Retailer	NSW	SE Queensland	South Australia
AGL Energy <sup>57</sup> (all standing offer customers)	10% off the usage component for all standing offer customers who have been on standing offers for a minimum of 12 months	5% off the usage component for all standing offer customers who have been on standing offers for a minimum of 12 months	7% off the usage component for residential and small business standing offer customers who have been on standing offers for 12 months
EnergyAustralia <sup>58</sup> (residential standing offer customers only)	15% off the usage component for all concession standing offer customers	15% off the usage component for all concession standing offer customers	15% off the usage component for all concession standing offer customers
Origin Energy <sup>59</sup> (residential standing offer customers only)	10% off the usage component for all concession standing offer customers	10% off the usage component for all concession standing offer customers	10% off the usage component for all concession standing offer customers
Red Energy/Lumo Energy <sup>60</sup> (all customers)	10% off the whole bill for all standing offer customers	10% off the whole bill for all standing offer customers	10% off the whole bill for all standing offer customers
Alinta Energy (all customers)	15% off the usage component for all standing offer customers	20% off the usage component for all standing offer customers	17% off the usage component for all standing offer customers

Source: Hon. Angus Taylor, Energy Minister, 1 January 2019, <http://www.environment.gov.au/minister/taylor/media-releases/mr20190101.html>

<sup>57</sup> AGL, *AGL announces safety net for electricity customers*, 16 November 2018, <https://www.agl.com.au/about-agl/media-centre/asx-and-media-releases/2018/november/agl-announces-safety-net-for-electricity-customers>

<sup>58</sup> EnergyAustralia, *EnergyAustralia concession customers to receive automatic discounts*, November 27 2018, <https://www.energyaustralia.com.au/about-us/media/news/energyaustralia-concession-customers-receive-automatic-discounts>

<sup>59</sup> Origin, *Origin to lower energy prices for concession customers*, 30 November 2018, <https://www.originenergy.com.au/about/investors-media/media-centre/origin-to-lower-energy-prices-for-concession-customers.html>

<sup>60</sup> Red Energy, *Snowy Hydro's retailers give unconditional discounts to their standing offer customers*, 30 November 2018, <https://www.redenergy.com.au/media-releases/snowy-hydro-retailers-give-unconditional-discounts-to-their-standing-offer-customers.html>

## 2.9 Proposed legislative framework for DMO prices

As identified in the letter from the Commonwealth Government, the introduction of the DMO price will require legislative support. This legislation is not yet in place. However, the Commonwealth Government is currently consulting on a draft *Competition and Consumer (Industry Code—Electricity Retail) Regulations 2019 (Electricity Retail Code of Conduct)* (the draft Code) which is proposed to be implemented through Commonwealth legislation.

Nonetheless, to make a determination by 30 April 2019 and allow for appropriate consultation with stakeholders, we have commenced work in advance of the legislation being finalised. As further information becomes available on the final form of the legislation, we will reflect this in our process.

The draft Code is available on the website of the Commonwealth Department of the Environment and Energy. We have referenced the relevant draft Code requirements where relevant throughout this draft determination.

### 3 Annual price determination

This chapter sets out our pricing methodology and reasoning for our draft determination DMO prices for 2019-20.

The draft determination DMO prices for each distribution zone are set out in Table 6 below.

**Table 6: Draft Determination Default Market Offer prices – 1 July 2019**

Distribution zone	Residential Flat Rate	Residential Flat Rate with Controlled Load (30% controlled load)	Small Business Flat Rate
Ausgrid	\$1,441 for 3,800 kWh p.a.	\$2,063 for 6,800 kWh p.a.	\$7,266 for 20,000 kWh p.a.
<i>Median saving<sup>#</sup></i>	\$122	\$195	\$937
Endeavour Energy	\$1,720 for 4,900 kWh p.a.	\$2,144 for 7,400 kWh p.a.	\$6,167 for 20,000 kWh p.a.
<i>Median saving<sup>#</sup></i>	\$174	\$200	\$578
Energex	\$1,572 for 4,600 kWh p.a.	\$1,928 for 6,300 kWh p.a.	\$5,972 for 20,000 kWh p.a.
<i>Median saving<sup>#</sup></i>	\$115	\$168	\$453
Essential Energy	\$1,924 for 4,600 kWh p.a.	\$2,330 for 6,600 kWh p.a.	\$7,940 for 20,000 kWh p.a.
<i>Median saving<sup>#</sup></i>	\$146	\$176	\$745
SA Power Networks	\$1,943 for 4,000 kWh p.a.	\$2,420 for 6,000 kWh p.a.	\$9,014 for 20,000 kWh p.a.
<i>Median saving<sup>#</sup></i>	\$169	\$218	\$790

# Median saving is the difference in the median standing offer and the default market offer in that distribution zone, at that consumption level.

We note that the DMO prices outlined above are an indicative price based on an assumed benchmark consumption level, and are not a 'maximum bill'. For an individual customer, their actual bill will vary depending on how much electricity they use, their distribution zone, and how their retailer has set the fixed and variable charges on their standing offer.

In accordance with the draft Code, we have specified DMO prices as annual price amounts, based on the benchmark consumption levels, rather than as fixed and variable charges. Under the draft Code, retailers must structure prices to not exceed the DMO annual price for the stated consumption level.<sup>61</sup> Our methodology for calculating these benchmarks is discussed in detail below (chapter 4).

We consider that presenting the DMO price as an annual price is more comprehensible for customers, and facilitates easier comparison than individual tariff components. It also provides retailers with some flexibility to translate the annual amount into different tariff structures. Different retailers will have different tariff components of supply charges and usage charges. This approach was generally supported by stakeholder submissions to our Position Paper.<sup>62</sup>

However, our expectation is that retailers would take reasonable steps to ensure that customers will not be worse off under a DMO price, compared to what they are currently paying

In most distribution zones, we observe that a few retailers' current standing offer prices are below the draft determination DMO price (see **Appendix 4**). As the DMO price is a maximum price, there is no basis or requirement for these standing offers prices to be increased to the DMO price level. Our expectation is that the DMO price would not impact these retailers' standing offer prices and their customers would continue to receive the current (as at October 2018) standing offer price levels.

Similar to the above point, there will be no constraint on retailers continuing to offer discounts off their DMO prices. As outlined in section 2.8, a number of retailers introduced discounts on standing offer prices that took effect in January 2019. It has been reported that these discounts will affect approximately half of existing standing offer customers. These discounted prices appear to reflect what the retailers themselves consider are a fairer level of standing offer prices for this subset of customers. Our expectation is that standing offer customers who are currently benefitting from a retailer discount would continue to receive the discounted prices where they are lower than the DMO price, and not be disadvantaged in any way by the introduction of the DMO price.

We expect no customer should be worse off under the implementation of DMO prices, irrespective of their consumption level. Where a retailer's fixed and variable cost structure remains broadly consistent over time, we expect that the introduction of the DMO would not increase the fixed or variable charge components of existing standing

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<sup>61</sup> The ACCC would be responsible for compliance and enforcement of the draft Code.

<sup>62</sup> EWON, *Submission to the AER: Default Market Offer Price*, 6 December 2018, p. 4; Handled, *Submission to the AER: Default Market Offer Price*, 23 November 2018, p. 7; EWOSA, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 3; CHOICE, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 10; Simply Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 3; OC Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p.3; Vocus Group, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 3.

offer prices that are subject to the DMO. In transitioning to DMO prices we consider retailers should not increase the current levels (as at October 2018) of their fixed and variable components of each DMO tariff type. This approach would enable retailers to maintain their different tariff structures and still provide some flexibility to set their fixed and variable tariff components but, consistent with the policy intent, would safeguard against customers at different consumption levels being worse off with the introduction of the DMO price. This is an issue that the AER intends to monitor following the implementation of the DMO price.

### 3.1 Draft Code requirements

Under section 14(1)(b) of the draft Code, we are required to determine what we consider is a reasonable total annual price for supplying electricity to a customer within a distribution region, for a certain consumption level.

In making this determination, we must have regard to the matters under section 14(4) and have used the relevant model annual usage amounts outlined in chapter 4.

We have also had regard to the submissions made in response to our Position Paper, and considered stakeholder feedback from our public forum.

Table 7 summarises how we have had regard to each of these matters under section 14(4) in determining total annual prices.

**Table 7: Matters the AER is required to consider in determining DMO prices**

Draft Code Section 14(4)	AER considerations
(a) the prices electricity retailers charge for supplying electricity in the region to that type of small customer	<p>We have used a sample of the generally available market offers and standing offers in each distribution region sourced from Energy Made Easy as part of our pricing methodology.</p> <p>We have had regard to the different levels and dispersion of available offers in each distribution region in determining DMO prices.</p> <p>We have also had regard to the retail offer prices for customers on the relevant tariff type in each distribution zone.</p>



<p>(b) the principle that an electricity retailer should be able to make a reasonable profit in relation to supplying electricity in the region</p>	<p>We have used information on the generally available market offers and standing offers that are offered in each distribution region in determining DMO prices.<sup>63</sup> The observed standing and market offers (on a portfolio basis) will reflect market participants' own expectations about the efficient costs of providing retail services in particular distribution zones, including a reasonable profit margin.</p> <p>In addition we have set DMO prices above the observed median market offer in each distribution region in order to exclude any potential below cost prices/loss-leading offers that may not reflect a reasonable profit margin.</p>
<p>(c) the following costs:</p> <p>(i) the wholesale cost of electricity in the region;</p> <p>(ii) the cost of distributing and transmitting electricity in the region;</p> <p>(iii) the cost of complying with the laws of the Commonwealth and the relevant State or Territory in relation to supplying electricity in the region;</p> <p>(iv) if relevant to the region—the cost of acquiring and retaining small customers;</p> <p>(v) the cost of serving small customers;</p>	<p>Our pricing methodology takes account of these types of costs in two key ways.</p> <p>First, as noted above, we have used the generally available market offers and standing offers in a distribution region as part of our pricing methodology. The offers will reflect market participants' own expectations about the costs of providing retail services in particular distribution zones, including the cost of acquiring and retaining small customers.</p> <p>Second, to account for any potential changes to costs in 2019-20, we have considered the likely direction and magnitude of changes for the main types of costs:</p> <ul style="list-style-type: none"> <li>• We have had regard to publicly available information on forecast changes in the wholesale energy costs for 2019-20.</li> <li>• We have had regard to the AER's pricing determinations for regulated transmission and distribution costs for 2019-20.</li> <li>• We have had regard to the forecast costs of complying with regulatory requirements such as the large-scale renewable energy target (LRET), the small-scale renewable energy scheme (SRES), jurisdictional schemes and</li> </ul>

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<sup>63</sup> This is discussed in sections 3.3 and 3.4.

Feed-in-Tariff (FiT) schemes.

- We have considered what changes in the retail costs component of charges – including those for costs to serve and customer acquisition and retention cost – is appropriate.<sup>64</sup>

(d) any other matter the AER considers relevant.

We have had regard to the policy intent for introducing a DMO price as outlined in the ACCC's REPI Final Report. This was to:

- reduce unjustifiably high standing offer prices, and
- provide a consistent base from which market offer discounts could be calculated.

In recommending a DMO, the ACCC was explicit in its intention that the DMO price should be set at a level that allowed retailers to recover the efficient costs of servicing customers in each distribution zone, including costs for acquiring and retaining customers.

The ACCC also noted that the DMO should be set at a level that did not dis-incentivise competition. In its submission to our Position Paper, the ACCC restated its position that the DMO should not be the lowest or near the lowest price level in the market.<sup>65</sup>

Where available, we have had regard to relevant publicly available cost stack information such as the QCA's analysis of the efficient retail costs in South-East Queensland and the AEMC's Residential Price Trend report.

Each aspect of our approach to determining DMO prices is discussed in detail below.

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<sup>64</sup> This is discussed in Section 3.5.

<sup>65</sup> ACCC, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 2.

## 3.2 Pricing methodology

In our Position Paper, we proposed an approach to setting DMO prices in reference to observed and publicly available price data. We described this as a ‘top-down’ approach.

Our preliminary view was that by having regard to both competitive market offers and standing offers in distribution zones with retail competition, and where most customers are on market offers, this approach would capture market participants’ own expectations about the efficient costs of providing retail services.<sup>66</sup>

In summary, our proposed steps to determine DMO prices in each distribution zone under this approach were to<sup>67</sup>:

1. Source standing and market offer data from the AER’s Energy Made Easy<sup>68</sup> website, using as a dataset offers available to new customers in October 2018. This dataset would be cleansed to exclude duplicates of offers<sup>69</sup>, and any offers with demand charges.
2. Calculate an annual bill amount for each standing and market offer based on a consumption benchmark.
3. Identify a range of prices that we consider is consistent with the policy intent (as described above). We proposed the upper end of this range would be the median standing offer, while the lower end would be the median market offer.
4. Consider the forecast efficient changes in retailers’ input costs for 2019-20, such as network charges, wholesale costs, and environmental costs.
5. Select a point within the identified range for the DMO price.
6. Consider any other publicly available information about retailers’ costs as a cross-check on the estimated DMO prices.

For the initial DMO price determination, we considered this approach preferable to the alternative of a ‘bottom-up’ cost-based approach. Our reasons for this included:

- Given the purpose of a DMO and the presence of retail competition, we considered that the use of a price-based approach for determining DMO prices would be a reasonable and effective pricing methodology.
- Our limited access to retailers’ detailed cost information, and lack of information gathering powers to obtain this data.

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<sup>66</sup> AER, *Default Market Offer (DMO) Position Paper*, November 2018, section 2.2, p. 15.

<sup>67</sup> AER, *Default Market Offer (DMO) Position Paper*, November 2018, section 2.3.1, p. 16-19.

<sup>68</sup> Retailers are required to submit all generally available offers to EME for publication.

<sup>69</sup> We proposed to exclude offers with the same tariff structure and rates, but with different incentives – for instance, an online sign-up bonus.

- The limited time available to us to request and evaluate detailed cost data for each distribution zone, in time to make a final determination by 30 April 2019.

As part of our ongoing role setting a DMO price for future years, we stated that we would explore the benefits of introducing additional 'bottom-up' analysis of the retailers' underlying costs into our approach.

### **Stakeholder submissions**

There was qualified support for our proposed pricing approach.

Some stakeholders supported the use of the top-down approach, agreeing with our position that published prices in a competitive market are a transparent basis for determining DMO prices, and should reflect retailers' efficient costs.<sup>70</sup>

While most submitters accepted that a top-down approach is a pragmatic and achievable pricing method for our initial determination, a significant number of submissions considered a bottom-up, cost-based approach was preferable in future years.<sup>71</sup> Reasons for this view included that DMO prices based on a bottom-up approach would:

- provide more transparency of all elements of retailers' cost stack, and identify unreasonable cost elements<sup>72</sup>
- ensure DMO prices accurately reflected efficient costs<sup>73 74</sup>
- be less reliant on regulator judgement, and reduce the risk of error.<sup>75</sup>

Our position remains that a top-down approach is the most robust and pragmatic approach for this initial DMO price determination given the time available.

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<sup>70</sup> ACCC, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 2; Alinta Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 7; Vocus Group, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 1; EWON, *Submission to AER on Default Market Offer Position Paper*, 6 December 2018, pp. 1-4.

<sup>71</sup> PIAC, *Submission to Default Market Offer Position Paper*, 10 December 2018, p. 6; ACROSS, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 5; CHOICE, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 7; Active Utilities, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, pp. 1-10; EWOSA, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, pp. 1-4; OC Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, pp. 1-2.

<sup>72</sup> PIAC, *Submission to Default Market Offer Position Paper*, 10 December 2018, p. 6; ACROSS, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 5; CHOICE, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 7 6; Anna Johnson & Gary Hammer, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 1; Business SA, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, pp. 1-4; EWON, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, pp. 1-5.

<sup>73</sup> EnergyAustralia, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 3.

<sup>74</sup> PIAC, *Submission to Default Market Offer Position Paper*, 10 December 2018, pp. 1-6; ACROSS, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 5; CHOICE, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, pp. 1-7.

<sup>75</sup> AGL, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 6.

We acknowledge that a top-down approach will not be as transparent in terms of the individual cost components that make up retail prices as a bottom up cost-based approach.

In relation to concerns that DMO prices determined through a top-down approach would be more reliant on regulatory judgement, and therefore carried a greater risk of error, we note that bottom-up approaches also require regulators to apply judgement in relation to the various cost stack elements.

In particular, the wholesale and retail components will require the AER to determine an appropriate set of assumptions that estimate the representative retailer's costs. Given the diversity in the types of retailers and the information asymmetries, the AER would need to consider these complex factors in arriving at an estimate of the representative retailer's costs for the purposes of a DMO price.

Additionally, the objective for determining DMO prices is different from setting a regulated price in areas where there is limited retail competition present (where bottom up methodology has traditionally been used).

The ACCC's submission emphasised this point. It strongly supported a top-down approach. The ACCC clarified that the intention of the REPI recommendations is not that the AER should determine efficient costs, or set the DMO at an efficient price.<sup>76</sup>

We consider that both types of pricing approaches ('top-down' and 'bottom-up') have advantages and disadvantages. Furthermore, the use of one approach does not preclude the use of another, either as another piece of information for determining a price or as a supporting cross-check. As we noted in our Position Paper, we will look to develop our regulatory tool kit for setting DMO prices, including considering how a bottom-up approach (or elements of this approach) could be used in determining DMO prices in future years.

Several retailers encouraged us to have reference to the QCA's existing bottom-up methodology and forecasting assumptions for setting the notified price in Ergon's distribution zone. This was proposed as a way to cross-check the annual bill amounts derived under our approach, as well as provide consistency and stability of approach over future years.<sup>77</sup>

The QCA determines price caps for standing offers in Ergon's (regional Queensland) distribution zone. In doing so, the Queensland Government has asked the QCA to have regard to the Queensland Government's uniform tariff policy (UTP), under which a government subsidy ensures that regional customers in Queensland pay tariffs

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<sup>76</sup> ACCC, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 2.

<sup>77</sup> Powershop, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 1; AGL, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 3; Origin, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 2.

based on an estimate of the cost of supply in Energex's (South-East Queensland) distribution zone.<sup>78</sup>

The QCA gives effect to this direction by basing its determination of regional maximum prices on retail price drivers in Energex's distribution zone. As part of this process, the QCA undertakes a comprehensive annual 'bottom-up' analysis of the efficient retail costs in South-East Queensland. This analysis is not used to regulate prices for South-East Queensland standing offers, but instead is used to determine price caps for standing offers in Ergon's distribution zone under the UTP.<sup>79</sup>

In our view, it is appropriate for us to have regard to the QCA's estimates in developing our DMO price for Energex's zone.

We understand the QCA will make a draft determination in February 2019. We are liaising with the QCA as part of this DMO price determination process.

We note that pricing stability would be a relevant consideration in future DMO price determinations.

### ***Our draft determination approach***

Consistent with our Position Paper view, we have used a 'top-down' approach for setting DMO prices based on the available price data.

In considering the purpose of a DMO, we believe that the use of this price-based approach is a reasonable and effective pricing methodology. Given the circumstances of this initial DMO price determination, including the limited timeframe and our access to cost information, we consider a 'top-down' approach is preferable to a cost-based 'bottom-up' pricing methodology.

As part of our on-going role setting a DMO price for future years, we will explore the benefits of introducing additional 'bottom-up' analysis of the retailers' underlying costs into our approach.

## **3.3 Price range in 2018-19**

In our Position Paper we proposed that a DMO price consistent with the policy objectives would fall within a range between:

- Lower bound – The median of market offer across all retailers operating in each distribution zone. This would include all conditional and unconditional discounts. This should provide a reasonable indication of the efficient costs of supplying a customer within the distribution zone and would mitigate the impact of any below-cost short-term pricing strategies.

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<sup>78</sup> See: <https://www.dews.qld.gov.au/electricity/regulation>

<sup>79</sup> See: <http://www.qca.org.au/Electricity/Regional-consumers/Reg-Electricity-Prices/Final-Report/Regulated-Electricity-Prices-2018-19>

- Upper bound – The median standing offer of all retailers in the distribution zone or alternatively some measure of the Tier 1 retailers, to reflect that most standing offer customers are with Tier 1 retailers.<sup>80</sup>

### **Stakeholder submissions**

While most stakeholders did not raise issues with our approach to setting a price range, some provided feedback about:

- the appropriateness of our selection of offers as the basis for establishing a price range
- specific views about the upper and lower bounds of this range.<sup>81</sup>

Origin Energy considered that our proposal to use offers available to new customers in October 2018 may not be representative of offers available over an entire year, and may include unsustainably low-price offers to attract new customers.

It considered we should adjust our offer set upward to reflect the weighted price of all market contracts, not just offers made during a particular month.<sup>82</sup>

To support this point, Origin Energy compared the average discounts over a single month of unweighted offers (i.e. the AER's proposed approach) to an analysis of discount levels weighted across a year, sourced from the ACCC's REPI report.

This comparison showed that discount levels were higher using our proposed approach. Origin Energy stated this showed a lower bound derived using our approach would be lower than if a full year of offers were used.<sup>83</sup>

We consider that offer data from October 2018 represents the best available information set for the purpose of developing DMO prices under the current circumstances. This is because:

- Prices from October 2018 are close to the DMO determination period and therefore are more reflective of current price trends than prices across a whole year. Historical prices may reflect cost drivers that may not be as relevant to the DMO determination period.

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<sup>80</sup> AER, *Default Market Offer (DMO) Position Paper*, November 2018, p. 15.

<sup>81</sup> AEC, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 2; OC Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 3; Vocus Group, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 2; AGL, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, pp. 1-2; Origin, *Submission to the AER: Default Market Offer Price*, pp. 1-2; Simply Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, pp. 1-2; Powershop, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 1; EnergyAustralia, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, pp. 1-4.

<sup>82</sup> Origin, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 2.

<sup>83</sup> Origin, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 2.

- Prices from October 2018 are prior to the release of our Position Paper that outlined our proposed pricing approach, therefore cannot be influenced by retailers' strategic behaviour in response to the proposed pricing approach.
- We are not persuaded that offers available in October 2018 are subject to any seasonality factors or other factors that would bias the observed prices. Our analysis showed little difference in the observed median market and standing offers outcomes when data from 1 July 2018 to 31 October 2018 was used, compared to use of data from 1 October 2018 to 31 October 2018.
- We consider the size of discounts are not indicative of actual prices levels that customers are paying. As the ACCC REPI final report makes clear, large discounts are often off high base rates and this is the policy rationale for the introduction of the reference bill mechanism. Therefore, Origin Energy's comparison of discount levels is not instructive in terms of the actual price levels observed over different time periods.

Alinta Energy also raised the issue of weighting in relation to the lower bound of the range.

It noted that customers did not always qualify for conditional discounts, and considered we should apply a weighting to these offers to reflect that missed discounts were taken into account as part of retailers' recovery of efficient costs.<sup>84</sup>

We accept that some retailers may take into account missed conditional discounts in their pricing strategies to recover their efficient costs, depending on their risk appetite, and note the ACCC's REPI findings that many customers miss out on conditional discounts.<sup>85</sup> We have taken this into account as one of the factors that has influenced us in setting DMO prices within the specified range.

Some retailers raised the issue of weighting in relation to the upper bound of the proposed range.<sup>86</sup>

Powershop considered we should use a weighted average for standing offers based on customer numbers per retailer, in order to capture any outliers. This methodology would better factor in the concentration of standing offer customers.<sup>87</sup>

We acknowledge that different retailers have different numbers of standing offer customers, and accept that Tier 1 retailer prices are of more relevance than inflated standing offers prices used by retailers with few standing offer customers. In setting the upper bound of the range, we note the following:

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<sup>84</sup> Alinta, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018 pp. 7-8.

<sup>85</sup> ACCC, *Retail Electricity Pricing Inquiry - Final Report*, June 2018, p. 264.

<sup>86</sup> Powershop, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 2; ERM Power, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 3.

<sup>87</sup> Powershop, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 2.



- Our use of the median standing offer as our upper boundary reduces the influences of very high and low offers on our analysis.
- Our analysis shows the median standing offer of Tier 1 retailers is close to the median standing offer of all retailers in most distribution zones – given the majority of standing offer customers are with these retailers, a customer weighted average would likely yield a similar result.
- We have had particular regard to the local area retailer’s standing offer price, as this is what most affected customers will be paying.

Origin Energy also noted that, from October 2018, retailers were required under our revised Retail Pricing Information Guidelines (Guidelines) to submit ‘restricted’ offers to Energy Made Easy, not generally available to members of the public, such as heavily discounted ‘win-back’ and ‘retention’ offers. Origin Energy was concerned the inclusion of these offers in our set may skew the lower bound.<sup>88</sup>

The revised Guidelines extended the scope of offers defined as ‘generally available’ to require retailers publish previously excluded offers with eligibility criteria (for example, club membership). Win-back and retention are not generally available under the Guidelines.<sup>89</sup>

We note that only generally available offers have formed part of our offer set.

### ***Our draft determination approach***

In making this draft determination, we have used generally available offers from October 2018 (unweighted) to calculate a price range of:

- the median of all relevant market offers for all retailers operating in the distribution zone as a lower bound.
- the median of all relevant standing offers for all retailers in the distribution zone as an upper bound.

We consider this range should provide a reasonable indication of the efficient costs of supplying a customer within the distribution zone in 2018-19 and provides a reasonable starting point for determining a DMO price in 2019-20.

The key assumptions we have used in calculating the annual price ranges are outlined in **Appendix 3**.

The annual price ranges in each distribution zone are illustrated in charts in **Appendix 4**.

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<sup>88</sup> Origin, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 5.

<sup>89</sup> AER Retail Pricing Information Guidelines, v5.0, April 2018 - <https://www.aer.gov.au/retail-markets/retail-guidelines-reviews/retail-pricing-information-guidelines-2018>

### 3.4 Selection of price point in 2018-19

Our Position Paper made clear that we would need to exercise our judgement to set a DMO price point for each distribution zone that met the policy objectives of:

- Reducing unjustifiably high standing offer prices for customers
- Allowing retailers to recover the efficient costs of providing services
- Not dis-incentivising competition and market participation by customers and retailers

We also noted that the ACCC's REPI final report provides policy guidance about the level at which we should set DMO prices.

*The default offer is, in a sense, a premium offer with additional safeguard features that come at a cost. This will result in a price that is higher than the lowest priced offers in the market, but is much lower than current standing offer prices. The ACCC considers that this price should be between the median market offer price and median standing offer price, and closer to the median market offer price, but notes that this will ultimately be a matter for the AER.<sup>90</sup>*

While we have determined a DMO price that is at the mid-point of this range, we have had regard to the ACCC's views along with those provided in submissions in making our draft determination.

#### **Stakeholder submissions**

Stakeholders had a range of views about where in the price range the DMO price point should be.

A number of submissions noted the potential risks to the market and competition from selecting an inappropriate price point. Retailers, in particular, considered we should set the price at the higher end of the range in order to reduce the risk of unintended impacts on the market and allow some flexibility to accommodate market price movements.<sup>91</sup>

The ACCC's submission restated key points of its REPI recommendation. Specifically that:

- the DMO should not be a viable alternative for engaged consumers, and so should not be the lowest price, or close to the lowest price, in the market

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<sup>90</sup> ACCC, *Retail Electricity Pricing Inquiry - Final Report*, June 2018, p. 249.

<sup>91</sup> Origin, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 1; OC Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018 Price, p. 3; Powershop, *Submission to AER on Default Market Offer Position Paper*, 6 December 2018, p. 2.

- to facilitate effective competition, retailers would need room to discount ‘well below the DMO’.<sup>92</sup>

A number of consumer representatives noted that increases in standing offer prices meant they were no longer acting as a safety net.<sup>93</sup>

Some submissions considered a safety net DMO price would not include any allowance for customer acquisition and retention costs, or a reasonable retail margin, or would limit what costs retailers could recover for these elements.<sup>94</sup>

Brotherhood of St Laurence and Australian Council of Social Service, for example, considered DMO prices should reflect a ‘fair and efficient price’ to deliver electricity.<sup>95</sup> This would be close to market offer prices, and incorporate a fair retail margin and some customer acquisition and retention costs.

Some stakeholders considered setting DMO prices at the mid-point of the range (i.e. the 50th percentile) was consistent with the policy objectives.<sup>96</sup>

NSA noted that, based on analysis of our chart for the Ausgrid zone from our Position Paper, setting the DMO at the high end of the range (i.e. the level of the median standing offer price) would result in a price higher than several retailers’ current standing offer prices, potentially punishing customers with these retailers. In contrast, it noted a DMO based on the mid-point would be lower than the standing offers of all but one retailer.<sup>97</sup>

A number of stakeholders considered we should set the DMO prices at top of the proposed range, at the price of the median standing offer in each distribution zone.<sup>98</sup>

EnergyAustralia considered the DMO should be set at the median standing offer point, as this would decouple the price from market offers and avoid strategic pricing by retailers.<sup>99</sup>

AGL also considered this was a sensible point as it would offer bill reductions to customers on inflated standing offer price (that is, over the median standing offer),

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<sup>92</sup> ACCC, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 2.

<sup>93</sup> For instance, PIAC, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, pp. 1-3; CHOICE, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, pp. 4-5; ACOSS, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, pp. 1-3.

<sup>94</sup> PIAC, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 4; CHOICE, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, pp. 4; ACOSS, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 4.

<sup>95</sup> ACOSS, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 3.

<sup>96</sup> NSA, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 4; Handled, *Submission to AER on Default Market Offer Position Paper*, 23 November 2018, p. 5.

<sup>97</sup> NSA, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 5.

<sup>98</sup> EnergyAustralia, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 7; AGL, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 7.

<sup>99</sup> EnergyAustralia, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 7.

while reducing the risks of unintended market impacts.<sup>100</sup> AGL considered that if we set the DMO price at a point to provide greater savings to standing offer customers, we should select a point that was known and transparent, such as the 80th percentile between the median standing offer and median market offer.<sup>101</sup>

Two retailers suggested alternative models for setting DMO price levels, not based on our proposed range.

Simply Energy suggested the DMO price be set in reference to the median of each retailer's best generally available offers, plus a 20 per cent risk premium for servicing non-market customers.<sup>102</sup>

Alinta Energy proposed we set an allowable percentage variation between a retailer's market offer tariffs and its standing offer, in effect linking the two prices. It considered this approach allowed retailers to better manage their risk by maintaining their ability to set their own prices.<sup>103</sup>

### ***Our draft determination approach***

Our draft determination position is that the DMO price point in 2018-19 for each distribution zone will be the mid-point (50th percentile) of the range between the median market offer and median standing offer, based on generally available offers in Energy Made Easy in October 2018.

We consider this approach achieves the policy intent for the introduction of the DMO and has regard to all the matters to which we are to have regard to under the draft Code. Our reasons for this position are set out below.

The policy intent for the DMO involves a number of objectives, as discussed previously.

In determining DMO prices that meet these objectives we have examined the available data on standing offer customers.

Given that the majority of standing offers customers are with the relevant LAR in each distribution zone, our starting point is that DMO prices must be lower than the LAR's standing offer in each distribution zone in order to meet the policy intent for introducing a DMO – to reduce the unjustifiably high standing offer prices for customers.

In determining what point below the LAR's standing offer price to set DMO prices, we have considered the available price data and submissions from stakeholders to our Position Paper.

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<sup>100</sup> AGL, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 7.

<sup>101</sup> AGL, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 7.

<sup>102</sup> Simply Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 4.

<sup>103</sup> Alinta Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 2.

Given our pricing methodology and the information before us, we consider that the 50th percentile of the range between the median market offer and median standing offer based on generally available offers in October 2018 represents a reasonable balance of the different policy objectives we are trying to achieve.

We have chosen this level based on the observed price ranges in each distribution zone (see **Appendix 4**), having particular regard to the following factors:

- This price point would result in lower standing offer prices and provide price relief for affected customers, which is the key policy objective for introducing DMO prices. Reductions from the median standing offer level would range between:
  - \$115 in Energex's zone and \$174 in Endeavour's zone for residential customers on a flat rate tariff.
  - \$168 in Energex's zone and \$218 in SAPN's zone for residential customers on a flat rate tariff with controlled load.
  - \$453 in Energex's zone and \$937 in Ausgrid's zone for small business customers on a flat rate tariff.
- One of our key policy objectives is to not dis-incentivise customer engagement and market participation. We consider this price point provides sufficient margin between the DMO price and more competitively priced market offer prices in each distribution zone such that there are still benefits for customers seeking out market offers that best meet their needs (see Table 8).
- It provides an additional margin above the median market offer price to enable retailers to continue their current practice of competing on discounts.

While we consider that the median market offer of our data set represents a price point at which a retailer is able to recover its efficient costs, setting the DMO at the mid-point between the median market offer and median standing offer also provides for additional margin to address some of the potential issues raised in stakeholder submissions:

- The impact of missed conditional discounts, for retailers whose cost recovery strategies include consideration of this factor.
- Changes to cost drivers not captured in the forecast cost input changes (discussed in the next chapter).
- Unaccounted for variables in our dataset that may downwardly bias the median market offer level observed.

**Table 8: Margins between DMO and median and lowest market offers**

Distribution zone	Tariff type	Margin - DMO and median market offer	Margin - DMO and lowest market offer
<b>Ausgrid</b>	Residential – flat rate	\$122	\$264
	Residential – flat rate with CL	\$195	\$474
	Small business – flat rate	\$937	\$1,686
<b>Endeavour</b>	Residential – flat rate	\$174	\$322
	Residential – flat rate with CL	\$200	\$492
	Small business – flat rate	\$578	\$1,288
<b>Energex</b>	Residential – flat rate	\$115	\$258
	Residential – flat rate with CL	\$168	\$425
	Small business – flat rate	\$453	\$970
<b>Essential</b>	Residential – flat rate	\$146	\$364
	Residential – flat rate with CL	\$176	\$477
	Small business – flat rate	\$745	\$2,120
<b>SAPN</b>	Residential – flat rate	\$169	\$300
	Residential – flat rate with CL	\$218	\$398
	Small business – flat rate	\$790	\$1,723

### 3.5 Forecast changes in cost inputs in 2019-20

Observed prices in October 2018 will reflect retailers' views on the underlying costs and competitive conditions at that time. In determining DMO prices for 2019-20, we will need to take account of forecast changes in input costs for 2019-20 (such as networks charges, wholesale costs and environmental costs).

Our Position Paper stated that we would examine the publicly available information on the likely direction and magnitude of any changes in key input costs for 2019-20. We noted that there are broadly two ways we could incorporate these forecast changes in input costs as part of our process for determining DMO price for 2019-20:

- Have regard to forecasts as a factor in selecting a price point within the relevant range of the observed October 2018 price data, or
- Select a point within relevant range of the observed October 2018 price data, and adjust that point based on the forecast changes of each input cost for 2019-20

### ***Stakeholder submissions***

In response to the Position Paper, we received a number of submissions outlining the type and sources of information we could use to assess the likely direction and magnitude of any forecast changes in the input cost components.

Several stakeholders noted:

- For network costs, we should rely on AER revenue determinations.<sup>104</sup>
- For wholesale energy costs, we should have regard to the weighted price of ASX energy futures contracts.<sup>105</sup>
- For environmental costs, we should have regard to the forecast 2020 Renewable Energy Target targets along with historical Large-scale Generation Certificates (LGC) and clearinghouse Small-scale Technology Certificate (STC) prices.<sup>106</sup>

Origin Energy suggested that the QCA's bottom-up approach for setting notified prices in Ergon's distribution zone is a reliable source for cost forecasts.<sup>107</sup>

For wholesale costs, AGL noted that it does not support the use of the AEMC price trends report as an indicator of price drivers.<sup>108</sup> EnergyAustralia considered long run marginal costs (LRMC) of a new entrant and or at least smoothed market prices over the longer run as the best approach to forecast wholesale costs. It also suggested

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<sup>104</sup> PIAC, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 6; ACROSS, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 5; Origin, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 8; EnergyAustralia, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 5; Active Utilities p10.

<sup>105</sup> PIAC, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 6; ACROSS, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 5; Origin, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 8; Active Utilities, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 10.

<sup>106</sup> PIAC, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 6; ACROSS, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 5; Origin, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 8; Active Utilities, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 10; PIAC, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 4;; ACROSS, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 5.

<sup>107</sup> ACROSS, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 3.

<sup>108</sup> Origin, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 3.

<sup>109</sup> AGL, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 8.

including load shape costs to reflect the load profile of a retailer's customer base.<sup>109</sup> Alinta Energy noted that the wholesale purchasing arrangements are constantly evolving, such as the advent of peer-to-peer trading models.<sup>110</sup> Simply Energy noted that, even with use of physical and financial offsets, fixing retail prices for 12 months may leave retailers exposed to market events. It noted that this may be the case where uncontrolled events lead to a substantial increase in energy spot prices.<sup>111</sup> WIN Connect noted variation in cost and hedging decision occurring over different time horizons for different retailers' impact on forecasting wholesale costs.<sup>112</sup>

For retail costs, in addition to retailer's operating costs and profit margin, some submissions highlighted the importance of factors such as compliance costs for transition from standing offer to DMO (as well as other recent policy and regulatory changes) and headroom for innovation.<sup>113</sup>

Stakeholders had differing views on the inclusion of customer acquisition and retention costs (CARC). EnergyAustralia, Powershop, NFF, Active Utilities and Origin Energy supported inclusion of a reasonable margin for CARC.<sup>114</sup> ACOSS, PIAC and Queensland Council of Social Service (QCOSS) noted that CARC should be excluded from the DMO price if the DMO is developed as a safety net for customers.<sup>115</sup> CHOICE noted an alternate approach where CARC and retail margin are capped.<sup>116</sup>

On a more general point, Origin Energy noted that many retailers have not passed through the underlying costs of supply for the last three years with an aim of ameliorating cost fluctuations.<sup>117</sup>

### ***Our draft determination approach***

Based on the publicly available information, we have found that:

- Wholesale costs in relevant distribution zones for 2019-20 are expected to decrease compared to cost in 2018-19. Increases in wholesale costs arising

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<sup>109</sup> EnergyAustralia, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 5.

<sup>110</sup> Alinta Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 6.

<sup>111</sup> Simply Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 4.

<sup>112</sup> WIN connect, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 1.

<sup>113</sup> Alinta Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 9; Powershop, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 2; EnergyAustralia, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 5.

<sup>114</sup> EnergyAustralia, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 4; Powershop, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 2; NFF, *Submission to AER on Default Market Offer Position Paper*, 5 December 2018, p. 1; Active Utilities, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 6; Origin, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 7.

<sup>115</sup> PIAC, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 5; ACOSS, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 5; QCOSS, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 4.

<sup>116</sup> CHOICE, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, pp. 3-4.

<sup>117</sup> Origin, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 8.



from higher fuel prices and reduction in base load supply are forecast to be tempered by increases in the supply of new renewable generation coming online. We have based our wholesale cost forecasts on the AEMC's 2018 Residential Electricity Price Trend Review (AEMC Price Trends review).<sup>118</sup>

- Network costs in the relevant distribution zones are expected to increase at low nominal levels between 2018-19 and 2019-20. In particular, recent draft determinations for the New South Wales distribution networks indicate increases of at or below CPI. We have based our network costs forecasts on the relevant AER distribution and transmission revenue determinations.
- Changes in the environmental costs components between 2018-19 and 2019-20 vary:
  - the Long-term Renewable Energy Target (LRET) cost is forecast to decline marginally.
  - the Short-term Renewable Energy Target (SRET) cost is forecast to increase moderately.
  - changes in the cost of meeting jurisdictional schemes are likely to be negligible.

We have based our forecasts for these environmental cost components on the AEMC Price Trends review.

Our forecasts of changes to the cost components between 2018-19 and 2019-20 and the impact on retail prices in each distribution zone is set out in Table 9 below.

**Table 9: Changes in cost components and overall impact for 2019-20 prices (nominal)**

Distribution zone	Wholesale	Network	Environmental	Overall price impact <sup>#</sup>
Energex	25.2% reduction	1.7% reduction	9.4% reduction	8.2% reduction
Essential	15.0% reduction	1.8% increase	1.3% increase	3.8% reduction
Endeavour		1.3% increase		5.1% reduction
Ausgrid		0.6% reduction		5.6% reduction
SAPN	11.8% reduction	3.2% increase	1.9% reduction	3.9% reduction

<sup>#</sup> This includes adjusting the residual component of the price stack by inflation.

Source: AEMC 2018 Residential Electricity Price Trends Review and AER Regulatory Determinations

<sup>118</sup> We will need to take into account changes in ASX contract futures prices since the AEMC's Residential Electricity Price Trends review when considering 2019-20 wholesale forecasts.

Consistent with our Position Paper, our proposed approach is to have regard to these forecasts as a factor in exercising our judgement in selecting a price point within the relevant range of the observed October 2018 price data. We consider that incorporating forecast cost changes in this way would be fit-for-purpose and well aligned with our proposed top-down pricing methodology.

While the forecast changes in the key input cost components between 2018-19 and 2019-20 would lead to a moderate decline in retail prices, we do not propose to adjust the proposed DMO price point for expected changes in costs between 2018-19 and 2019-2020. We consider this is a reasonable approach given:

- The DMO price point in 2018-19 is the mid-point of the price range of the median market offer and median standing offer price in each distribution zone
- The relatively modest forecast changes in the retail prices in the context of our task, which is to estimate the likely direction and magnitude of cost changes.

We would consider the impact of changes in key input costs annually as part of any ongoing DMO price determination process.

The following sections discuss each cost component and the key factors we have considered in assessing the changes in costs.

An overview of each of the changes in costs with reference to the overall retail price stack can be found in **Appendix 5**.

### 3.5.1 Wholesale component

Wholesale costs are the retailers' costs of buying electricity in spot and hedge markets, and represent the costs of producing electricity. Wholesale electricity in eastern and southern Australia is traded through the NEM, where supply and demand conditions determine prices in real time.

Generators and retailers often enter into hedge contracts traded on the Australian Securities Exchange (ASX) or negotiated directly between the parties (over-the-counter), to lock in future electricity prices. Alternatively, participants can balance out the risks across each market by having both generation and retailing businesses. Other risk management strategies include purchasing weather derivatives to reduce exposure in adverse weather conditions and entering into demand response contracts with customers.

Wholesale costs comprise:

- spot market price of electricity
- hedging cost incurred on purchase of derivatives
- market fees that the Australian Energy Market Operator (AEMO) charges to market participants to cover its operating expenses

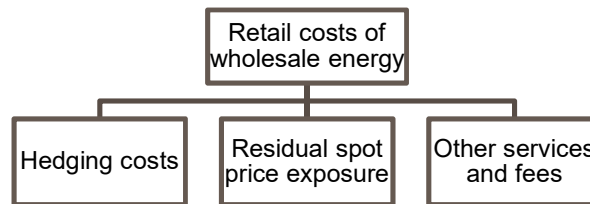
- ancillary service charges for services provided by AEMO to manage the power system's safety, security and reliability
- prudential capital costs, incurred by a retailer to provide financial guarantees to AEMO and meeting ASX margin requirements.

The wholesale costs are largely driven by various factors affecting the supply-demand balance, fuel prices and market volatility.

As discussed below, we consider that the AEMC Price Trends review provides a reasonable indication of how the wholesale and the environmental cost components are likely to change from 2018-19 to 2019-20. Furthermore, when publicly available, we will also take into account the QCA's assessment of Retail Electricity Tariffs for the Ergon distribution network.

### Our Approach

The wholesale cost component is comprised of three key underlying components; the hedging cost, the residual exposure to the wholesale electricity spot market and other fees arising from the provision of electricity.



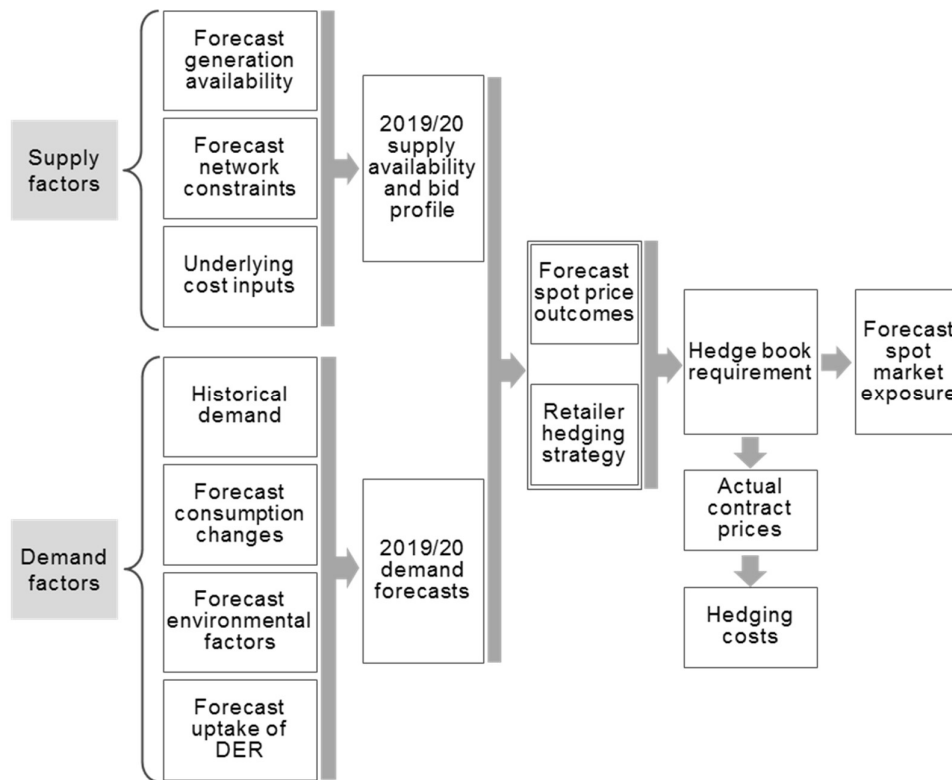
While the energy sold to customers is bought by the retailer in the wholesale electricity spot market, retailers have a strong commercial incentive to hedge their exposure to the spot price through purchasing derivative contracts and other financial instruments. Alternatively if the retailer is vertically integrated through owning generation assets, it will have a natural hedge whereby the retailer will optimise the operation of this asset to mitigate its exposure to the spot price.

A significant factor in determining an appropriate hedged position is the retailer's expectation of wholesale spot price outcomes for the relevant period. Based on this expectation the retailer will apply a hedging strategy to achieve an appropriate volume and mix of hedging contracts.

A retailer's hedging strategy will also depend on a variety of factors such as its internal management of generation and other energy assets, risk management strategies and the nature and scale of its retail customer load and how these customers are contracted.

As outlined in the diagram below, the AEMC uses market modelling to provide an indication as to how changes in supply and demand factors could in turn impact on the wholesale spot market and the contract market. These supply and demand factors, along with forecast market outcomes, may be then applied to estimate a retailer's hedging costs by estimating a hedging requirement and strategy.

**Figure 3: Process in determining the wholesale costs**



The AEMC Price Trends review contains a detailed assessment into how wholesale prices are forecast to change. We note that the AEMC has changed its forecasting methodology to better reflect a representative retailer's hedging strategy to take into account both the concepts outlined above and the actual contract price information. In the report, the AEMC stated<sup>119</sup>:

*Previous Residential Electricity Price Trends reports estimated retailers' wholesale electricity purchase costs by forecasting spot market outcomes and applying a contract premium for managing risk. This approach assumed that a retailer buys all its electricity and hedging contracts at a single point in time, so that its entire position is effectively purchased at the prevailing market price. However, it became apparent in the past two years, that with high volatility in forward prices after generator retirements, short-term estimates made through this method were becoming inconsistent with market outcomes. For this reason, this report estimates wholesale costs using a blended method.*

As discussed in the report, the most significant change in underlying market conditions is the expected availability of renewable generation (3,396 MW). This increase in supply has tempered previous increases in wholesale energy prices as a result of increases in fuel costs and the reduction in base load capacity (such as the closure of

<sup>119</sup> AEMC, *Residential Electricity Price Trends Review 2018*, 21 December 2018, vii.

Hazelwood power station in Victoria). The AEMC/EY market modelling has taken these factors into account in estimating the wholesale spot market pricing impact.

In the case of contract markets, we expect that these changes in market fundamentals will also be reflected through the contract prices of the relevant products. This is because the industry will take these factors into account when agreeing to 2019-20 contract prices. As noted above, the AEMC report has incorporated these contract prices by using actual contract data, when available, in applying the hedging strategy and in turn determining hedging costs. Importantly, the underlying hedging strategy will determine the appropriate hedged position based on the trade-off between the anticipated exposure to the spot market for a particular period and the cost of purchasing the relevant contracts.

In conjunction with its consultant (EY), the AEMC has incorporated the following features into its wholesale cost modelling<sup>120</sup>:

- Wholesale electricity purchase costs were estimated using a blended method:
  - where possible, the analysis uses observable futures contract prices that retailers use to build up their hedge contract book over time.
  - where limited forward contract data were available, then a forecast of spot market outcomes and a contract premium was used.
- In the case of New South Wales, South Australia and South East Queensland, the retailer will have completed the hedging requirement for the entire financial year by April.
- Hedging costs are based on two different book build profiles depending on the size of the retailer:
  - For large retailers a two-year book build profile is applied.
  - For small retailers a one-year book build profile is applied.
- EY has used in-house modelling (2-4-C®) to assess the wholesale market outcome and an optimal hedging strategy.

The AEMC/EY modelling represents one approach to market modelling the wholesale cost component. We acknowledge that there are various approaches that can be applied to market modelling to assess the wholesale component. Ultimately, what information is assessed and used to translate into a representative retailer price will depend on the purpose of the assessment and the underlying methodology and assumptions of the approach. For example, how the modelled outcomes are applied to

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<sup>120</sup> For further detail on the AEMC 2018 Residential Electricity Price Trends Methodology Report and the accompanying EY consultant report.

determine retail prices will depend on what type of retailer is emulated and/or the customer load and profile under assessment.

We are mindful that the purpose of the AEMC Price Trends review is to assess changes in retail cost for a representative consumer in each state rather than changes in costs for particular customer consumption types. Further, the report provides a single cost estimate of a representative retailer by proportionally combining small and large retailer costs. As outlined in chapter 3 the proportion of customers on standing offers are almost entirely with the large retailers.

Whilst these factors will need to be taken into account, we consider that the AEMC's wholesale cost assessment is an appropriate and reasonable basis to assessing how the cost components have likely changed for a standing offer tariff and more broadly the market. In particular:

- EY's market modelling incorporates the likely changes in market fundamentals to assess the overall impact on wholesale spot prices and hedging strategy, and
- The incorporation of actual contract information and a standardised retailer's hedging strategy.

### **Updating the AEMC/EY analysis**

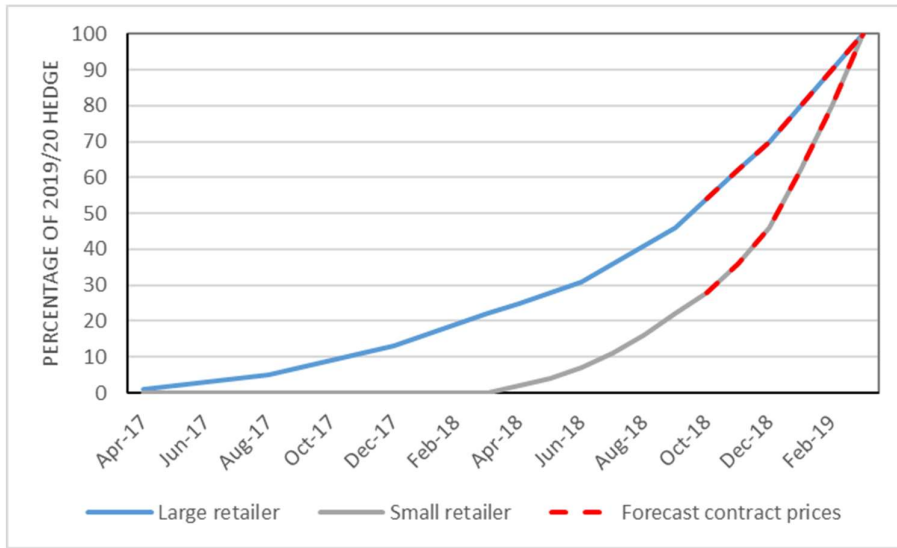
As outlined in the AEMC's report, wholesale electricity purchase costs were estimated using a blended method of combining observable futures contracts where available and, if not available a forecast contract price was applied.<sup>121</sup>

The AEMC analysis is based on observed contract prices and volumes up to October 2018. In the case of estimating the wholesale costs for 2019-20, due to the exponential shape of the book build profile the estimated contract prices have a material impact on the outcome of cost estimate.

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<sup>121</sup> AEMC, *Residential Electricity Price Trends Methodology Report 2018*, 21 December 2018, p. 26.

**Figure 4: AEMC Standardised Book Build Strategy for Small and Large Retailers**



Source: AEMC

Given all relevant actual contract prices and volumes for 2019-20 contracts will be publicly available by the end of March 2019 we propose to update the AEMC wholesale cost estimate to take this additional information into account.

#### **Taking into account QCA retail price regulation review**

As noted above, in Queensland, QCA regulates retail electricity prices for the Ergon Energy distribution zone. The Queensland Government directs the QCA to have regard to the Queensland's Uniform Tariff Policy (UTP) under which a government subsidy ensures that regional customers in Queensland pay tariffs based on an estimate of the cost of supply in Energex distribution zone.

As part of this process, the QCA undertakes a comprehensive annual 'bottom-up' analysis of the efficient retail costs in Energex zone. This analysis is used to determine price caps for standing offers in Ergon zone to meet the UTP objectives.

In particular we note that for wholesale costs, it uses a hedged book build approach, based on trade-weighted contract price data of base, peak and cap contracts. Furthermore, different load profiles are applied for different retail tariff types when modelling wholesale costs. The profiles for the tariffs relevant to the DMO are based on the Energex net system load profile and controlled load profile.

For the purpose of analysing changes in costs for DMO, the costs estimated in the QCA's notified price determination will provide an additional layer of information to assess how costs have changed in the Energex distribution zone. We will have regard to this information when it is made public in February 2019.

### 3.5.2 Environmental costs

Environmental schemes at both a Commonwealth and State level determine the environmental cost component of the retail price.

Environmental costs broadly fall into two main categories:

- National schemes or the RET
  - Large-scale RET (LRET)
  - Small-scale RET (SRES)
- State schemes
  - State certificate and energy efficiency schemes
  - Premium feed-in tariff (FiT) schemes

Under the RET, retailers have an obligation to purchase renewable energy certificates from generators and surrender them to the government in proportion to the overall amount of energy consumed by their customers. The costs to purchase these certificates are passed on to all customers.

Other jurisdiction-specific environmental schemes include energy efficiency incentives to assist consumers in reducing their energy consumption and incentives to drive take up of solar photovoltaic (PV) generation. Distribution network businesses pass these costs on to retailers through their annual tariffs. Retailers then pass these costs on to the whole customer base.

#### LRET

The overall cost of meeting the LRET obligation is the cost of acquiring the necessary amount of LGCs. The number of LGCs under the LRET required each year is determined, in part, by a Renewable Power Percentage (RPP) set annually by the Minister for Energy.

The change in LRET costs will depend on the changes in the RPP and the LGC price. This is set out in the box below.

#### Figure 5: Summary of LRET cost

$$LRET\ requirement = Retailer\ Energy\ consumption * RPP$$

Therefore

$$LRET\ Cost = LGC\ price * LRET\ requirement$$



Retailers can acquire LGCs through three avenues; directly through the spot market, as part of a Power Purchase Agreement (PPA), or they can instead pay a tax-effective shortfall charge of \$90/MWh.<sup>122</sup>

The AEMC Price Trends review provides an assessment of how the LRET costs are forecast to change across the 2018-19 to 2019-20 period.

The AEMC notes that in many cases the LGC price is embedded in a PPA. In effect these contracts bundle both the future delivery of electricity and the LGC into a single price. In estimating the separate costs of each of these bundled components, EY has estimated the cost of the subsidy required for a new entrant renewable generator.<sup>123</sup> The report notes that due to the scale and long-term nature of these types of bundled products, large retailers traditionally acquired these products to cover their LRET obligations.

Smaller retailers may be less likely to entirely cover their LRET obligations through the relevant PPAs. These type of retailers will therefore be more exposed to the LGC contract spot market and higher LRET costs.

EY's forecasts of the LGC spot price and LGC component of the PPA are in Table 10 below.

**Table 10: EY forecasts of the RRP and LGC Prices**

Year	RPP	LGC price - Large retailer (PPAs)	LGC price - Small retailer (spot market)
2018-19	16.52%	38.7	70.8
2019-20	18.32%	39.0	24.5

Source: AEMC

## SRES

The STCs under the SRES reflect the installation of and generation by eligible solar hot water or small generation (rooftop solar PV) units. Retailers have the option of either purchasing an STC on the market at a value of around \$35 or from the clearinghouse at \$40. The liability of STC surrender is estimated annually as the Small-scale Technology Percentage (STP).

Unlike the RPP, STP is calculated to follow the creation of STCs, rather than meet a specified target. As there is no cap for the creation of STCs, the STP can vary from year to year. The STP is determined by setting the demand for the certificates to

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<sup>122</sup> The penalty is \$65, however as this is not a tax deductible expense it is traditionally grossed up to \$90.

<sup>123</sup> AEMC, *Residential Electricity Price Trends Methodology Report 2018*, 21 December 2018, p. 41.

balance with supply. The STP is therefore dependent on the forecast number of STCs to be created within the calendar year.

#### Figure 6: Summary of SRES cost

$$SRES \text{ requirement} = STP * \text{Retailer Energy Consumption}$$

Where the STP is predominantly a function of STCs created in the calendar year

Therefore

$$SRES \text{ Cost} = STC \text{ price} * SRES \text{ requirement}$$

As part of the AEMC's 2018 Retail Price Trend report, EY has forecast the STC price and the STP for 2019-20. The STP is forecast to increase from 2018-19 to 2019-20. Due to a significant uplift in the uptake of STCs, the STP will be significantly higher than the previous year. This means that the cost of meeting this obligation will likely increase from 2018-19 to 2019-20.

**Table 11: EY forecasts of the STP and STC price**

Year	STP	STC price - Large retailer	STC price - Small retailer (clearing house)
2018-19	17.71%	35.0	40.0
2019-20	19.37%	35.0	40.0

Source: AEMC

#### Jurisdictional schemes

In addition to the RET costs, a retailer may also need to pass through jurisdictional scheme costs.<sup>124</sup> Approved jurisdictional schemes<sup>125</sup>, such a jurisdictional feed-in-tariff, are passed through to retailers via the distribution network business' annual tariffs.

The AEMC Price Trends review forecasts that jurisdictional scheme costs are expected to remain constant in South Australia. In New South Wales, given the low proportion of the overall retail price and the negligible changes of between 2 to 3 per cent in costs,

<sup>124</sup> The cost of these schemes are placed on network businesses through a legislative obligation.

<sup>125</sup> NER r6.18.7A

these changes will have a limited overall price impact. We note that in Queensland the jurisdictional scheme costs are recovered by a State Government grant up to at least 2020.

### 3.5.3 Regulated Network component

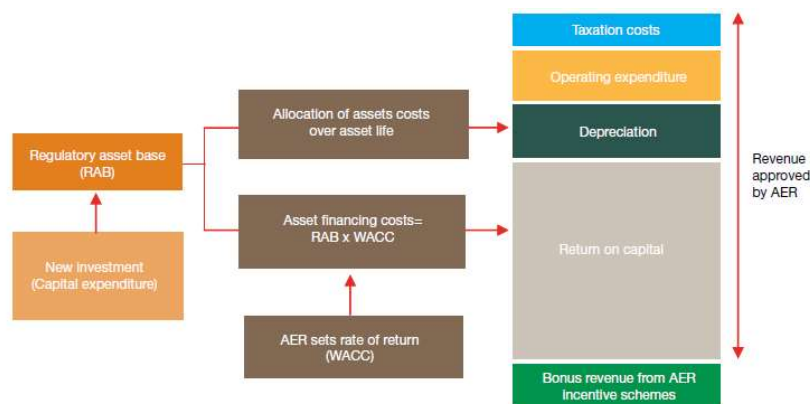
Network costs are constituted of three main components

1. a transmission network cost to transport electricity over the high voltage network incurred by the transmission network service providers (TNSPs)
2. a distribution network cost associated with delivering electricity to homes or businesses incurred by the distribution NSPs (DNSPs)
3. a metering cost to install and maintain the meters.<sup>126</sup>

Under the National Electricity Rules (NER), the AER regulates the revenues that transmission and distribution network businesses can recover from consumers.

The building block model used in the regulatory framework accounts for a return on capital invested in the network, its running costs and other expenses. Each revenue decision sets cap on a network business' revenue for a forward-looking five year period. Figure 7 below provides an overview of the costs that are considered in the revenue decisions under the building block model.

**Figure 7: Building block model to forecast network revenues**



Source: AER 2018 State of the Energy Market report.

<sup>126</sup> Metering and related services are provided under a competitive framework since December 2017 (except Victoria), whereas previously metering costs were regulated. However, until a consumer's meter is replaced with a digital meter, the DNSPs are required to provide for type 6 accumulation meters as an alternative control service (ACS). For this purpose metering costs are identified as part of network costs.

We consider the change in annual revenue<sup>127</sup>, as set out in the relevant regulatory determinations, provides the best indicator for how network costs will change in 2019-20.

In the case of New South Wales, we will take into account the November 2018 draft determinations for the 2019–24 regulatory control period. We note that Endeavour Energy and Essential Energy draft determinations reflect the final remittal decisions<sup>128</sup> for the previous regulatory period. In the case of Ausgrid,<sup>129</sup> the draft determination reflects the draft remittal decision.

For South Australia and South-East Queensland, the current regulatory distribution and transmission determinations include 2019-20.

### 3.5.4 Retail component

Retail costs are incurred by retailers to acquire, service and retain customers, including meeting regulatory obligations.

Aside from regulatory obligations, retail costs include:

- cost to serve (CTS) or operating expenses to manage billing systems, handle customer enquiries, and comply with regulatory obligations
- customer acquisition and retention costs (CARC) to gain or retain customers
- a retail margin or the return to investors for exposure to systematic risks associated with providing retail services
- and other costs such as depreciation, amortisation, interests and taxes.

While CTS do not vary significantly across regions, CARC tend to be higher in jurisdictions with high rates of customer switching.

Aside from an inflationary adjustment, we have not forecast a further change in the abovementioned underlying components from 2018-19 to 2019-20.

Retailers also incur costs through meeting Commonwealth and State obligations. Whilst these costs predominantly relate to the RET (discussed above) there may be additional changes in costs resulting from ongoing regulatory reform or new obligations arising in 2019-20. We note that several retailers<sup>130</sup> have raised concerns regarding the

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<sup>127</sup> This is referred to as the X factor in AER revenue determinations.

<sup>128</sup> AER, *Essential Energy 2019 – 24 Draft Decision overview*, November 2018, p8 and AER, *Endeavour Energy 2019 – 24 Draft decision overview*, November 2018, p. 8.

<sup>129</sup> AER, *Ausgrid 2019 – 24 Draft decision overview*, November 2018, p. 8.

<sup>130</sup> EnergyAustralia, *Submission to AER on Default Market Offer Position Paper*, 11 December 2018, p. 5; Alinta Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 5; Powershop, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 2.

costs of implementing the DMO itself along with other regulatory reforms.<sup>131</sup> Based on the information provided to the AER through submissions and direct discussions with retailers, we do not consider these obligations will result in a change in retail costs that will in turn have a material impact on retail prices.

We also note that the COAG Energy Council is expected to reach a final decision regarding the rules underpinning the Retail Reliability Obligation. When the obligation applies (potentially as early as 1 July 2019), AEMO will also need to determine if a T-3 recommendation to trigger the obligation for a particular region is required. At this stage it is also unclear the likely costs incurred by retailers at this preliminary stage of the reform. We have therefore taken this into account as a factor when exercising our discretion as to whether the overall 2019-20 cost reductions should result in an adjustment to the DMO price point for 2018-19 discussed above.

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<sup>131</sup> This includes the proposed implementation of the Retailer Reliability Obligation. In December 2018, the COAG Energy Council indicated that the RRO will likely apply from 1 July 2019.

### 3.6 DMO prices

Using the methodology described above, we have determined the following DMO prices for 2019-20.<sup>132</sup>

#### *Residential flat rate tariffs*

Table 12 lists the calculations for each distribution zone for residential flat rate tariffs. This shows the median standing offer, median market offer, DMO price and the savings from the median standing offer.

**Table 12: Default Market Offer prices and savings from median standing offer – Residential flat rate tariffs**

	Ausgrid	Endeavour	Energex	Essential	SAPN
<b>Single load kWh p.a.</b>	3,800	4,900	4,600	4,600	4,000
<b>Median Standing Offer</b>	\$1,564	\$1,895	\$1,688	\$2,069	\$2,112
<b>Median Market Offer</b>	\$1,319	\$1,546	\$1,457	\$1,778	\$1,773
<b>DMO</b>	<b>\$1,441</b>	<b>\$1,720</b>	<b>\$1,572</b>	<b>\$1,924</b>	<b>\$1,943</b>
Saving from SO median	\$122	\$174	\$115	\$146	\$169
DMO above MO median	\$122	\$174	\$115	\$146	\$169
DMO above MO minimum	\$264	\$322	\$258	\$364	\$300
DMO percentile within range	50%	50%	50%	50%	50%

#### *Residential flat rate tariffs with controlled load*

Table 13 lists the calculations for each distribution zone for residential flat rate tariffs with controlled load. This shows the median standing offer, median market offer, DMO price and the savings from the median standing offer.

<sup>132</sup> Numbers in the tables may not fully reconcile due to rounding.

**Table 13: Default Market Offer prices and savings from median standing offer – Residential flat rate tariffs with controlled load**

	Ausgrid	Endeavour	Energex	Essential	SAPN
Single load kWh p.a.	4,800	5,200	4,400	4,600	4,200
Controlled load kWh p.a.	2,000	2,200	1,900	2,000	1,800
<b>Total load kWh p.a.</b>	<b>6,800</b>	<b>7,400</b>	<b>6,300</b>	<b>6,600</b>	<b>6,000</b>
<b>Median Standing Offer</b>	<b>\$2,259</b>	<b>\$2,344</b>	<b>\$2,096</b>	<b>\$2,505</b>	<b>\$2,639</b>
<b>Median Market Offer</b>	<b>\$1,868</b>	<b>\$1,944</b>	<b>\$1,761</b>	<b>\$2,154</b>	<b>\$2,202</b>
<b>DMO</b>	<b>\$2,063</b>	<b>\$2,144</b>	<b>\$1,928</b>	<b>\$2,330</b>	<b>\$2,420</b>
Saving from SO median	\$195	\$200	\$168	\$176	\$218
DMO above MO median	\$195	\$200	\$168	\$176	\$218
DMO above MO minimum	\$474	\$492	\$425	\$477	\$398
DMO percentile within range	50%	50%	50%	50%	50%

### ***Small business flat rate tariffs***

Table 14 lists the calculations for each distribution zone for small business flat rate tariffs. This shows the median standing offer, median market offer, DMO price and the savings from the median standing offer.

**Table 14: Default Market Offer prices – Small business flat rate tariffs**

	Ausgrid	Endeavour	Energex	Essential	SAPN
<b>Single load kWh p.a.</b>	20,000	20,000	20,000	20,000	20,000
<b>Median Standing Offer</b>	\$8,203	\$6,745	\$6,424	\$8,684	\$9,804
<b>Median Market Offer</b>	\$6,329	\$5,589	\$5,519	\$7,195	\$8,224
<b>DMO</b>	<b>\$7,266</b>	<b>\$6,167</b>	<b>\$5,972</b>	<b>\$7,940</b>	<b>\$9,014</b>
Saving from SO median	\$937	\$578	\$453	\$745	\$790
DMO above MO median	\$937	\$578	\$453	\$745	\$790
DMO above MO minimum	\$1,686	\$1,288	\$970	\$2,120	\$1,723
DMO percentile within range	50%	50%	50%	50%	50%



## 4 Annual model usage determination

The draft Code requires us to determine model annual usage amounts for residential and small business customers in each distribution zone, from which a DMO price and reference bill can be calculated.<sup>133</sup>

For this draft determination, we have used the model annual usage amounts in Table 15 below.

**Table 15: Annual consumption benchmarks for all network distribution zones**

Distribution Zone	Residential - flat rate <sup>#</sup>	Residential - flat rate with controlled load total <sup>++</sup>	Small business <sup>^</sup>
Ausgrid	3,800 kWh	6,800 kWh	20,000 kWh
Endeavour	4,900 kWh	7,400 kWh	20,000 kWh
Energex	4,600 kWh	6,300 kWh	20,000 kWh
Essential	4,600 kWh	6,600 kWh	20,000 kWh
SAPN	4,000 kWh	6,000 kWh	20,000 kWh

<sup>#</sup> Source: Network distribution businesses' annual pricing proposals

<sup>++</sup> Source: Network distribution businesses' annual pricing proposals, with CL assumptions based on the AER's 2017 Energy Consumption Benchmarks

<sup>^</sup> Source: Energy Consumers Australia, SME Retail tariff tracker

Our reasoning for determining these model annual usage amounts is outlined below.

Additionally, the draft Code requires we determine the 'timing and pattern' of supply for each region over a year.<sup>134</sup>

We have determined this to be:

- Uniform consumption throughout the year – daily consumption is consistent across the year with no adjustments for seasonality, or variation between weekday/weekend consumption
- For controlled load, we have apportioned 30 per cent of total consumption as CL (see below)

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<sup>133</sup> Draft Code, s 14(1)(a)(i).

<sup>134</sup> Draft Code, s 14(1)(a)(ii).

- While have not determined DMO prices for TOU tariff offers, we have determined a TOU profile for use as a consistent basis for retailers to calculate annual reference bills for these offer (see below).

### ***Residential flat rate tariffs***

In the Position Paper, we proposed using the average consumption per customer in each distribution zone based on data from the Economic Benchmarking Regulatory Information Notices (EBRINs) collected from distribution network businesses.

A number of stakeholders supported our proposed approach of using the average consumption sourced from the EBRINs.<sup>135</sup>

Other stakeholders considered the AER's Energy Consumption Benchmark data was a better data source. This is data collected by the AER every three years to develop household consumption benchmarks for different sized households, for inclusion on residential energy bills, as required under the NERL.<sup>136</sup> This data is also used in our Energy Made Easy (EME) energy comparison website, to calculate annual price estimates.

Stakeholders considered this approach would result in DMO prices and reference bills being calculated on a comparable basis to the annual price estimates calculated by the AER's Energy Made Easy website.<sup>137</sup>

Active Utilities considered the consumption benchmarks should be based on the demographic characteristics of each distribution zone due to differences in dwelling types and other factors.<sup>138</sup>

For residential customers, we have calculated the flat rate average consumption per customer from the distribution business' annual pricing model for 2018-19. This is a departure from our proposed approach of using the EBRIN data.

We consider this is a more accurate approach as this data identifies information specific to residential customers rather than all customer types within a distribution zone. Specifically, the annual pricing proposal models show the latest forecast customer numbers and expected total usage for each customer type.<sup>139</sup> This data is

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<sup>135</sup> EWOSA, *Submission to the AER: Default Market Offer Price*, 7 December 2018, p. 3; Powershop, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 3.

<sup>136</sup> See AER website: <https://www.aer.gov.au/retail-markets/retail-guidelines-reviews/electricity-and-gas-bill-benchmarks-for-residential-customers-2017>

<sup>137</sup> AGL, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 7; Alinta Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 8; Simply Energy, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 3.

<sup>138</sup> Active Utilities, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 9.

<sup>139</sup> The annual pricing proposals can be found on our website at: [https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/pricing-proposals-tariffs?f%5B0%5D=type%3Aaccc\\_aer\\_pricing\\_proposal](https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/pricing-proposals-tariffs?f%5B0%5D=type%3Aaccc_aer_pricing_proposal). Some of the annual pricing models are not published as they are commercial-in-confidence.

current and has been through a process of quality assurance by the network businesses and assessed by the AER in the context of the annual pricing approval processes. In some cases, we also contacted the distribution businesses to clarify the average usage for residential flat rate and controlled load.<sup>140</sup>

**Table 16: Annual consumption benchmarks – Residential flat rate**

Distribution Zone	Residential - flat rate
Ausgrid	3,800 kWh
Endeavour	4,900 kWh
Energex	4,600 kWh
Essential	4,600 kWh
SAPN	4,000 kWh

In terms of stakeholders' views that we should rely on the EME's Energy Consumption Benchmarks data, we note that these benchmarks have been developed for climate zones<sup>141</sup>, and are not directly transferable to network distribution zones. While it would be possible to re-analyse the data to derive a benchmark figure for each network distribution zone, we consider the availability and robustness of annual distribution pricing data means this is not necessary.

We note the variation in the residential benchmarks between different distribution zones. This is likely to be due to a range of factors, including the prevalence of mains gas in the region, and climatic differences accounting for different heating and cooling appliances and profiles.

#### ***Residential flat rate tariffs with controlled load***

We have used the distribution business' annual pricing models for 2018-19 to calculate the flat and controlled load usages.

Distribution businesses provide CL-specific consumption information as part of their annual pricing models, enabling a current and accurate picture of CL usage in each network distribution zone.

<sup>140</sup> We contacted SA Power Networks and Essential Energy for additional clarification.

<sup>141</sup> The benchmarks use the Australian Building Codes Board's climate zones, and local zones for SA based on Nationwide House Energy Rating Scheme (NATHERS). See <https://www.aer.gov.au/retail-markets/retail-guidelines-reviews/electricity-and-gas-bill-benchmarks-for-residential-customers-2017>

To determine the total consumption for CL customers, and the relative proportion of CL and non-CL usage, we undertook the following steps:

- Analysed data provided in each distribution business' annual pricing proposals for 2018-19 to determine the average controlled load consumption of customers with a controlled load.<sup>142</sup>
- Analysed residential consumption data collected by ACIL Allen during the 2017 Energy Consumption Benchmark project<sup>143</sup> to determine the proportion of total consumption of CL and non-CL. This analysis indicated that across the areas for which we are determining DMO prices, the proportion of CL usage was consistently close to 30 per cent of total usage. Given this outcome, we have used the 30 per cent figure across all calculations.
- We derived the total consumption by applying the 30 per cent figure to the CL consumption, eg:

*If CL (30%) is 1900kWh pa, non-CL consumption (70%) will be approximately 4,400kWh pa*

- The remainder of total residential usage not allocated to customers with controlled load was divided by the number of flat rate customers.
- In some cases we could calculate the flat and controlled load usages directly from the model or alternatively we contacted the distribution business directly to clarify this data.

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<sup>142</sup> The annual pricing proposals can be found on our website at: [https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/pricing-proposals-tariffs?f%5B0%5D=type%3Aaccc\\_aer\\_pricing\\_proposal](https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/pricing-proposals-tariffs?f%5B0%5D=type%3Aaccc_aer_pricing_proposal). Some of the annual pricing models are not published as they are commercial-in-confidence.

<sup>143</sup> <https://www.aer.gov.au/retail-markets/retail-guidelines-reviews/electricity-and-gas-bill-benchmarks-for-residential-customers-2017>

**Table 17: Annual consumption benchmarks – Residential flat rate with controlled load**

Distribution Zone	Residential - flat rate portion	Residential - controlled load portion	Total usage
Ausgrid	4,800 kWh	2,000 kWh	6,800 kWh
Endeavour	5,200 kWh	2,200 kWh	7,400 kWh
Energex	4,400 kWh	1,900 kWh	6,300 kWh
Essential	4,600 kWh	2,000 kWh	6,600 kWh
SAPN	4,200 kWh	1,800 kWh	6,000 kWh

For offers with multiple CL components, we have analysed distributor data to determine the average proportion of CL1 and CL2 usage in each distribution zone<sup>144</sup>. To calculate annual bills for these offers, we have used this proportion to derive a consumption figure for each zone. Table 18 shows these proportions.

**Table 18: Annual consumption benchmarks – Controlled load proportions**

	CL1 %	CL2 %
<b>Ausgrid</b>	67%	33%
<b>Endeavour</b>	67%	33%
<b>Energex</b>	29%	71%
<b>Essential</b>	77%	23%
<b>SAPN</b>	100%	--

Source: AER analysis

Only one stakeholder, QCOSS, specifically addressed the issue of consumption benchmarks for CL tariffs. It noted that given the large numbers of South East Queensland customers on CL tariffs, it was important that our assumptions about CL

<sup>144</sup> Some distribution zones have multiple controlled load options which have different times of operation. For example overnight only for a hot water heater and a set period during the day for pool pumps. Retailers may bundle these together in a retail offer of flat rate and controlled load, or have a retail offer with flat rate and two controlled loads.

consumption be robust if the relevant DMO price/reference bill was to accurately reflect these costs.<sup>145</sup>

### ***Small business flat rate tariffs***

In our Position Paper, we proposed using publicly available information on small business consumption benchmarks, such as those published by Energy Consumers Australia (ECA) and AEMO.

A number of submissions noted the challenges around setting a meaningful consumption benchmark for small businesses, particularly given the heterogeneous nature of small business electricity consumption.<sup>146</sup>

We have adopted a benchmark of 20,000kWh for small business customers, consistent with that published by ECA.<sup>147</sup> We consider this is the best source of business consumption data available.

### ***Time of Use assumptions***

While the draft Code does not require us to develop DMO prices for Time of Use offers, retailers will need to be able to calculate annual bills for TOU offers for comparison to the reference bill.

For consistency, these calculations will need to be made using a common set of assumptions about usage at different times.

We consider a reasonable approach to provide consistency is for retailers to calculate annual prices using EME's algorithm, which incorporates TOU profiles.<sup>148</sup> These profiles are based on household usage data collected as part of our 2017 Energy Consumption Benchmark project. Consultants ACIL Allen analysed usage data from households with interval meters to determine the proportion of electricity typically used across Peak, Off-peak and shoulder periods in each climate zone.<sup>149</sup>

As with the consumption benchmarks, ACIL Allen developed the TOU profiles for the climate zones, several of which may overlap a single distribution zone.

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<sup>145</sup> QCOSS, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 5.

<sup>146</sup> Active Utilities, *Submission to AER on Default Market Offer Position Paper*, 7 December 2018, p. 4; Origin, *Submission to the AER: Default Market Offer Price*, p.7; AGL, *Submission to AER on Default Market Offer Position Paper*, 10 December 2018, p. 7.

<sup>147</sup> Energy Consumers Australia, *SME Retail Tariff Tacker report*, June 2018. The 20,000kWh figure is based on a rounded average consumption for small businesses in various NEM by Jacobs Australia for AEMO.

<sup>148</sup> Retailers have access to EME's algorithm through the site's retailer portal. We expect detailed requirements about how retailers would calculate and use prices developed through EME will be set out in a future guidance note.

<sup>149</sup> For more information on the 2017 energy benchmarks, see: <https://www.aer.gov.au/retail-markets/retail-guidelines-reviews/electricity-and-gas-bill-benchmarks-for-residential-customers-2017>

To simplify the process of calculating a DMO price/reference bill for retailers, we have determined that the profile for the most relevant climate zone should be used as the profile for each distribution zone.

For New South Wales, we have determined the most relevant climate zone is the one with the greatest geographical overlap with each distribution zone.

- Ausgrid – NSW climate zone 5
- Endeavour – NSW climate zone 6
- Essential – NSW climate zone 4

EME uses a single set of assumptions for South Australia, based on analysis of data from climate zones 5 and 6.

All of Energex is in Queensland's climate zone 2.

The time of use assumptions for each distribution zone are included as **Appendix 6**.

## Appendix 1 – Letter requesting AER commence work on a DMO



TREASURER  
MINISTER FOR ENERGY

MS18-001177

Ms Paula Conboy  
Chair  
Australian Energy Regulator  
GPO Box 520  
MELBOURNE VIC 3000

Dear Ms Conboy *Paula*

You would be aware that the Prime Minister recently confirmed the Australian Government will adopt a number of recommendations from the Australian Competition and Consumer Commission's (ACCC) Retail Electricity Pricing Inquiry.

The Australian Government is focussed on reducing retail electricity prices. A priority for the Government is the swift introduction of a default market offer for both residential and small business electricity consumers. This landmark reform will replace the standing offer for those customers who are not subject to state-based price regulation.

Consistent with the Inquiry recommendations 30 and 49, we consider the AER is the appropriate body for setting a maximum price for the default market offer in each network distribution region that does not have a regulated standing offer price.

Accordingly, we ask that the AER commence work immediately on developing a mechanism for determining the price of the default market offer, consistent with the ACCC's recommendations. As part of this, we ask that the AER also develop a mechanism for determining a reference bill amount for each network distribution region, from which headline discounts can be calculated, in accordance with ACCC Recommendations 32 and 50.

We ask that the AER's final determination for 1 July 2019 default offer prices and the reference bill be publicly released by 30 April 2019, to bring about price reductions for residential and small business consumers.

We recognise that introducing the default offer and reference bill will require legislative support. The Australian Government, intends to work closely in the first instance with state and territory governments to prepare the legislation to implement these changes. Should state and territory agreement not be forthcoming, the Australian Government will underpin the introduction of these reforms through Commonwealth legislation.

Following the introduction of legislative reforms supporting the default offer, the Australian Government intends to commence updating consumer protections and abolish the Standard Retail Contract, as recommended by the ACCC. This work will be undertaken in cooperation with the AER and state and territory governments, and informed by stakeholder consultation.

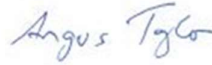


We ask that you work closely with officials from the Treasury and the Department of the Environment and Energy throughout this process, and undertake consultation as appropriate. As this is a priority for the Australian Government, we ask the AER provide a fortnightly update on the progress of the work.

Yours sincerely



**JOSH FRYDENBERG**  
Treasurer



**ANGUS TAYLOR**  
Minister for Energy

CC: The Hon Scott Morrison MP, Prime Minister of Australia

## Appendix 2 – List of submission to DMO Position Paper

1. Australian Competition & Consumer Commission (ACCC)
2. ACT Civil and Administrative Tribunal (ACAT)
3. Active Utilities (AU)
4. Australian Energy Council (AEC)
5. AGL Energy
6. Alinta Energy
7. Anna Johnson & Gary Hammer
8. Australian Council of Social Service (ACOSS)
9. Business SA (BSA)
10. CHOICE
11. Energy & Water Ombudsman NSW (EWON)
12. Energy and Water Ombudsman Victoria (EWOV)
13. EnergyAustralia
14. ERM Power
15. Energy & Water Ombudsman SA (EWOSA)
16. Handled
17. Locality Planning Energy (LPE)
18. National Farmers Federation
19. National Seniors Australia
20. Next Business Energy (Confidential submission)
21. OC Energy (OCE)
22. Origin Energy
23. Public Interest Advocacy Centre (PIAC)
24. Powershop
25. Queensland Council of Social Service (QCOSS)
26. Red Energy/Lumo Energy (confidential submission)
27. SA Minister for Energy and Mining
28. Simply Energy
29. St Vincent de Paul Society (SVdP)/South Australian Council of Social Service (SACOSS)
30. VOCUS group (M2 Energy Pty Ltd and Dodo P&G, Commander P&G)
31. WINconnect

## Appendix 3 – List of annual bill calculation assumptions

Subject	Specifications
Raw data	All available data from Energy Made Easy (EME) for October 2018.
Unique data set	For offers to be considered unique, the following criteria are used: <ul style="list-style-type: none"> <li>• Contract type (standing, market)</li> <li>• Retailer</li> <li>• Total annual bill (unconditional, conditional)</li> <li>• Fixed component (unconditional, conditional)</li> <li>• Usage component (unconditional, conditional)</li> <li>• CL fixed component (unconditional, conditional)</li> <li>• CL usage component (unconditional, conditional)</li> </ul>
Demand component to flat tariff	Offers with a demand component to the flat tariff are removed from the data.
Usage profile	Assumption of uniform consumption throughout the year to calculate the annual bill. Hence the daily consumption is consistent across the year with no adjustments for seasonality.
Days per year, days per quarter	365 days per year. Quarter calculated by daily charge times 365 days then divided by 4.
Controlled loads CL1 & CL2	When CL1 and CL2 are listed in the raw data, we have apportioned the total CL usage depending on the distribution area. This represents the customer being on a retail offer with flat, CL1 and CL2. When the EME raw data only has CL1, this could represent CL1 or CL2 in a retailer's offer. Hence the customer is on a flat with CL1 offer or a flat with CL2 offer.
Standing offer with controlled load	Some retailers offer three standing offers with CL – flat rate with CL1, flat rate with CL2 or flat rate with CL1 and CL2. We have used the highest standing offer for each retailer in calculating the median standing offer. This is usually CL2.

Discounts	Discounts on unconditional and conditional offers are applied to usage and supply as per each offer (percentage or dollar amount) as applied in EME.
Fees	Most fees are excluded for the calculation of the annual bill as they are one-off payments or dependent on the customer's payment. These include connection fees, disconnection fees, late payment fees, direct debit dishonour payment fee, credit card processing fee, credit card merchant service fee, direct debit payments fee, establishment fee, other fees.
Membership fee	This annual fee is effectively a supply charge, hence it was included in the calculation of the annual bill.
Metering fees	Up front and ongoing metering charges are excluded, as there is no set scenario that would apply to most customers.
Bundling	No bundling included, such as gas, phone, internet, mobile, pool services.
Green charges	Assumption of no additional payment for green schemes to calculate the annual bill.
PV / Solar feed in tariffs	Offers with 'solar' in the title removed from data. Assumption of zero PV solar exported to calculate the annual bill.

## **Appendix 4 – Standing and market offers for each distribution zone**

Figure 5: Standing and market offers – Ausgrid – Residential flat rate tariffs

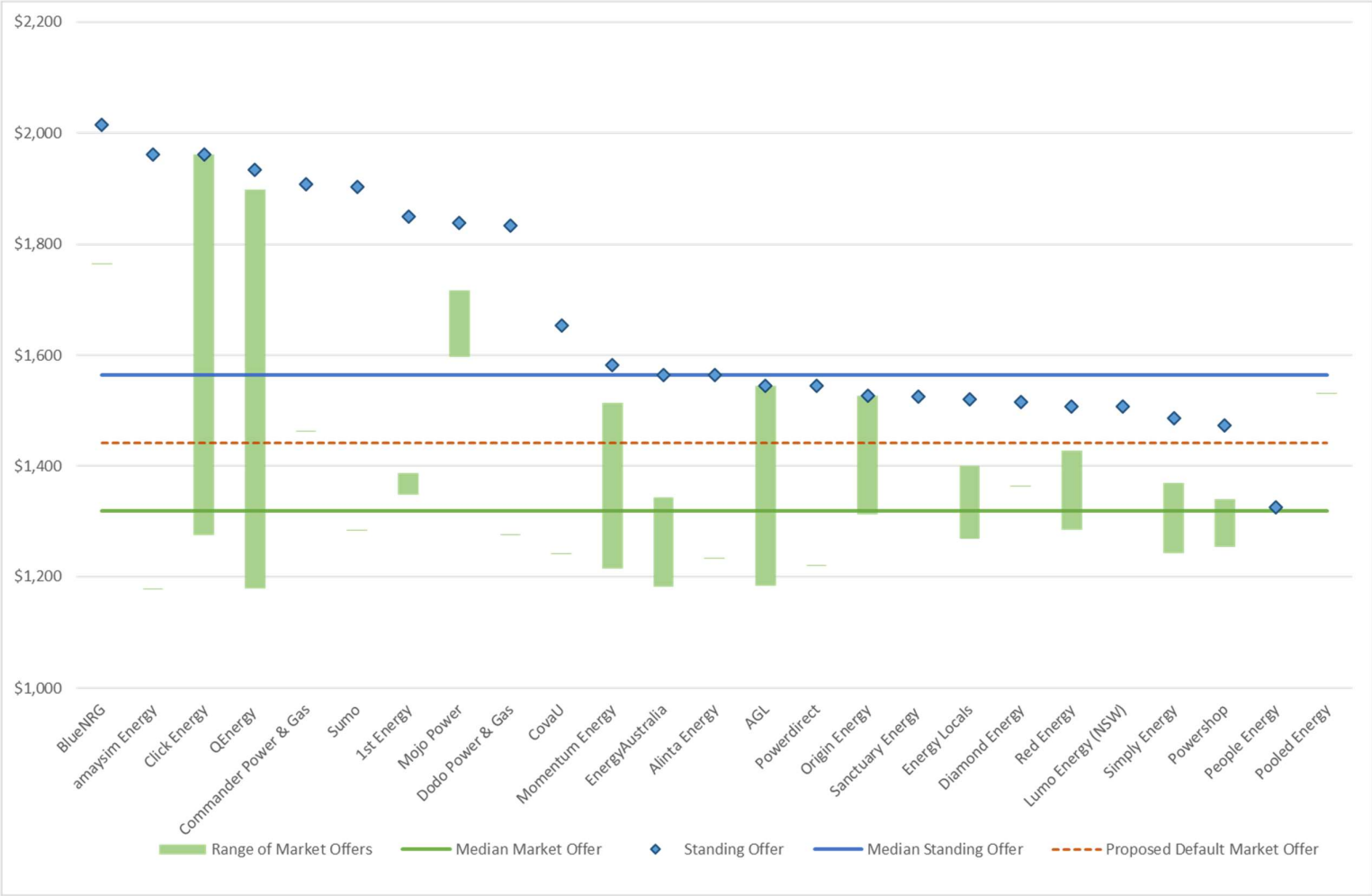


Figure 6: Standing and market offers – Ausgrid – Residential flat rate tariffs with controlled load

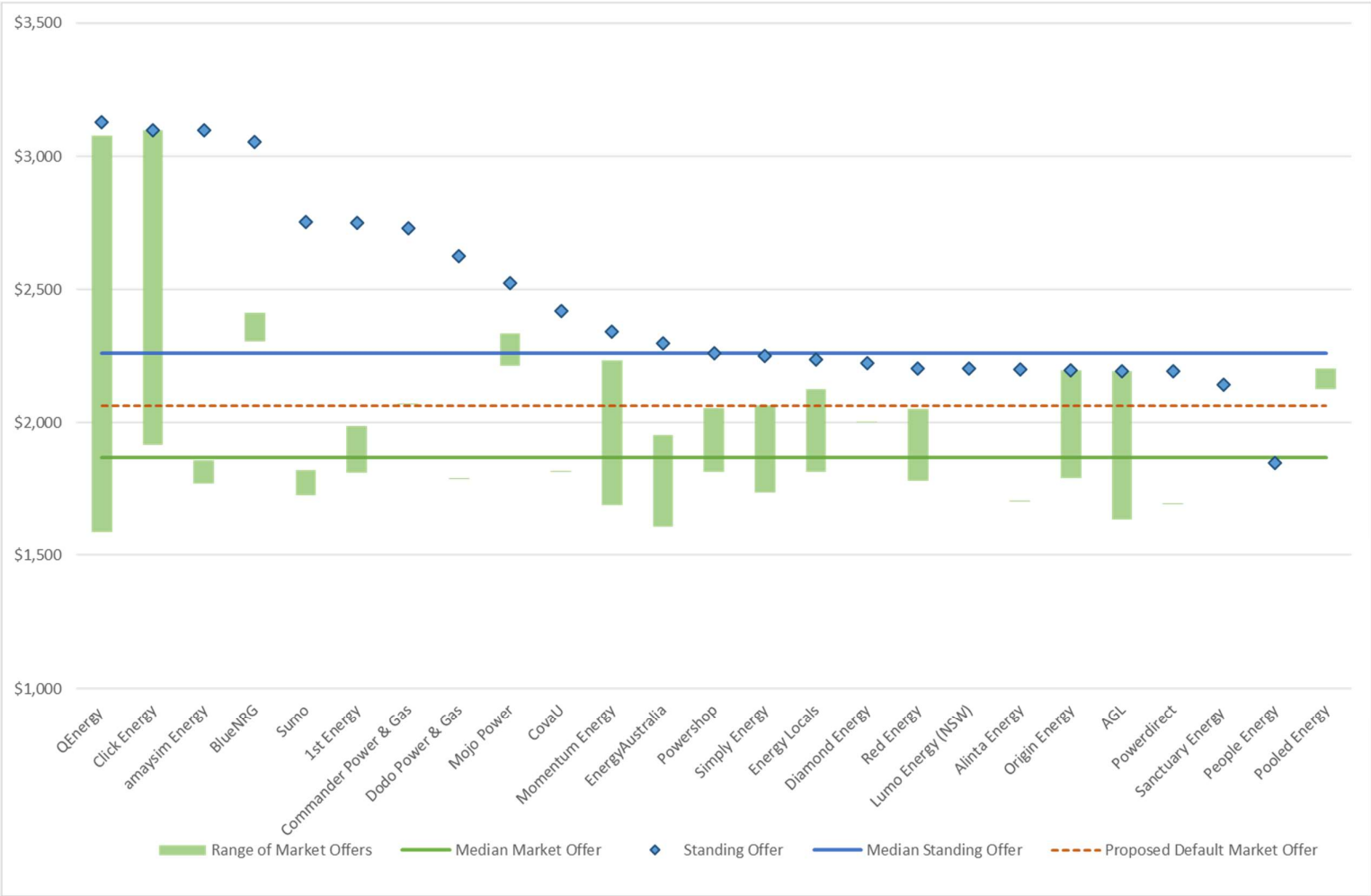


Figure 7: Standing and market offers – Ausgrid – Small business flat rate tariffs

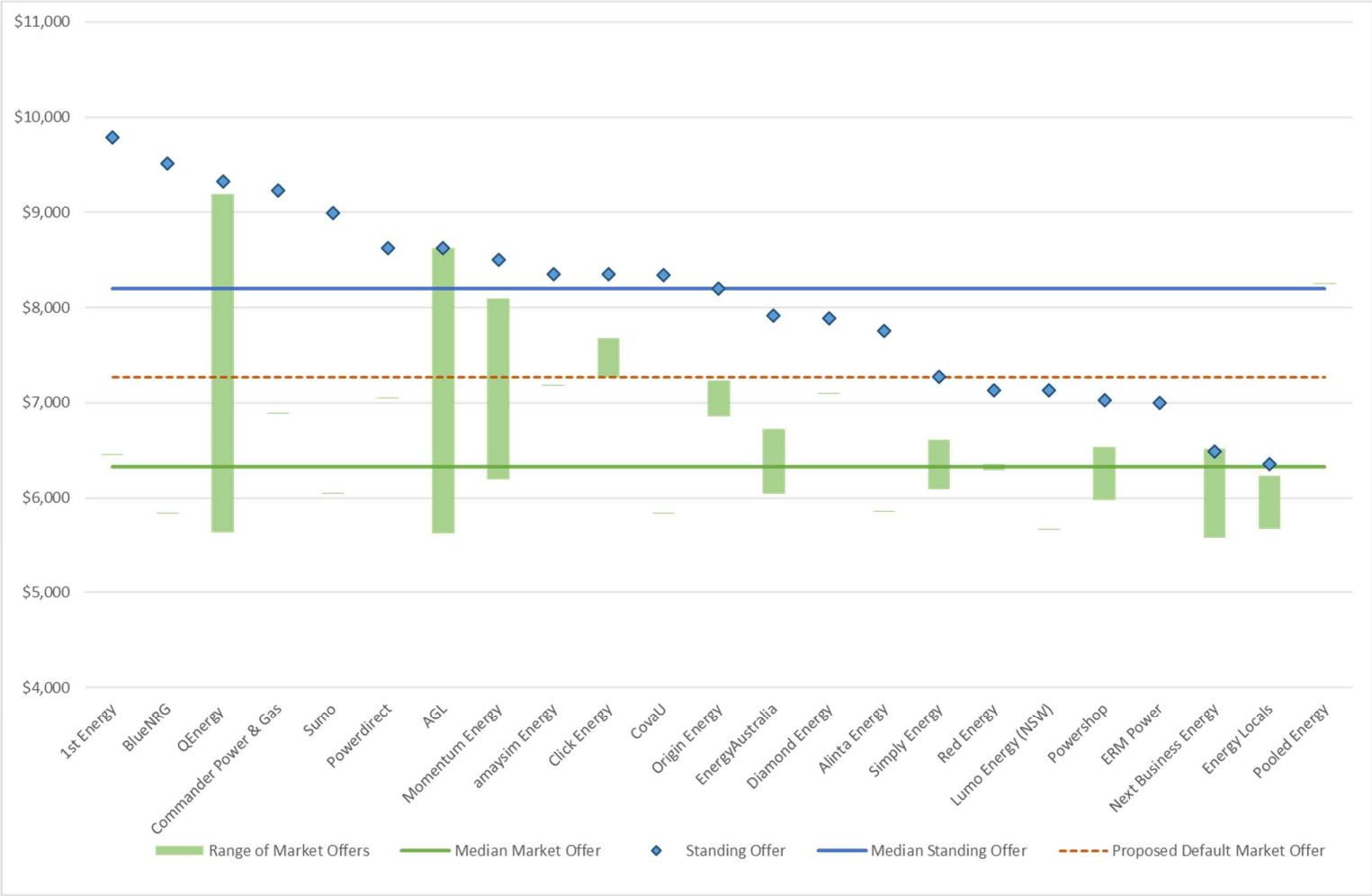




Figure 8: Standing and market offers – Endeavour – Residential flat rate tariffs

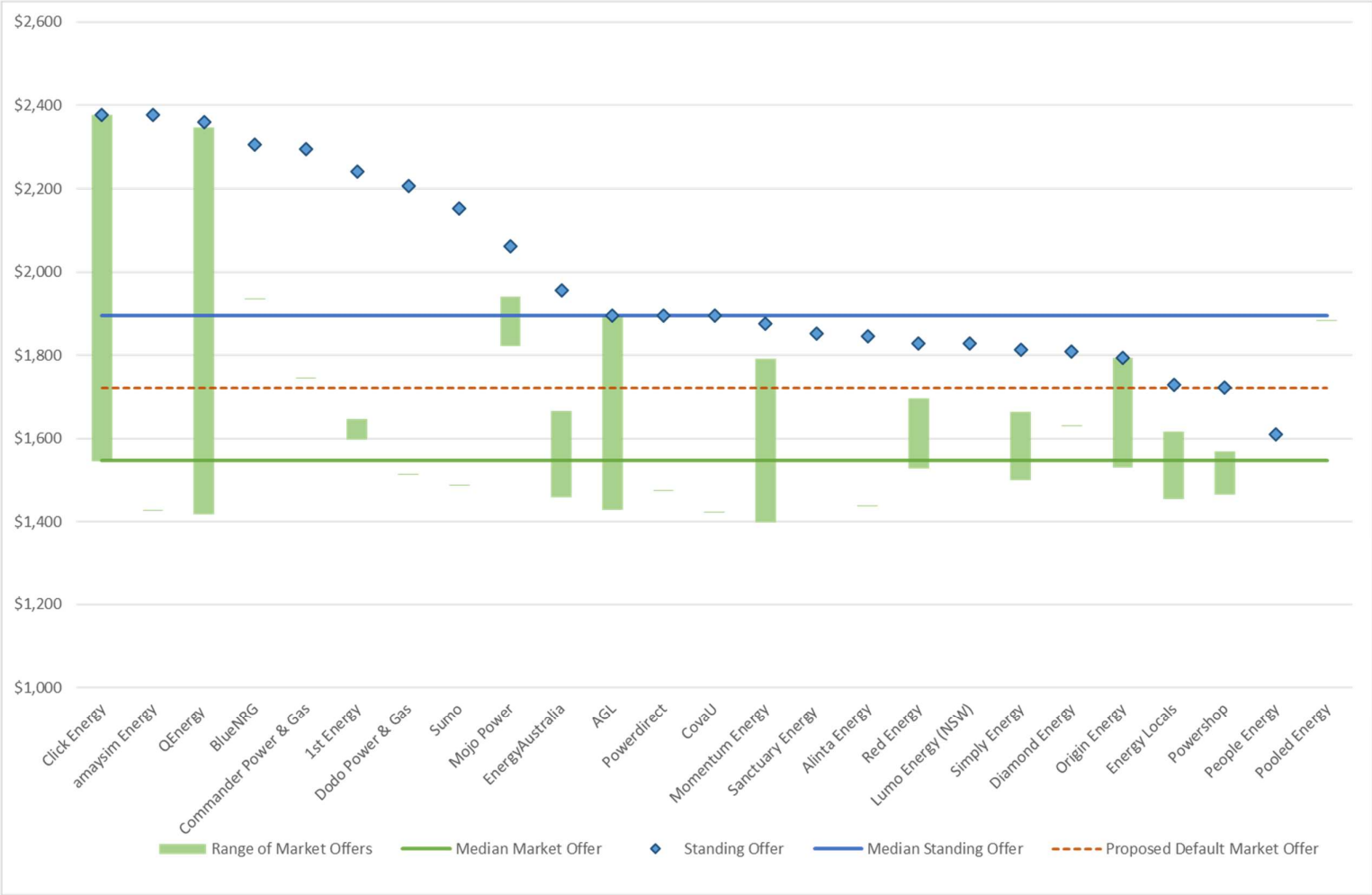


Figure 9: Standing and market offers – Endeavour – Residential flat rate tariffs with controlled load

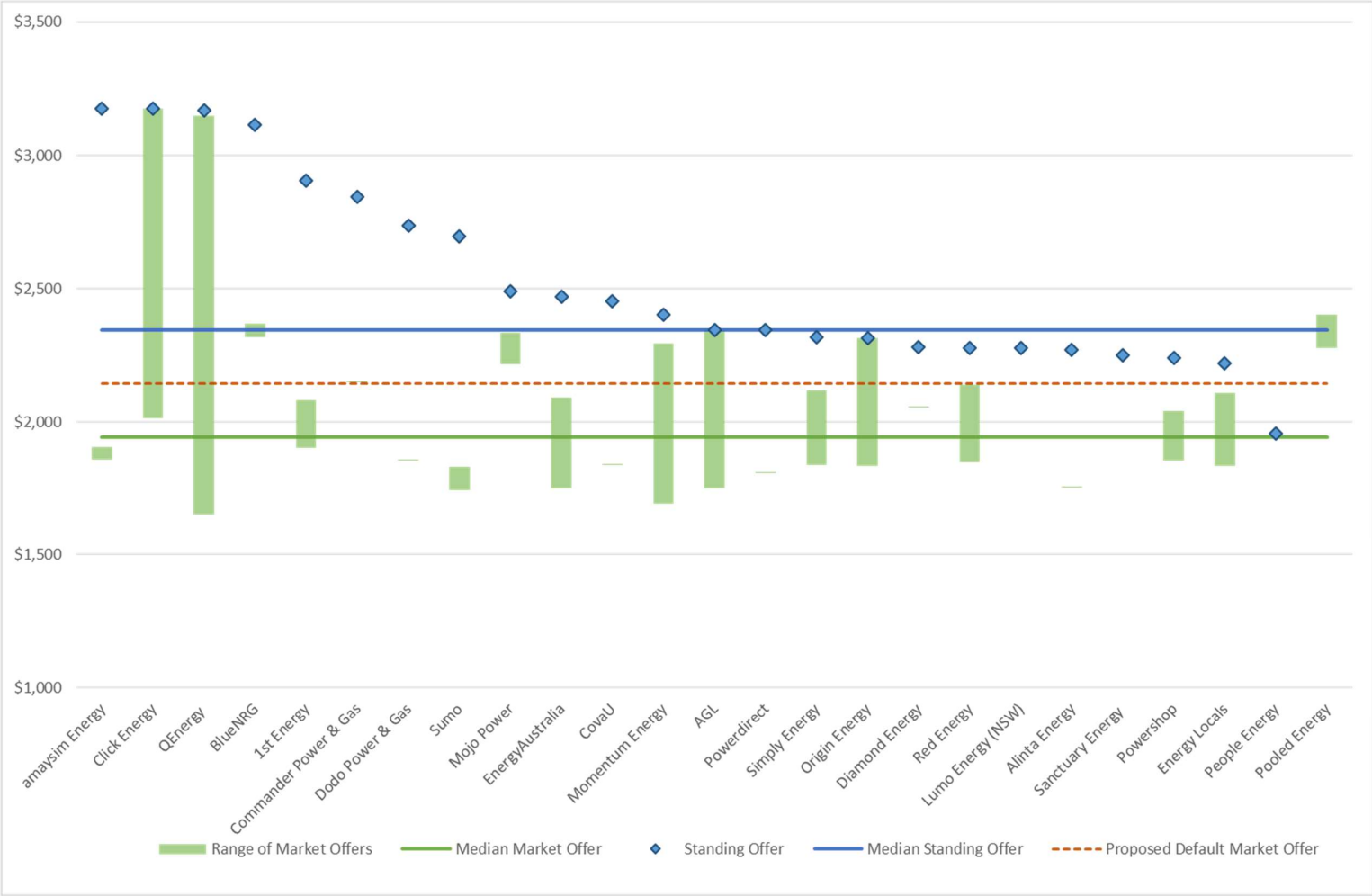


Figure 10: Standing and market offers – Endeavour – Small business flat rate tariffs

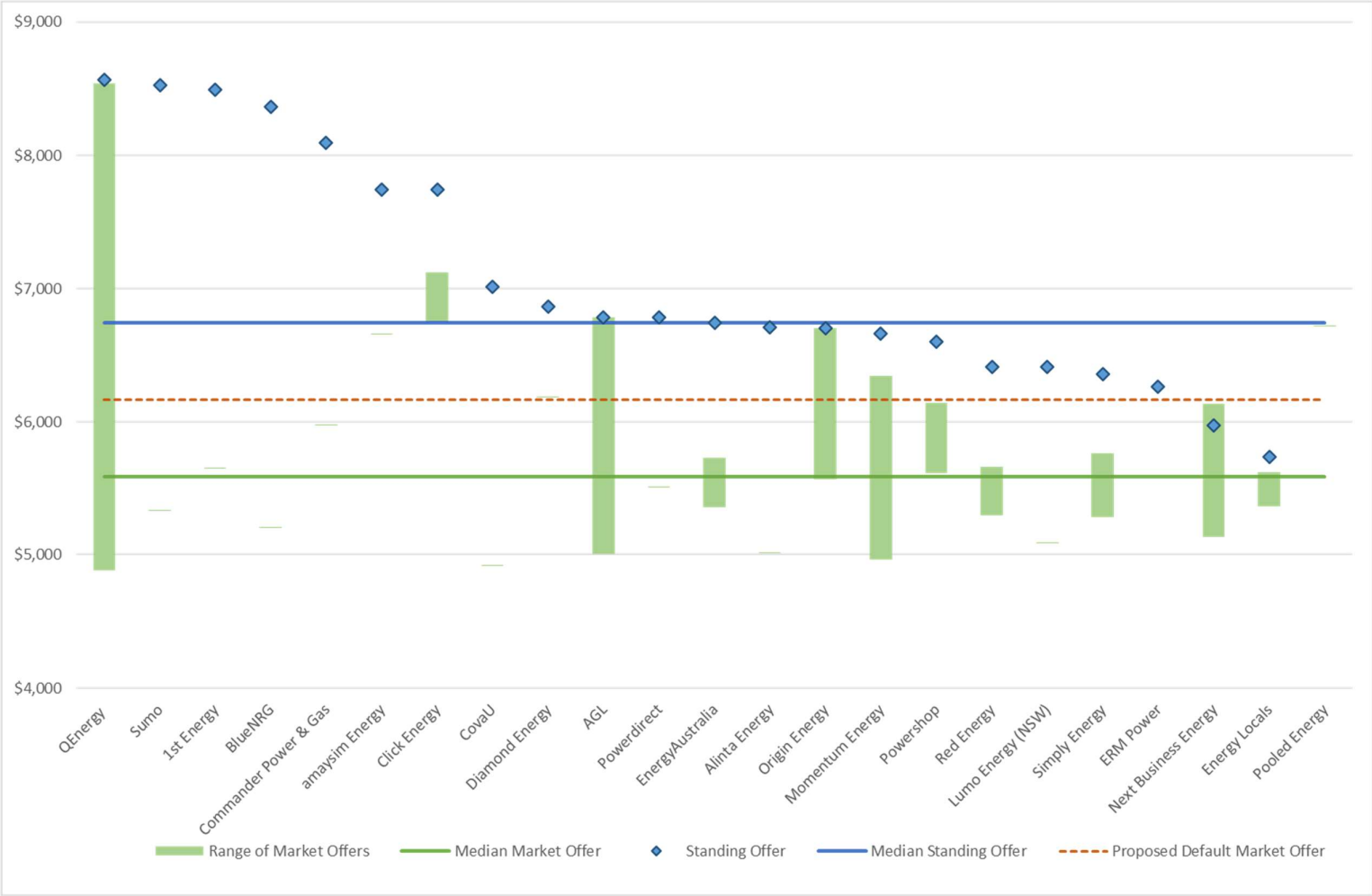


Figure 11: Standing and market offers – Energex – Residential flat rate tariffs

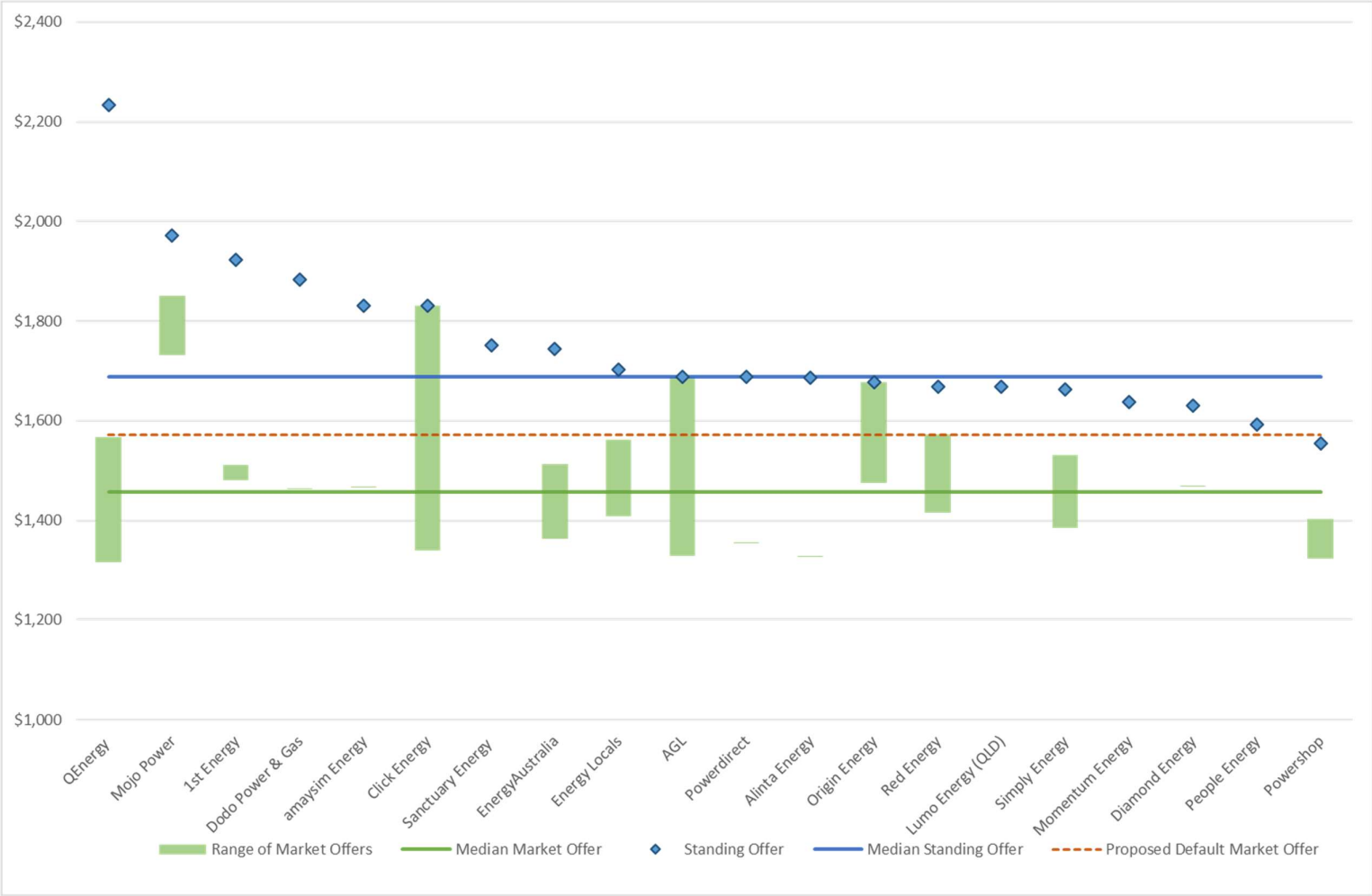


Figure 12: Standing and market offers – Energex – Residential flat rate tariffs with controlled load

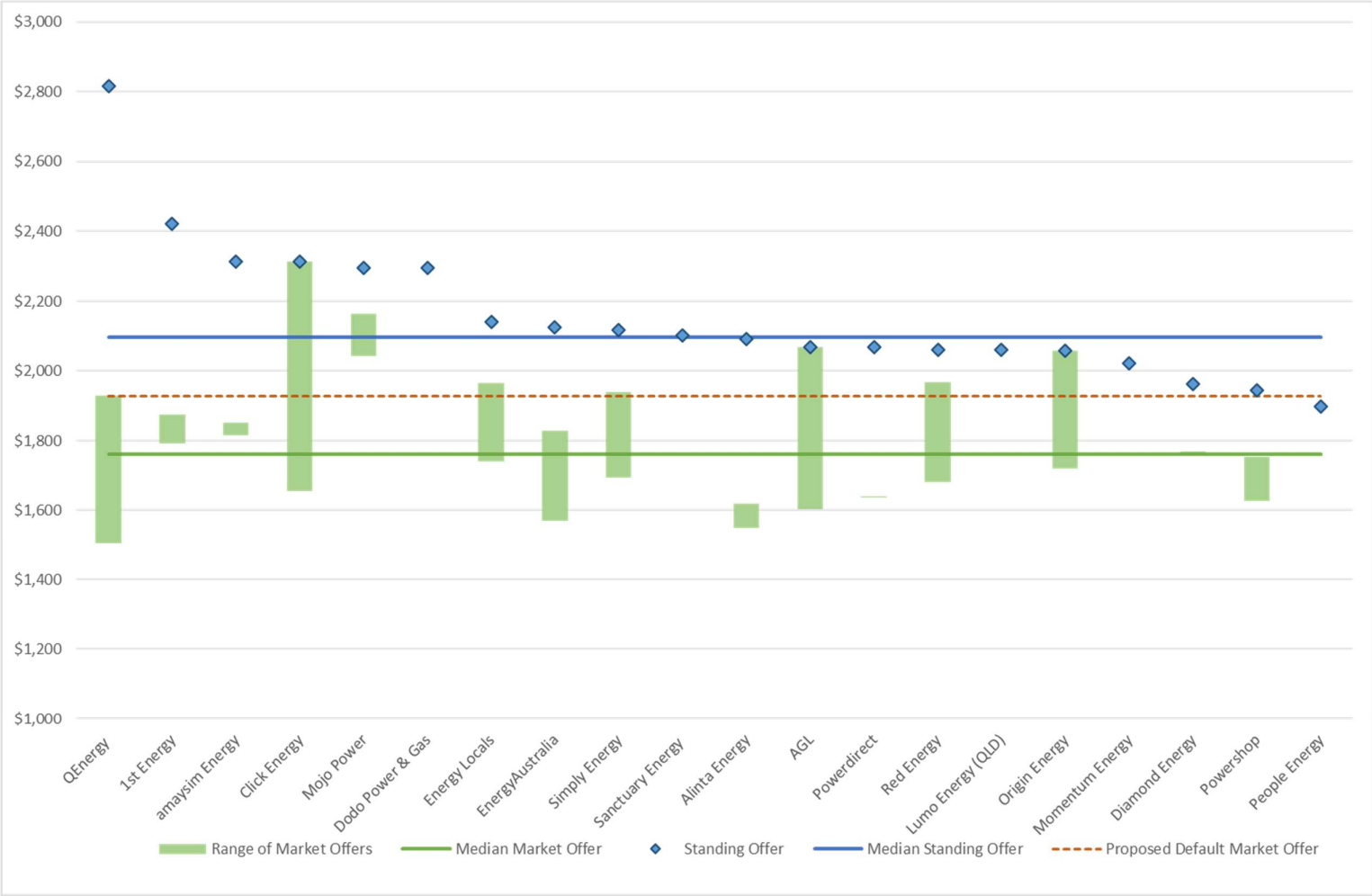
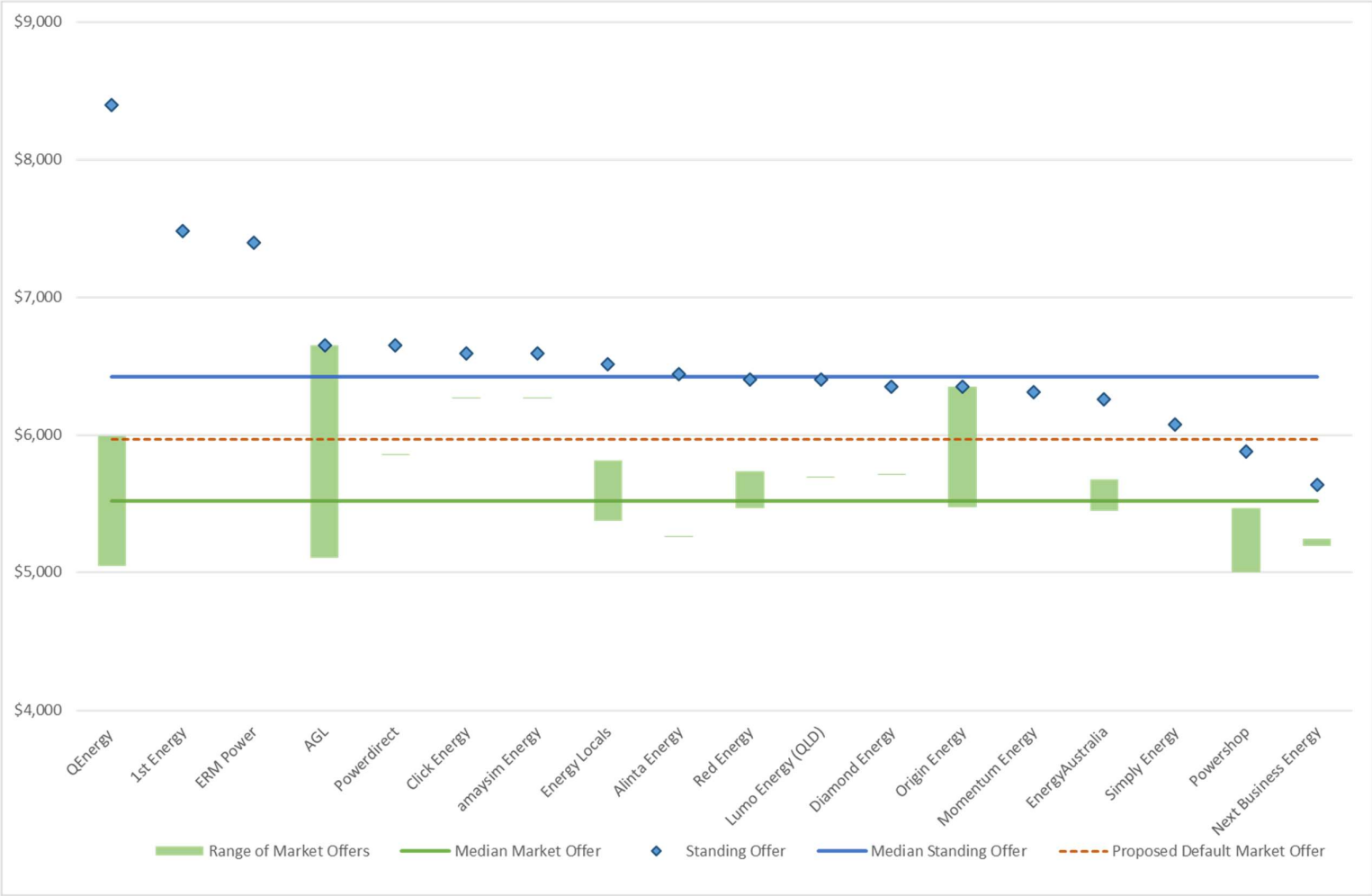


Figure 13: Standing and market offers – Energex – Small business flat rate tariffs



**Figure 14: Standing and market offers – Essential – Residential flat rate tariffs**

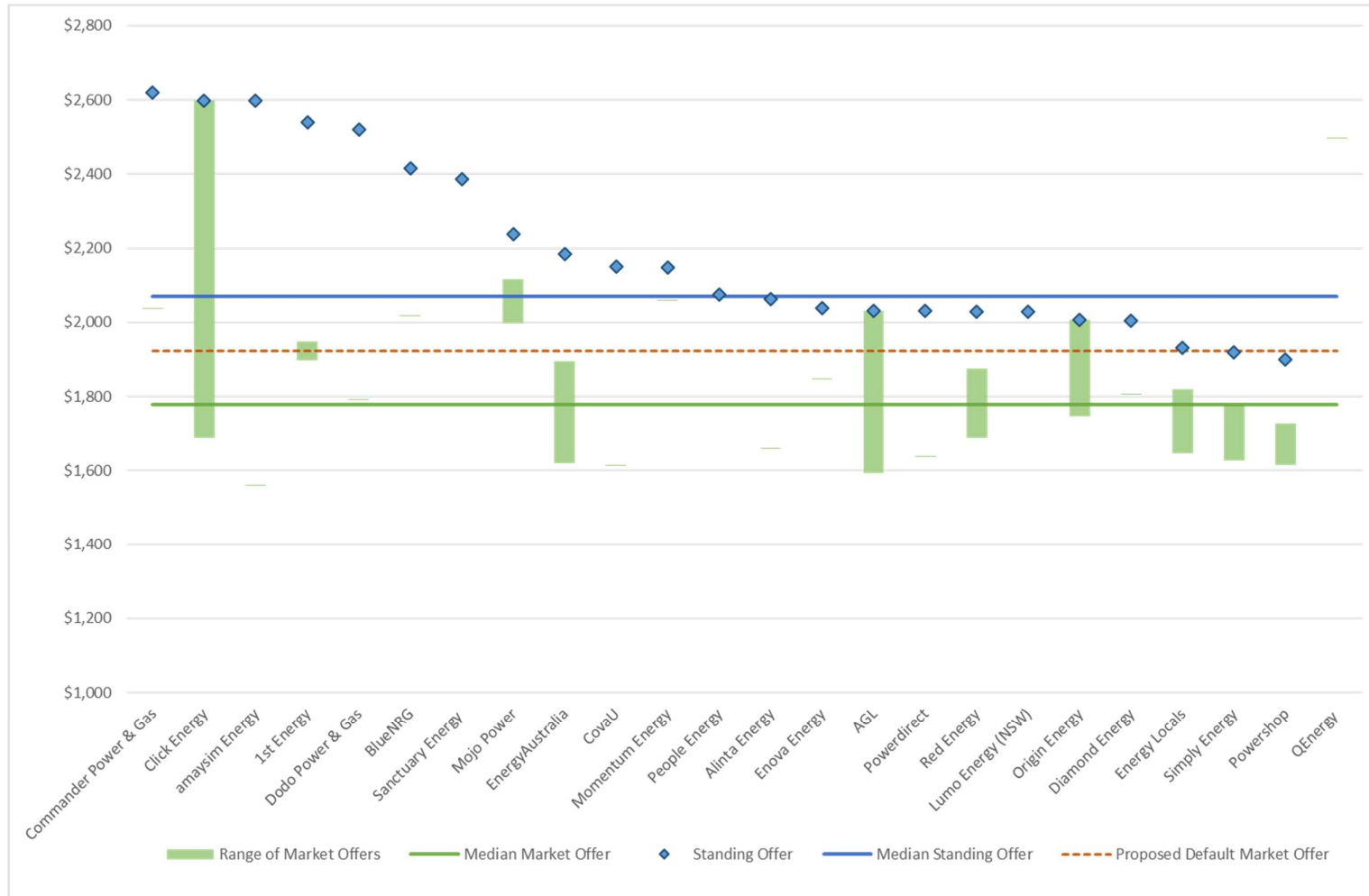


Figure 15: Standing and market offers – Essential – Residential flat rate tariffs with controlled load

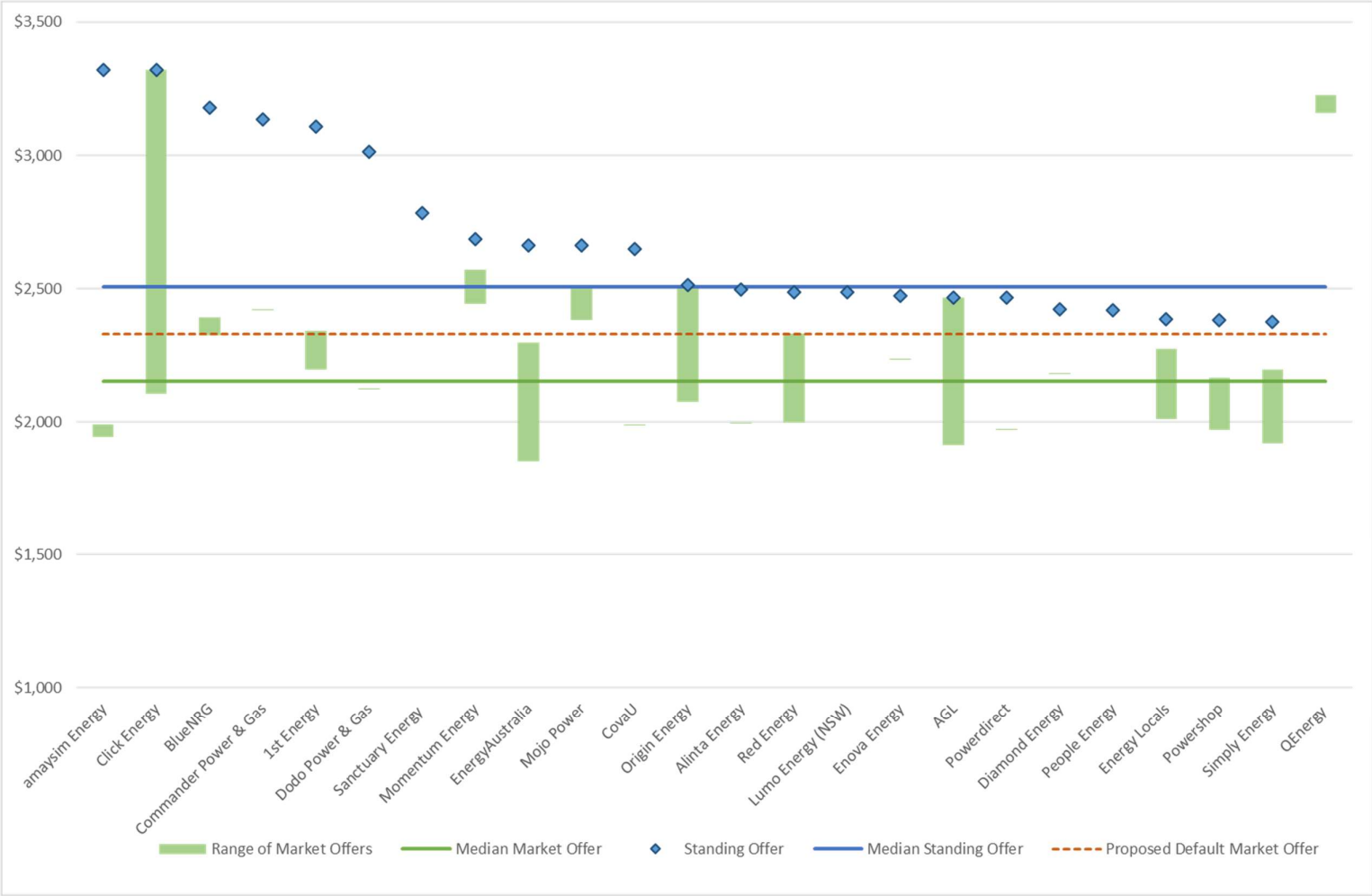
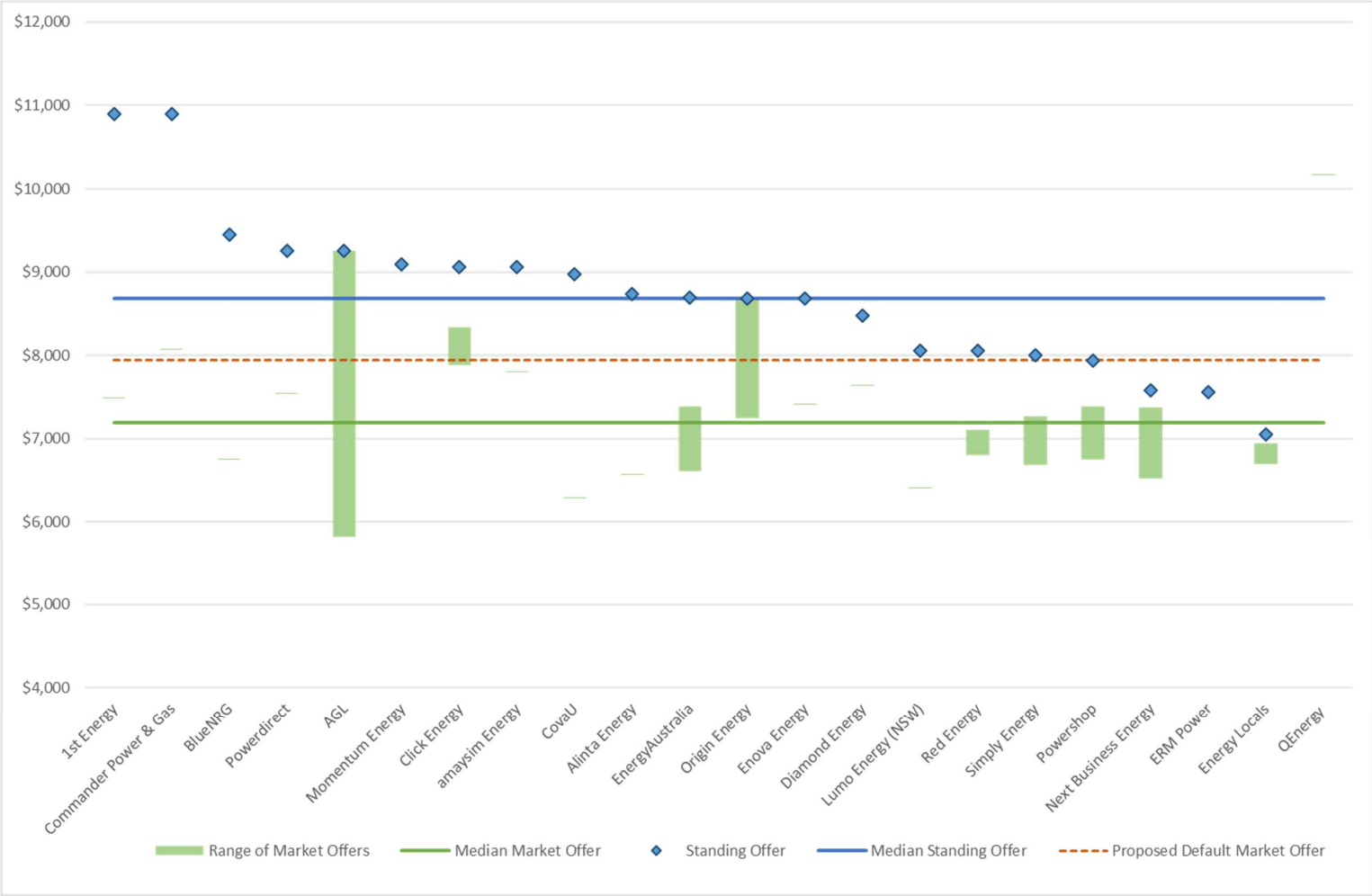




Figure 16: Standing and market offers – Essential – Small business flat rate tariffs



**Figure 17: Standing and market offers – SAPN – Residential flat rate tariffs**

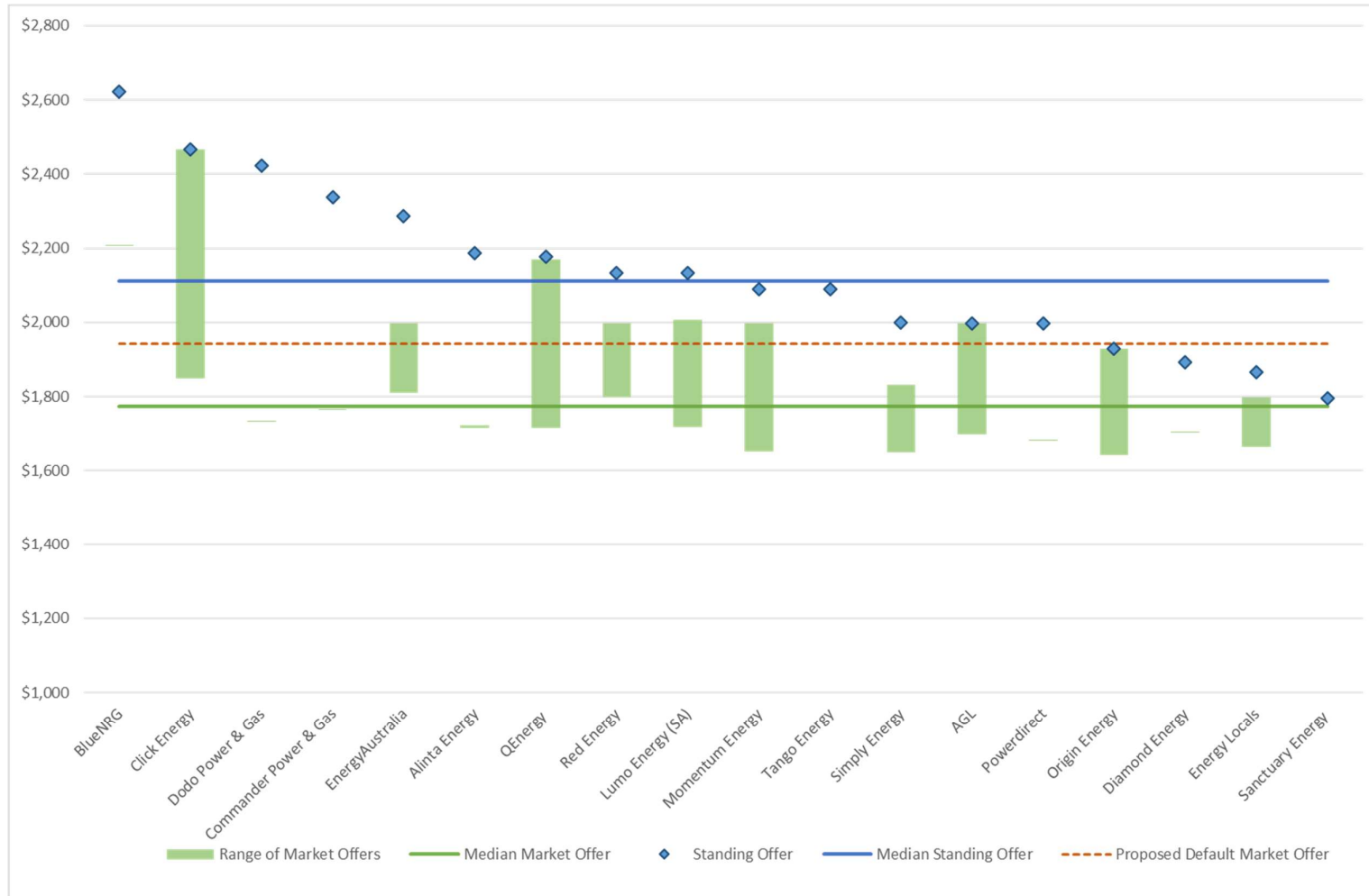


Figure 18: Standing and market offers – SAPN – Residential flat rate tariffs with controlled load

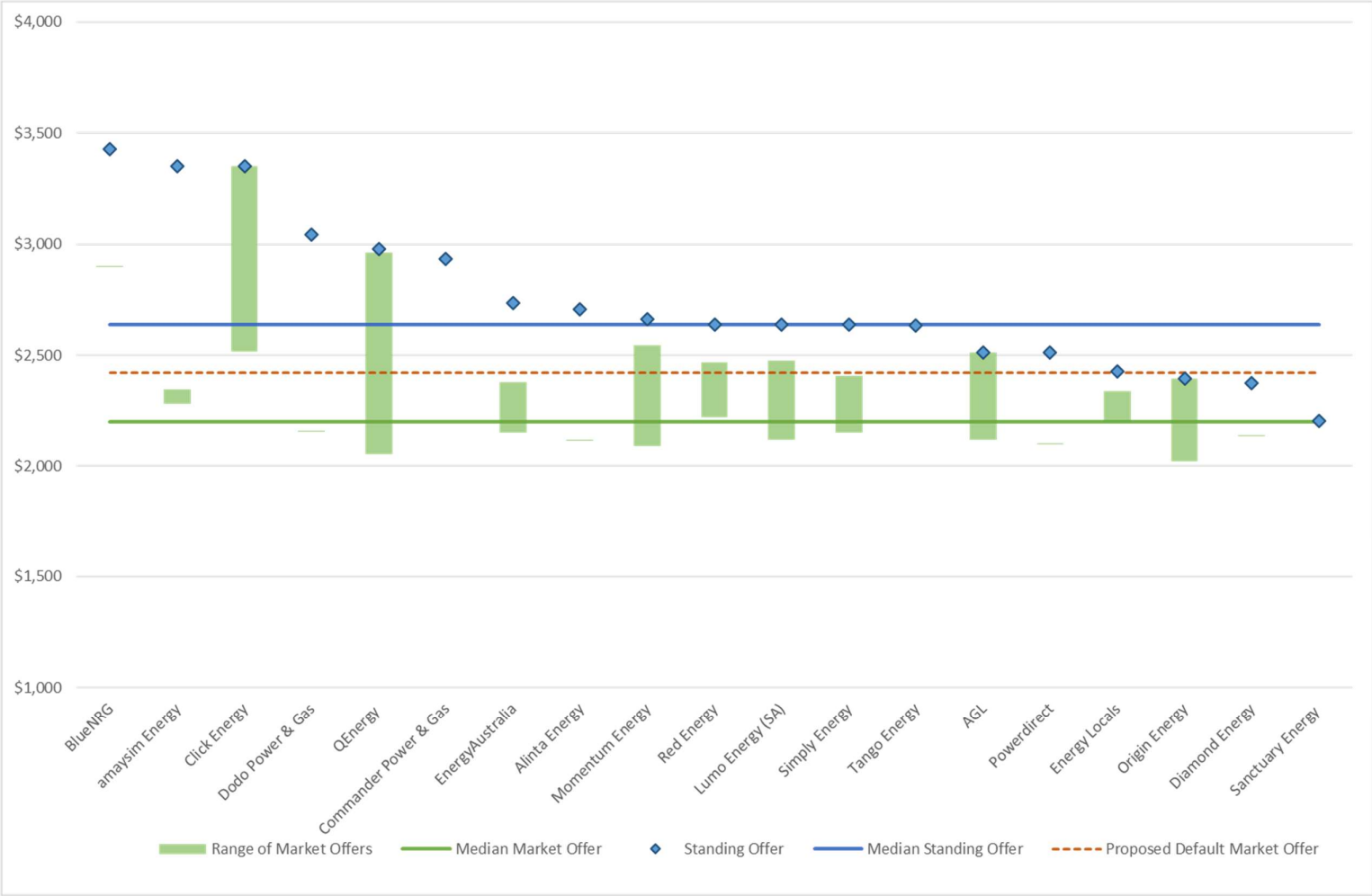
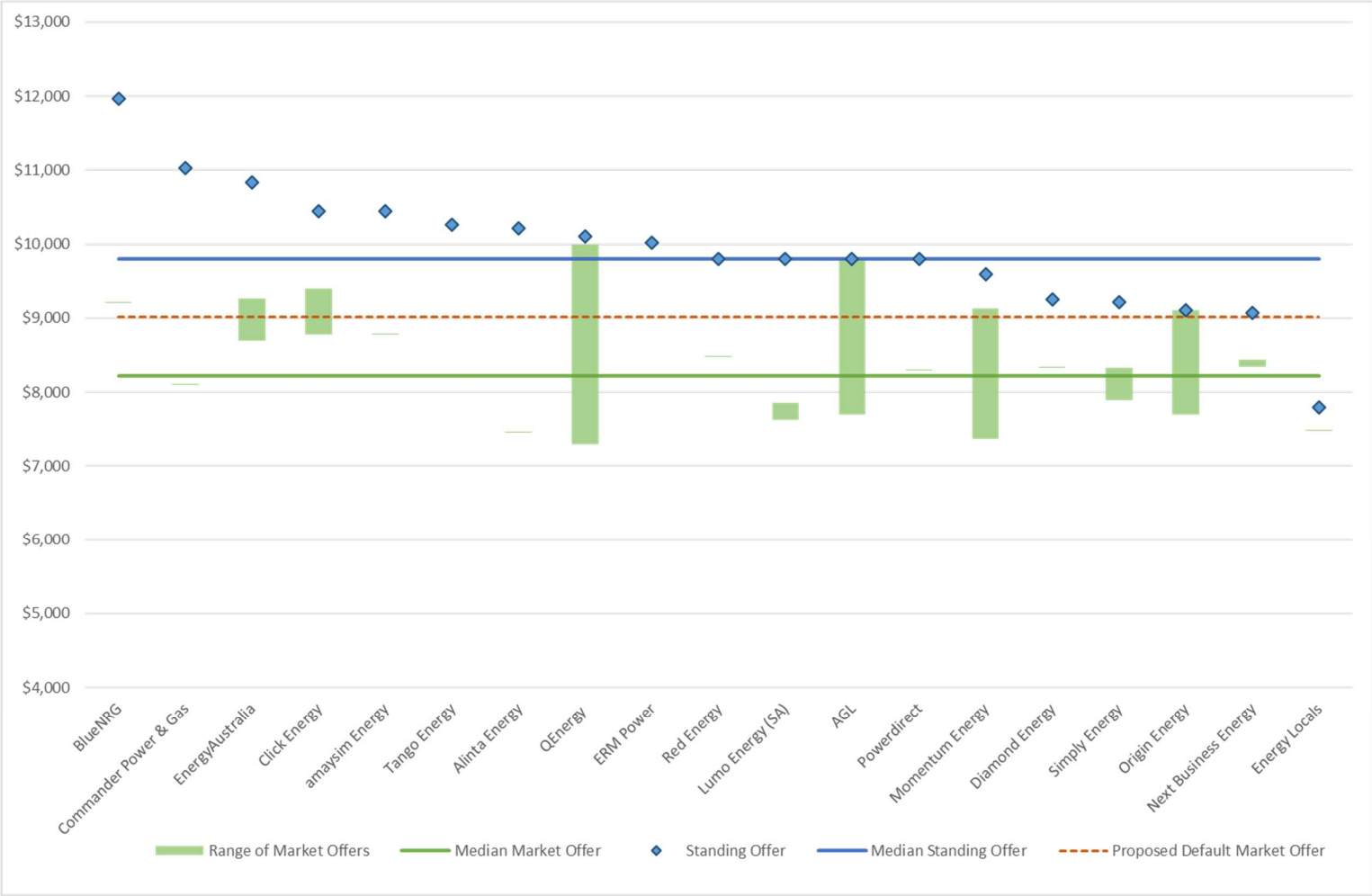


Figure 19: Standing and market offers – SAPN – Small business flat rate tariffs



### ***Differences from the Position Paper***

In our Position Paper we provided an illustrative price range based on September 2018 data. For each distribution zone we listed a consumption (based on EBRINs), the lower threshold being the median market offer and the upper threshold being the median standing offer.

The main differences in the DMO figures and tables from our Position Paper are:

- changes in benchmark usage (chapter 4) based on the distribution businesses' annual pricing proposal data to target the type of customer
- October 2018 data instead of September 2018 data from EME
- selection of price point (chapter 3.4) which was an open question in the Position Paper
- removal of certain offers that would misrepresent the data set such as flat tariffs with a demand component and offers specifically for solar PV customers (the full list is in **Appendix 3**).

The ranges vary between customers from different distribution zones. This reflects:

- differences in retail cost drivers between distribution zones—for example, network costs per customer in rural distribution zones may exceed those in urban distribution zones
- differences between the market and standing offers currently available to residential and small business customers
- differences between consumption levels for the representative customer in different distribution zones.

## Appendix 5 – Forecast changes in cost components

### *What is the Base case?*

As outlined in chapter 3, we have sourced all relevant standing offers and market offers as reported in the Energy Made Easy (EME) website. This sample is based on the offers available to new customers in October 2018.

Based on the AEMC's retail price review and further discussions with industry representatives, we consider that retailers generally formulate these offers based on the underlying costs as at the commencement of the 2018-19 financial year.

Based on this information we consider the underlying the 2018-19 financial year costs, as determined at the commencement of this period, will be reflected in 2018-19 tariffs.

### *How is the cost stack determined?*

In practice the ratio of the cost components will depend, among other things, on the tariff under assessment and the consumer's consumption profile.

The AEMC 2018 price trends review has determined the percentage of each of the cost components by first estimating the cost of each component in terms of kWh price and then, using a set consumption amount, calculated the percentage of the cost component relative to a representative tariff. In the AEMC review, this representative tariff is based on the best market offers for the relevant state.

Furthermore, as the cost components change over time, the proportion of each of the components to the overall price will also change. We note that in the AEMC 2018 price trends report, the cost stack is based on 2017-18 costs, however information was also provided to estimate the 2018-19 cost stack.

With these two features in mind, we have used the AEMC price stack information subject to two adjustments;

1. Based on the additional AEMC's data book<sup>150</sup> we have used the representative median market offer.
2. We have used the AEMC's cost stack for the 2018-19 financial year.

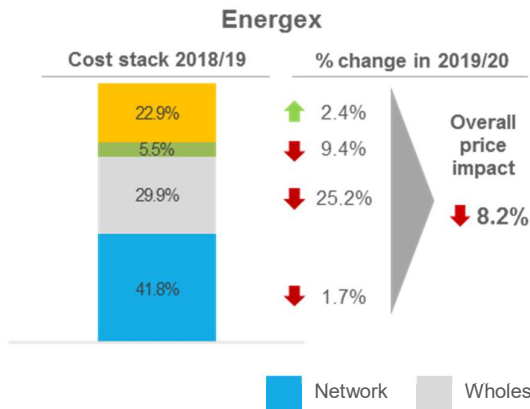
The AEMC price trend review provides cost stack information for each state rather than each distribution network. Whilst this is not an issue for South Australia and South East Queensland, the New South Wales cost stack was also adjusted to reflect the three network areas in New South Wales. Based on the respective network costs we have

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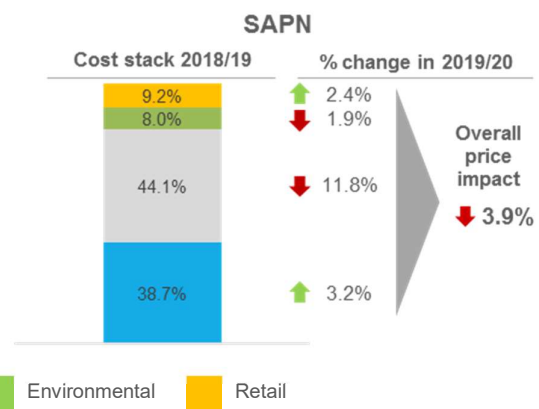
<sup>150</sup> See AMEC website: <https://www.aemc.gov.au/sites/default/files/2018-12/Databook%20-%202018%20Residential%20Electricity%20Price%20Trends.XLSX>

therefore modified the New South Wales cost stack keeping all other components the same.

### South East Queensland

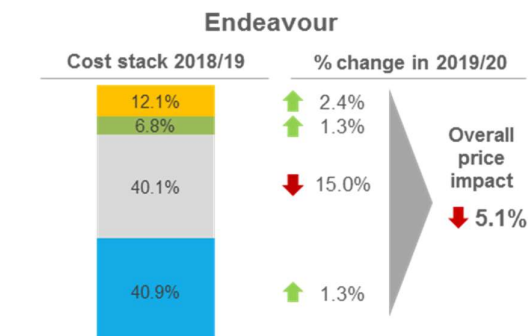
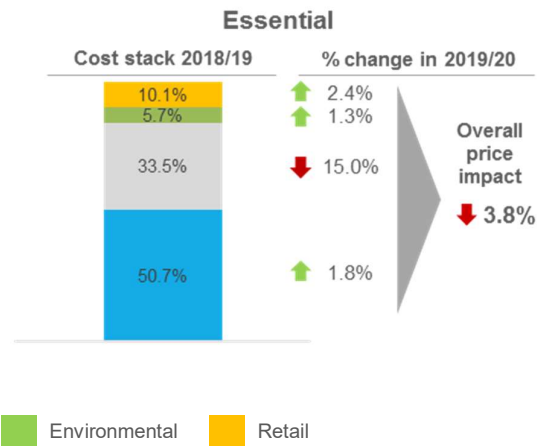
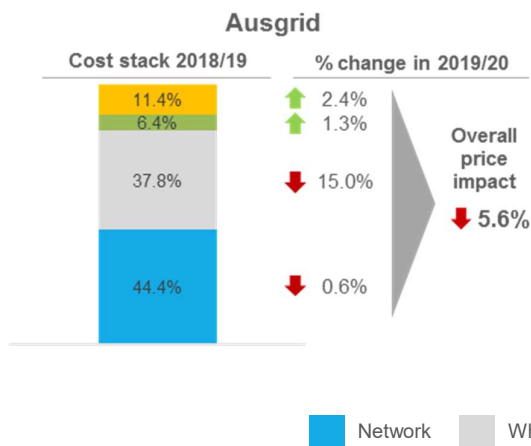


### South Australia



### New South Wales

As outlined above, the New South Wales cost stacks have been separated into each distribution zone to reflect the different network costs for each zone. For wholesale and environmental costs, we applied the same changes for all the distribution regions.



## Appendix 6 – Time of use assumptions

**Ausgrid (NSW CZ5)**

	Block	Summer	Autumn	Winter	Spring
2 period	P	0.68	0.65	0.64	0.65
	OP	0.32	0.35	0.36	0.35
3 period	P	0.35	0.32	0.30	0.31
	S	0.39	0.40	0.40	0.39
	OP	0.26	0.29	0.29	0.30
4 period	P	0.35	0.32	0.30	0.31
	S1	0.27	0.27	0.27	0.27
	S2	0.11	0.12	0.13	0.12
	OP	0.26	0.29	0.29	0.30

**Endeavour (NSW CZ6)**

	Block	Summer	Autumn	Winter	Spring
2 period	P	0.72	0.66	0.63	0.67
	OP	0.28	0.34	0.37	0.33
3 period	P	0.39	0.32	0.29	0.34
	S	0.38	0.39	0.41	0.39
	OP	0.23	0.29	0.30	0.28
4 period	P	0.39	0.32	0.29	0.34
	S1	0.27	0.27	0.27	0.27
	S2	0.11	0.12	0.14	0.12
	OP	0.23	0.29	0.30	0.28

**Energex (QLD CZ2)**

	Block	Summer	Autumn	Winter	Spring
2 period	P	0.69	0.68	0.68	0.67
	OP	0.31	0.32	0.32	0.33
3 period	P	0.36	0.34	0.32	0.34
	S	0.38	0.39	0.42	0.38
	OP	0.26	0.27	0.26	0.28
4 period	P	0.36	0.34	0.32	0.34
	S1	0.27	0.27	0.29	0.27
	S2	0.11	0.12	0.13	0.12
	OP	0.26	0.27	0.26	0.28

**Essential (NSW CZ4)**

	Block	Summer	Autumn	Winter	Spring
2 period	P	0.70	0.67	0.65	0.66
	OP	0.30	0.33	0.35	0.34
3 period	P	0.38	0.33	0.31	0.33
	S	0.37	0.39	0.41	0.38
	OP	0.25	0.28	0.29	0.28
4 period	P	0.38	0.33	0.31	0.33
	S1	0.25	0.27	0.27	0.26
	S2	0.11	0.12	0.14	0.12
	OP	0.25	0.28	0.29	0.28

**SAPN - (CZ 5 and 6)**

	Block	Summer	Autumn	Winter	Spring
2 period	P	0.65	0.63	0.63	0.62
	OP	0.35	0.37	0.37	0.38
3 period	P	0.35	0.32	0.29	0.29
	S	0.36	0.38	0.41	0.40
	OP	0.29	0.30	0.30	0.31
4 period	P	0.35	0.32	0.29	0.29
	S1	0.24	0.25	0.26	0.26
	S2	0.13	0.14	0.15	0.14
	OP	0.29	0.30	0.30	0.31