# AER Position Paper Default Market Offer Price

November 2018

AUSTRALIAN ENERGY REGULATOR

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Amendment Record

| Version | Date | Pages |
|---|---|---|
| 1.1 | 9 November 2018 | 27 |
| | | |

# Invitation for submissions

Interested parties are invited to make submissions on this position paper by 7 December 2018.

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

Submissions should be sent to: DMO@aer.gov.au

Alternatively, submissions can be sent to:

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Submissions should be in 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.[1]

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

# Contents

# Shortened forms

| Shortened form | Extended form |
| --- | --- |
| ACCC | Australian Competition and Consumer Commission |
| AEMC | Australian Energy Market Commission |
| AEMO | Australian Energy Market Operator |
| COAG EC | Council of Australian Governments Energy Council |
| DMO | Default market offer |
| EBRIN | Economic Benchmarking regulatory information notice |
| ECA | Energy Consumers Australia |
| EME | Energy Made Easy |
| FiT | Feed-in Tariff |
| kWh | Kilowatt Hours |
| kVa | Kilovolt Amperes |
| LRET | Large-scale Renewable Energy Target |
| NEM | National Electricity Market |
| NERL | National Energy Retail Law |
| NERR | National Energy Retail Rules |
| NGL | National Gas Law |
| QCA | Queensland Competition Authority |
| REPI | Retail Electricity Pricing Inquiry |
| SRET | Small-scale Renewable Energy Target |
| TOU | Time of Use |
| UTP | (Queensland) Uniform Tariff Policy |
| VDO | Victorian Default Offer |

# Summary

This position paper is the first step in a consultation process for developing default market offer (DMO) prices for electricity retail services by 30 April 2019.

We have been asked by the Commonwealth Treasurer and Minister for Energy to undertake this process and expect that it will become a legislative requirement in time to be implemented by 1 July 2019. The letter is included as **Attachment 1.**

The intention is that retailers will be obliged to offer the DMO to customers who do not otherwise take up a market offer for the provision of electricity retail services.

The July 2019 implementation of the DMO will incorporate the current standing offer framework including the standard retail contract. The new feature compared to the current standing offer framework is the introduction of a maximum price that is intended to apply to relevant standing offers for residential and small business customers in each network distribution zone where there is currently no price regulation.

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

In developing DMO prices, we propose to undertake an open, transparent and inclusive process in line with good regulatory practice, within the available timeframe. Our proposed consultation steps and indicative timeline are outlined in Table 1 below.

To allow for such consultation, we have developed preliminary positions on our approach to determining initial DMO prices. These preliminary positions are outlined in this position paper along with questions for stakeholders input.

### Table 1 Timeline for the development of DMO prices

| Stage | Timing |
|---|---|
| Release of positions paper | November 2018 |
| Submissions open for 4 weeks | November 2018 – December 2018 |
| Pre-draft consultation<br>Public forum<br>Bilateral meetings with consumer groups, retailers, jurisdictions, market bodies | November 2018 – January 2019 |
| Publish draft determination | Early February 2019 |
| Submissions open for 4 weeks. Further consultation over this period as required | Early March 2019 |
| Issue final determination | 30 April 2019 |

# 1 Background

The Australian Energy Regulator (AER) is the independent regulator for Australia's national energy market. We are guided in our role by the national electricity, gas, and energy retail objectives set out in in the National Electricity Law (NEL), National Gas Law (NGL) and National Energy Retail Law (NERL). These objectives focus on promoting the long-term interests of consumers.

This position paper is the first step in our process to determine DMO prices for residential and small business customers as recommended by the Australian Competition and Consumer Commission (ACCC) in its Retail Electricity Pricing Inquiry (REPI) final report and requested by the Commonwealth Government.

It sets out:

- The background and policy objectives for implementing DMO prices, including:
    - The ACCC's REPI recommendations (30,32,49 and 50)
    - The current standing offer framework
    - What the DMO is and which consumers it will affect.
- The AER's proposed process for consultation and development of DMO prices:
    - The purpose of this position paper and our timeline for determining DMO prices
    - How stakeholders can be involved in the development process.
- Our preliminary views on the proposed pricing methodology for determining DMO prices for initial implementation on 1 July 2019.

## 1.1 The Commonwealth Government's request

On 22 October 2018, the Commonwealth Treasurer and Minister for Energy requested that:[2]

> *…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 1 April 2019, to bring about price reductions for residential and small business consumers.*

The letter goes on to state that:[3]

> *We recognise that introducing these reforms will require legislative support. The Australian Government, intends to work closely in the first instance with state and*

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2 The Hon Josh Frydenberg, Treasurer and the Hon Angus Taylor, Minister for Energy, Letter to the AER, 22 October 2018

3 The Hon Josh Frydenberg, Treasurer and the Hon Angus Taylor, Minister for Energy, Letter to the AER, 22 October 2018

*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.*

The letter of request is at Attachment 1 to this position paper and also published on our website.[4]

## 1.2 ACCC Recommendations

In making its request to the AER, the Australian Government referred specifically to recommendations 30, 32, 49 and 50 from the ACCC REPI final report. These recommendations were:

### Table 2 REPI recommendations relating to the default market offer and reference bill

| Number | Recommendation |
|---|---|
| 30 | 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.<br>• 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<br>• The default offer should contain simple pricing, minimum payment periods, and access to bill smoothing and paper bills<br>• 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.<br>• 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. |
| 32 | 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. |

4 Available at: https://www.aer.gov.au/system/files/Letter%20to%20the%20AER%20Chair%20-%20dafault%20pricing.pdf

| | |
|---|---|
| | • 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).<br>• Retailers must calculate all discounts off the reference bill, including win-back and retention offers that have discounts attached to them<br>• Headline discounts in advertising must only include guaranteed (unconditional) discounts. |
| 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 SME 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 REPI final report as follows:[5]

- 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.

## 1.3 The current standing offer framework

Currently, the NERL, national energy retail rules (NERR) and Victorian Electricity Industry Act 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.[6] Retailers must publish, on their websites, a standard retail contract for all distribution zones in NEM regions that they operate in.[7] Retailers' standard retail contracts must adopt the model terms and conditions in the National Energy Retail Rules (NERR) or, in the case of Victoria, be approved by the ESC Victoria.[8] A retailer must adopt the model terms and conditions set out in legislation for its standard retail contract.[9] As summarised in the ACCC's REPI final report:[10]

5 ACCC, Retail Electricity Pricing Inquiry - Final Report, June 2018, p. 240
6 NERL, s. 22(1); NERR, r. 16; and Victorian Code, cl. 16.
7 NERL, s. 25(1); Electricity Industry Act 2000 (Vic), s. 35; Victorian Code, cl. 15A, 15B.
8 NERL, s. 25(3); Electricity Industry Act 2000 (Vic), s. 35; Victorian Code, cl. 12.
9 NERL clause 25

*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. As identified in the ACCC's REPI final report:

- Standing offer prices are normally higher and often much higher than most market offers
- There is material divergence between the standing offers within each distribution zone
- The majority of standing offer customers are customers of the 'big 3' retailers (AGL, EnergyAustralia and Origin Energy).[11]

## 1.4 What is the Default Market Offer?

The DMO is intended to be a service, which all retailers in a distribution zone are obliged to offer customers that do not otherwise take up a market offer for the provision of electricity retail services.

The Commonwealth Government has signalled in its letter that its preference is to work closely with state and territory governments to prepare legislation to implement the DMO. It has further indicated that in the case that state and territory agreement is not secured, it would implement the DMO through Commonwealth legislation. Under either approach, the new feature compared to the current standing offer framework is the introduction of a maximum default offer price for relevant standing offers. The intention is that the maximum default offer price will be in place for implementation by 1 July 2019.

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

## 1.5 ACCC Commentary on the DMO price

The objective of the DMO price is not that it should be the lowest price in the market, but rather that it 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.

With respect to the DMO price, the ACCC recommended that:

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

11 ACCC, Retail Electricity Pricing Inquiry - Final Report, June 2018, pp. 141; 241–242

> *…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.*[12]

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 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.*[13]

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.*[14]

## 1.6 Who will this affect?

The DMO price should result in lower retail electricity charges for customers 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 standing offer customers but not to customers on market offers. Market offer prices are typically below and often far below standing offer prices for the same retailer. The implementation of a DMO price should reduce this gap, but it is not designed to remove it by being at or near the lowest price in the market. Instead, the key policy intent of the DMO price is to mitigate the impact of unjustifiably high prices for standing offer customers.

Figure 1 sets out the trend and proportions of standing offer customers by distribution zone. While the number of customers on standing offers has reduced over time, there is still a significant proportion not accessing more competitive market offers. AEMC analysis of the

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12 ACCC, Retail Electricity Pricing Inquiry - Final Report, June 2018, p.249.

13 ACCC, Retail Electricity Pricing Inquiry - Final Report, June 2018, p.249

14 ACCC, Retail Electricity Pricing Inquiry - Final Report, June 2018, p.249

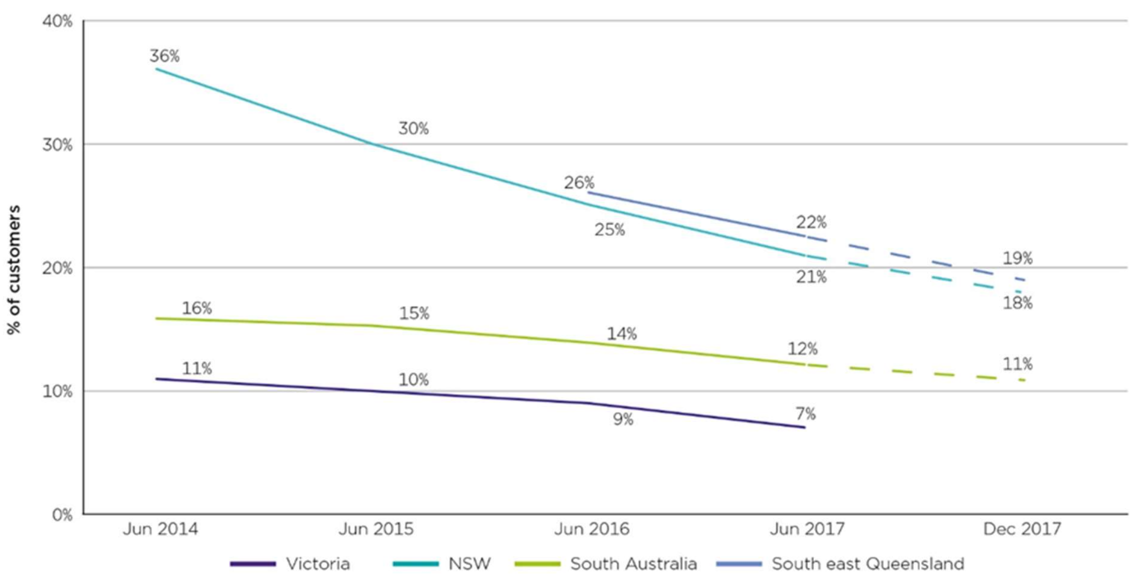
reasons for this inertia suggests that the reasons for not switching might depend on factors such as:[15]

- 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.

Importantly, the AEMC also highlighted that reasons for not switching may differ between customers and classes of customers.[16]

For example, if some consumer segments are not engaging in the market, this behaviour may be due to their own personal preferences. On the other hand, it may be because there are particular barriers, such as high search, complexity or switching costs. Understanding these differences can inform decisions about the need for policy responses to support different consumer segments and the nature of these responses.

### 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

15 AEMC, 2017 Retail Electricity Competition Review, July 2017, p. 73.

16 AEMC, 2017 Retail Electricity Competition Review, July 2017, pp. 75-84.

## Customers in distribution zones with deregulated prices

We have been requested to determine DMO prices in distribution zones that are not currently subject to price regulation by jurisdictional regulators. These distribution zones are in the following areas:

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

It is not the intention that DMO prices will apply in distribution zones that are subject to price regulation.

### The Queensland Uniform Tariff Policy (UTP)

The Queensland Government deregulated retail prices in South-East Queensland in July 2015. As such, we propose to determine DMO prices in this zone.

The Queensland Competition Authority continues to determine price caps for standing offers in Ergon Energy's 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 based on an estimate of the cost of supply in Energex's (South-East Queensland) distribution zone.

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 Energy's distribution zone under the UTP.

The existence of a comprehensive overlapping estimate of efficient retail costs in an unregulated distribution zone is unique amongst distribution zones for which we are required to determine a DMO. We consider it would be appropriate to have regard in some capacity to the analysis and outcomes of the QCA's annual process as part of our process for formulating DMO prices in the case of Energex's distribution zone.

**Question 1:** *To what extent and how should we take into account the QCA analysis for maximum prices for South-East Queensland standing offers in determining a DMO price in Energex's distribution zone?*

### The Victorian Default Offer

The Australian Government has asked us to develop a DMO price for all distribution zones not currently subject to state-based price regulation. At present, Victorian retail prices are not price regulated.

On 25 October 2018, the Victorian Government announced its intention to remove the standing offer framework from its retail laws and to replace this with a Victorian Default Offer

(VDO),[17] to be implemented by 1 July 2019. Like the DMO, the Victorian Government has indicated that the VDO should reflect the efficient costs of providing retail services including an allowance for CARC. Whether the DMO applies in Victoria is a matter for government.

## Tariff types for which we estimate a DMO price

Retailers are required under the NERL and Victorian Electricity Industry Act to offer to supply customers under a standing offer where the customer does not otherwise choose a market offer. 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. For example, a retailer in a particular distribution zone might offer residential customers the following types of standing offers:

### Table 3 Indicative tariff types

| Number | Recommendation |
|---|---|
| Flat rate | A flat rate tariff includes a fixed daily supply charge, and a variable charge reflecting the volume (in 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 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). |
| 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 kW or 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). |

17 The State of Victoria Department of Environment, Land, Water and Planning, Victorian Government, *Final Response to the Independent Review of the Electricity & Gas Retail Markets in Victoria*, October 2018, p. 5.

To determine DMO prices, we will rely on publicly available data to form a view on:

- Each market offer and standing offer within a distribution zone, including all charging parameters (e.g. consumption $/kWh)
- An estimate of what the representative customer would expect to incur under each of those charging parameters (e.g. how many kWh of usage, how many kW of demand).

This allows us to estimate a representative customer's annual bill under each available offer in the market. This information is more readily available for the more common flat rate tariffs.

Table 4, below, sets out the specific tariff structures for which we propose to determine a DMO price. We propose to determine DMO prices for these tariff types as they reflect the type of tariff that the majority of residential and small business standing offer customers are likely to be on, based on the available information. We consider this approach will give effect to the policy intent for introducing DMO prices identified by the ACCC and can be applied for the initial 1 July 2019 implementation. Specifically:

- It should mitigate the unjustifiably high impact of standing offer prices on those disengaged customers that remain on standing offers; and
- It should serve as a clear and transparent basis for a reference bill.

### Table 4 Tariff types subject to 1 July 2019 DMO prices

| Approach | Why we will adopt this approach |
|---|---|
| For residential customers we propose to establish a default market offer for:<br>• A flat-rate usage tariff<br>• A controlled-load tariff | Based on network pricing data, most residential customers use either flat rate or controlled-load tariffs. Due to the historical prevalence of flat-rate tariffs, we expect that the proportion of standing offer customers on flat-rate tariffs is likely to exceed the proportion of customers in total on standing rate offers. |
| For small business customers we propose to establish a default market offer for flat-rate tariffs only | The AEMC's 2018 Retail Performance Report suggests that 51 per cent of small business customers are on flat-use tariffs.[18] Unlike residential customers, there does not appear to be evidence of a high proportion of small businesses on controlled-load tariffs. We note that data on small business usage is relatively sparse compared to data availability for residential customers. |

18 Colmar Brunton, Australian Energy Market Commission: 2018 retail competition review—Small business, June 2018, p. 66.

**Question 2:** *For residential customers, what type of tariff structures should be subject to a DMO price? Should there be different types of tariff structures subject to a DMO price in different distribution zones? Please provide reasons for your preferred approach.*

**Question 3:** *For small business customers, what type of tariff structures should be subject to a DMO price? Should there be different types of tariff structures subject to a DMO price in different distribution zones? Please provide reasons for your preferred approach.*

## 1.7 Legislative framework for the DMO price

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 has signalled in its letter that its preference is to develop DMO legislation through amendments to the NERL. It has further indicated that in the case that state and territory agreement is not secured to enable amendments to the NERL, it would implement the DMO through Commonwealth legislation.

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

## 1.8 Related COAG Energy Council processes

At the COAG Energy Council meeting of 26 October 2018, Ministers agreed:[19]

- on the need to develop a reference point/comparison rate against which all offers could be measured, for consideration at the December Council meeting [20]
- that the AEMC undertake work on the impacts of the Commonwealth's proposed DMO on competition issues and customer impacts

In consulting on the development of DMO prices, we will monitor these concurrent processes closely. We consider that the proposed pricing methodology developed for DMO prices could be equally applicable to the implementation of a reference price/comparison rate. Furthermore, we note that the DMO price is an important input into our development of a reference bill for residential and small business customers, as per recommendations 32 and 50 of the ACCC's REPI final report.

## 1.9 How can you get involved?

We seek written submissions on this position paper. Throughout the position paper we have highlighted specific questions on which we seek stakeholder feedback. We have summarised these questions in section 0. However, this is not an exhaustive list of issues and we welcome feedback on any issues stakeholders wish to raise with us.

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19 COAG Energy Council, 20th Energy Council Ministerial Meeting Communique, 26 October 2018.

20 Western Australia, Victoria, Tasmania and the Northern Territory noted that this would not apply in their jurisdictions.

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

To make a written submission, or to register your interest in updates on this process and sign up to our process mailing list, please email: DMO@aer.gov.au

# 2 Pricing methodology for determining DMO prices

The following section sets out our preliminary views on how we propose to determine the initial DMO prices, to be implemented from 1 July 2019.

We propose to apply a 'top-down' approach based on current market and standing offer prices to determine DMO prices that are in line with the efficient costs of supplying customers in each distribution zone and meeting the stated policy objectives for introducing a DMO price.

This is a relatively simple approach that relies on publicly available information and can be implemented by 1 July 2019.

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.

The remainder of this section addresses the following issues:

- The factors guiding our approach to determining DMO prices
- Our proposed pricing approach for determining DMO prices
- An outline of how we will implement the proposed pricing approach.

## 2.1 What are the factors guiding our approach to determining DMO prices?

The key policy intent of the DMO price is to mitigate the impact of unjustifiably high standing offer prices on those consumers that remain disengaged or have been moved onto standing offers under the circumstances permissible in the NERL and Victorian Electricity Industry Act. In doing so, we are mindful that the level of a DMO price can affect the development of retail competition and the benefits realised by engaged consumers.

Setting a price at too low a level may dis-incentivise participation in the market by consumers, and may discourage market entry, the development of innovative product offerings and efficient investment by retailers. These outcomes would lead to reduced competition in the market and would ultimately not be in the long-term interest of consumers.

Balancing these considerations against the need to reduce the unjustifiably high level of standing offer prices for the dis-engaged segment of consumers in the market will necessarily be a matter of judgement.

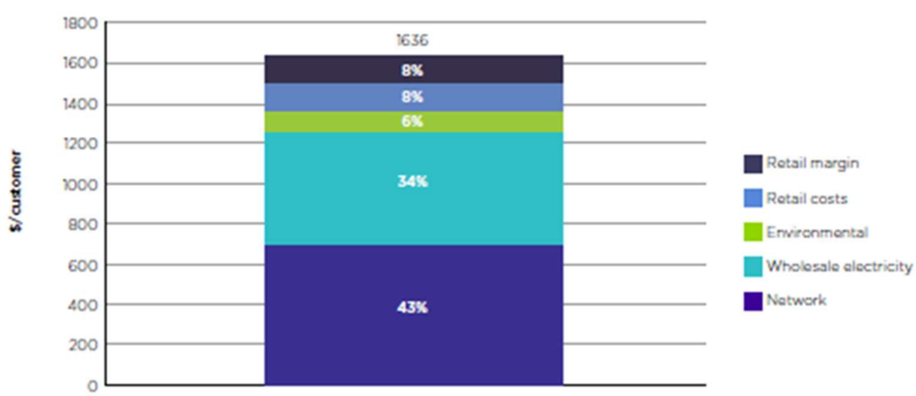
Consistent with the stated policy intent, we will not seek for the DMO price to be the lowest, or near to the lowest, offer in the market. It will be set at a level that should allow retailers to recover the efficient costs of providing electricity retail services to customers. [21]

The costs for a retailer to provide services to consumers would include:

- wholesale costs associated with purchasing electricity from the NEM and managing the associated risk
- network costs reflecting the transmission and distribution network cost of delivering the energy
- environmental scheme costs such as the large-scale renewable energy target (LRET), the small-scale renewable energy scheme (SRES), jurisdictional schemes and premium Feed-in-Tariff (FiT) schemes.
- retail operating costs to serve, acquire and retain customers, and a retail profit margin.[22]

In terms of the relative contribution of these cost inputs to retail charges, the ACCC identified that the average retail bill in the NEM is made up of the following key cost components:

### Figure 2 Components of an average residential customer bill across the NEM, $ per customer, 2017–18, real $2016–17, excluding GST




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

**Question 4:** *What factors should we take in account in determining DMO prices?*

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21. The ACCC considered that the default offer should include the following protections:
- Simple pricing—no conditional discounts and no additional fees or charges (including early termination fees)
- Guaranteed access to paper bills at no additional cost to the consumer
- A minimum period of 13 business days to make payment after a bill is issued or six business days after a bill reminder is issued
- Access to a bill smoothing arrangement that enables consumers to budget and plan for electricity bills.

22. Other costs would include transmission and distribution losses, NEM fees, ancillary service fees and retailer of last resort obligations.

## 2.2 What is our proposed pricing approach for determining DMO prices?

There are different pricing approaches that we could rely on to determine DMO prices in a manner consistent with the factors outlined in section 2.1.

In this initial implementation, we propose to determine the DMO price primarily by reference to observed and publicly available price data. We describe this as a ‘top-down’ approach. By having regard to both competitive market offers and standing offers, we should be able to capture market participants’ own expectations about the efficient costs of providing retail services in particular distribution zones. As this approach relies on publicly available data sources and relatively simple modelling, it is transparent and predictable. This approach also has the advantage of not being reliant on detailed cost information to determine a DMO price. However, as a consequence of the ‘top-down’ approach, it will not disaggregate the individual drivers of retail costs.

In contrast, jurisdictional regulators in Australia have generally applied cost-based bottom-up approaches when regulating retail electricity prices. These approaches involve the regulator determining the efficient costs that a retailer would incur in supplying services to consumers by estimating each of the main cost components and summing these to determine a price. There are a number of different methods and tools that can be used to estimate the efficient costs of the various cost components (e.g. actual costs, bottom-up forecasts, predictive modelling or benchmarking). The effectiveness of this approach depends on access to detailed and accurate cost information. It has the advantage of being transparent in terms of what specific cost elements are included in prices and how these have been derived. Nevertheless, even with comprehensive cost data, the regulator will face information asymmetries in making judgements about the efficient cost elements for a particular retailer (for example, the efficient level of customer acquisition and retention costs).

Both types of pricing approaches 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.

We propose to use a price-based top down approach for determining DMO prices for the following reasons:

- As discussed above, determining a DMO price is a different task to retail price regulation in areas where there is limited competition. We are determining DMO prices in distribution zones where there is competition and where a majority of customers are on market offers. This means that we can observe competitive market offers, which will reflect market participants’ own expectations about the efficient costs of providing retail services in particular distribution zones. This is a useful source of information we can utilise for estimating the efficient costs of providing retail services. Given this context, we consider that the use of a price-based approach for determining DMO prices would be a reasonable and effective pricing methodology.
- For this initial determination, we have limited access to detailed cost information. We also do not currently have information gathering powers for our role in determining DMO prices and limited time to seek this advice voluntarily from retailers. In addition,

the Government has requested that the initial determination be in place for 1 July 2019. This is a compressed timeframe in which to consult on, request and rigorously evaluate detailed cost information relevant to determining DMO prices across the various distribution zones. Given these factors, we consider it would be difficult to apply a cost-based bottom up approach in a way that is robust and minimises any potential regulatory error. For these reasons, we consider a price-based approach for determining DMO prices is the preferable approach for this initial determination. 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.

**Question 5:** *What if any other factors or risks should the AER consider in applying the proposed price-based top down approach for determining DMO prices?*

## 2.3 Outline of how we will implement the proposed pricing approach

This section describes our proposed approach for determining DMO prices. Specifically, it sets out:

- Steps in determining DMO prices
- How DMO prices should be specified
- Duration of the initial determination

### 2.3.1 Steps in determining DMO prices

As outlined in section 2.2, we propose to use a price-based approach to set DMO prices. The observed prices, in particular those for competitive market offers, will provide a reasonable basis for estimating the efficient costs of providing services to consumers in the relevant distribution zones.

Our proposed process for determining DMO prices for each tariff type involves the following steps.

1. We will source all the relevant standing offers and market offers as reported in the Energy Made Easy (EME) website and the Victorian Government's Victorian Energy Compare website. This will include all unique offers for the tariff structures for which we will develop DMO prices (outlined in section 1.6). This represents a comprehensive sample of prices in the market (generally available offers) in each distribution zone. Offers would be those available to new customers in October 2018. The chosen date would be prior to the AER's tasking letter to mitigate any impact from strategic responses by market participants to the Government's proposed intervention.
2. We will calculate an annual bill amount for each available standing offer and market offer based on a consumption benchmark. We propose to use the following consumption benchmarks for each tariff type:
    a. For residential consumers on flat rate tariffs, 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.

b. For residential consumers on controlled load tariffs, the same average consumption as used for the flat rate tariff with a proportion of total consumption allocated to controlled load element based on assumptions used in EME.

c. For small business consumers on flat rate tariffs, publicly available benchmarks in each distribution zone. For example, we note that Energy Consumers Australia (ECA) and the Australian Energy Market Operator (AEMO) have published estimated small business benchmarks. We encourage stakeholder input on the best available data sources for this purpose.

This will give us a range of available market and standing offers expressed an annual bill as presented in Figure 3 below.

3. We consider that a DMO price that is consistent with the Commonwealth Government's policy intent and the efficient costs of operating in each distribution zone (including the costs of supplying an offer in a competitive market with additional consumer protections, such as paper billing and bill smoothing, a reasonable margin) should sit within the range of:

    a. The median market offer across all retailers observed within the distribution zone – this would be the lower threshold. Only unique offers would be included in this calculation, and would be inclusive of all conditional and unconditional discounts. We consider this would provide a reasonable indication of the at least efficient costs of supplying a customer (including any relevant minimum customer protections) within the distribution zone. This lower threshold would also mitigate the impact of any short-term below-cost pricing strategies or particular terms and conditions.

    b. The median of the standing offer all retailers observed within the distribution zone – this would be the upper threshold. As the majority of standing offer customers are with the Tier 1 retailers an alternative methodology would be to base the upper bound of the range on a subset of retailers, or a weighting of standing offers, that better reflect the amount that these customers are currently paying.[23]

This range is identified in Figure 3.

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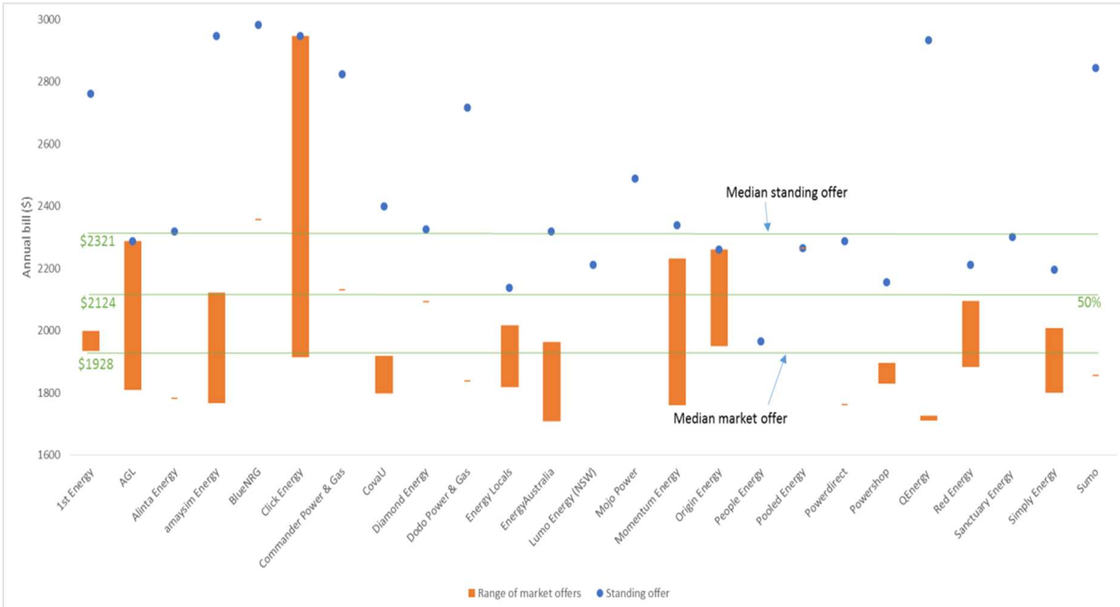
23 We recognise that not all Tier 1 retailers will have a significant market share in every distribution zone.

## Figure 3 Example range analysis—Residential retail offers in Ausgrid's distribution zone




4. We note that observed prices reflect retailers views on underlying costs and competitive conditions at a point in time, and so may not reflect the forecast efficient changes in input costs (such as networks charges, wholesale costs and environmental costs) for 2019-20. To account for any potential changes to underlying costs, we propose to look at publicly available forecast information on the likely direction and magnitude of any changes for 2019-20 for the main input costs. For example, this could include expected changes in network costs under AER's revenue determinations for transmission and distribution charges, futures prices for wholesale energy costs or the AEMC analysis of future retail price trends.

   Broadly, there are two ways we could incorporate these forecast changes in input costs as part of our process for determining DMO price for 2019-20.

   Our preferred option 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. For example, if the available information on forecast input costs for 2019-20 indicated substantive increases (or decreases) in key components such as network charges and wholesale costs, this may lead us to select a higher (or lower) point in the range of observed October 2018 prices. This would be one of a number of factors we would consider, and balance against other factors, in selecting the price point as part of the determining DMO prices. 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. We consider that this approach would be especially robust in the case where a DMO determination is made on an annual basis.

   Alternatively, we could select a point within relevant range of the observed October 2018 price data, and adjust that point based on forecast changes of each input cost for 2019-

20. In order to do this we would need to determine the relative proportions of cost components that make up the residential and small business bill (for example, using the NEM wide estimate in figure 2 produced by the ACCC above or available AEMC analysis). We would then apply a specific adjustment (an escalation or de-escalation) to each of the individual cost components to determine the overall change to the selected price point. This would represent a more mechanical and granular approach to incorporating forecast cost changes between years compared to our preferred approach described above. This approach may be more appropriate where a DMO determination is in place for a number of years.

5. We would need to exercise our regulatory judgement in selecting a point within this identified range having regard to the objectives for implementing a DMO price and the information before us, including forecast changes in input costs for the determination period.
6. In determining our DMO price estimates we will also have regard to any publicly available cost-stack data. This might include information in the AEMC's 2018 retail price trends report, which is due to be published in December 2018.

**Question 6:** *For residential customers, are the proposed upper and lower thresholds reasonable, given the policy intent? If a more targeted upper threshold was used, which retailers standing offers should be included? Are there any offers or categories of offers that we should not include as inputs into our proposed methodology? Should the range be the same in each distribution zone? Please provide reasons for your preferred approach.*

**Question 7:** *For small business customers, are the proposed upper and lower thresholds reasonable, given the policy intent? If a more targeted upper threshold was used, which retailers standing offers should be included? Are there any offers or categories of offers that we should not include as inputs into our proposed methodology? Should the range be the same in each distribution zone? Please provide reasons for your preferred approach.*

**Question 8:** *For residential customers, on what basis should we set the consumption benchmark as part of our proposed methodology? Please provide reasons for your preferred approach.*

**Question 9:** *For small business customers, on what basis should we set the consumption benchmark as part of our proposed methodology? Please provide reasons for your preferred approach.*

**Question 10:** *Given defined upper and lower bounds, at what point within the range should the DMO price be set? What factors should we take into account in determining this point?*

**Question 11:** *What type (and sources) of information should the AER have regard to in considering the likely direction and magnitude of any forecast changes in the main input cost for 2019-20 in setting a DMO price? How should we incorporate forecast changes in efficient input costs as part of our proposed pricing approach for determining DMO prices?*

### 2.3.2 How should DMO prices be specified?

Our methodology as described in section 2.3.1 will lead in the first instance to an annual bill estimate for representative residential and small business customers within a distribution zone. From this point, we have options for how the final DMO price is specified. We could specify:

- an overall amount (annual $, daily $ or c/kWh) which retailers could then calibrate into a fixed and variable component
- a fully specified tariff including caps on the fixed and variable components.

Our preliminary view is that we should specify the DMO price as an annual bill amount, which standing offer tariffs applied to the representative user's expected usage, cannot exceed. We reach this view for the following reasons:

- An overall amount is simple, transparent, and a form that is readily understandable for consumers
- These characteristics also make it well-suited for its use as the basis for the reference bill
- In contrast, we expect that capping particular tariff components may impact some retailers disproportionately to others where their cost structures differ. We consider the risks involved in this approach exceed the potential benefits.

Importantly, under either approach the ultimate bills faced by consumers will depend on their usage compared to the representative customer's usage. This means, for example, that a customer that uses more energy than the representative customer could face bills above the DMO price. Similarly, a customer that uses less energy than the representative customer could face bills below the DMO price.

**Question 12:** *How should the DMO price be specified? Please provide reasons for your preferred approach?*

### 2.3.3 Duration of the initial determination period

We consider DMO prices should be determined annually. In our view, this timing strikes an appropriate balance between providing pricing certainty and flexibility. In our view, it will allow:

- sufficient time to monitor the market and customer response to new DMO prices
- the opportunity for the AER to consult extensively with stakeholders for future determinations as part of our ongoing role, including on potential use of a 'bottom-up' cost build-up

Subject to the final form of the legislation, we do not intend to provide for adjustments of the DMO prices within a determination period. We recognise that underlying market conditions on which DMO prices are based may change over the course of a year. However:

- we will develop our methodology for estimating DMO prices having regard to this uncertainty

- following a wholesale market event of sufficient materiality to justify a change in price, we expect it may take a period of time to feed into updated contract prices. Following this we expect it could take further months for the impact of the event to manifest in measurable data that could be used to inform an updated view on the appropriate DMO price.
- for other changes in cost structure such as regulatory changes or tax changes, we will face similar issues in terms of the time taken to evaluate and incorporate their impact in the DMO price. Since we will update prices annually, it is unlikely that DMO prices could be robustly reset quicker than the scheduled price update.
- any such change would require a period of consultation to provide fair opportunity to all stakeholders.

For these reasons, we consider it is unlikely that the impact of a market event could be reflected in an updated DMO price much earlier than would otherwise be expected under an annual review. In our view, the incremental benefits of aiming to do so are outweighed by the loss of certainty and predictability about the timing of DMO prices.

**Question 13:** *What should be the duration of the AER's DMO price determination? Please provide reasons for your preferred approach. To what extent and under what circumstances should there be scope to reopen the AER's determination?*

## 2.4 Illustrative price range

Using data from September 2018 (and June 2018 for Victoria), we have set out below an illustrative price range for residential customers in NSW, South-East Queensland, South Australia and Victoria applying the methodology described above to flat-rate tariffs. This is purely to demonstrate the upper and lower thresholds under the proposed pricing methodology described above and does not include a price point for determining a DMO price. This analysis also does not take account of any forecast changes in input costs (such as networks charges, wholesale costs and environmental costs) for 2019-20. We have included distribution zones in Victoria as part of this analysis, however, as noted above, whether the DMO applies in Victoria is a matter for government.

Our data sources and representative customer assumptions are as follows:

- All offers (market and standing offers) are from:
    - For New South Wales, South-East Queensland and South Australia—from offers provided for and published on EME
    - For Victoria—from data provided for and published on the Victorian Government's 'Victorian Energy Compare' offer comparator service
- Representative customer consumption profiles are:
    - For residential customers, state averages based on 2017 data provided to the AER by distribution network businesses in EBRINs
    - Consumption for all customers is assumed to occur evenly throughout the year
- The lower and upper thresholds are identified as well as the mid-point of the range.

Table 5 sets out an illustrative price range for residential customers using a top-down methodology

### Table 5 Illustrative price range for residential customers

| State | Network zone | Consumption (kWh) | Lower threshold ($) | Upper threshold ($) | Mid point ($) | Price range ($) |
|---|---|---|---|---|---|---|
| NSW | Ausgrid | 6130 | 1928 | 2321 | 2124 | 393 |
| | Endeavour Energy | 6130 | 1915 | 2278 | 2097 | 364 |
| | Essential Energy | 6130 | 2231 | 2599 | 2415 | 368 |
| SE QLD | Energex | 5947 | 1782 | 2066 | 1924 | 283 |
| SA | SA Power Networks | 5104 | 2195 | 2575 | 2385 | 380 |
| Vic | United Energy | 4811 | 1518 | 1969 | 1743 | 451 |
| | Jemena | 4811 | 1538 | 2074 | 1806 | 536 |
| | Citipower | 4811 | 1431 | 1887 | 1659 | 456 |
| | Powercor | 4811 | 1596 | 2066 | 1831 | 470 |
| | AusNet Services | 4811 | 1651 | 2264 | 1958 | 613 |

Source: AER analysis, Energy Made Easy, Victorian Energy Compare

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.

## Questions for submissions

The following is a summary of specific questions on which we seek stakeholder feedback. However, this is not an exclusive list and we welcome feedback on other issues that stakeholders wish to raise.

**Question 1:** *To what extent and how should we take into account the QCA analysis for maximum prices for South-East Queensland standing offers in determining a DMO price in Energex's distribution zone?*

**Question 2:** *For residential customers, what type of tariff structures should be subject to a DMO price? Should there be different types of tariff structures subject to a DMO price in different distribution zones? Please provide reasons for your preferred approach.*

**Question 3:** *For small business customers, what type of tariff structures should be subject to a DMO price? Should there be different types of tariff structures subject to a DMO price in different distribution zones? Please provide reasons for your preferred approach.*

**Question 4:** *What factors should we take in account in determining DMO prices?*

**Question 5:** *What if any other factors or risks should the AER consider in applying the proposed price-based top down approach for determining DMO prices?*

**Question 6:** *For residential customers, are the proposed upper and lower thresholds reasonable, given the policy intent? If a more targeted upper threshold was used, which retailers standing offers should be included? Are there any offers or categories of offers that we should not include as inputs into our proposed methodology? Should the range be the same in each distribution zone? Please provide reasons for your preferred approach.*

**Question 7:** *For small business customers, are the proposed upper and lower thresholds reasonable, given the policy intent? If a more targeted upper threshold was used, which retailers standing offers should be included? Are there any offers or categories of offers that we should not include as inputs into our proposed methodology? Should the range be the same in each distribution zone? Please provide reasons for your preferred approach.*

**Question 8:** *For residential customers, on what basis should we set the consumption benchmark as part of our proposed methodology? Please provide reasons for your preferred approach.*

**Question 9:** *For small business customers, on what basis should we set the consumption benchmark as part of our proposed methodology? Please provide reasons for your preferred approach.*

**Question 10:** *Given defined upper and lower bounds, at what point within the range should the DMO price be set? What factors should we take into account in determining this point?*

**Question 11:** *What type (and sources) of information should the AER have regard to in considering the likely direction and magnitude of any forecast changes in the main input cost for 2019-20 in setting a DMO price? How should we incorporate forecast changes in efficient input costs as part of our proposed pricing approach for determining DMO prices?*

**Question 12:** *How should the DMO price be specified? Please provide reasons for your preferred approach?*

**Question 13:** *What should be the duration of the AER's DMO price determination? Please provide reasons for your preferred approach. To what extent and under what circumstances should there be scope to reopen the AER's determination?*

# Attachment 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