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AER Position Paper: Default Market Offer Price

AGL would like to take this opportunity to comment on the Australian Energy Regulator's (AER) Position Paper on a Default Market Offer Price.

AGL is one of Australia's leading integrated energy companies with over 3.5 million electricity and gas retail accounts in New South Wales, Victoria, Queensland and South Australia and is highly concerned with the re-introduction of regulated pricing and the potential impact it will have on the competitiveness of retail energy markets in Australia.

We recognise that the AER has been tasked by the Commonwealth Treasurer and Minister for Energy to calculate and deliver a default market offer (DMO) price by 30 April 2019 and therefore has limited scope to consider it merits. However, AGL believes it is important that the AER recognise the potential damage that a poorly derived DMO price could have as it develops an appropriate methodology.

The objectives of the regulated DMO price and its use as a reference price were clearly articulated in the Australian Competition and Consumer Commission's (ACCC) Retail Electricity Pricing Inquiry as:

- providing effective price comparison in the retail energy market by requiring all product marketing to refer to a consistent reference price or bill and improve pricing transparency for customers; and
- ensuring that any customers remaining on retailers' standing offer prices are not paying inflated rates because of their inaction.

AGL supports the introduction of a reference price to improve the transparency of energy pricing for customers. We also propose that a reference price has the capability of meeting both objectives without the potential, negative consequences of applying a regulated DMO price.

In AGL's experience, a reference price can indirectly constrain Standing Offer prices and would highlight the situation in Queensland where regulated notified prices that apply in regional Queensland are directly comparable to the retail electricity prices in the competitive southeast Queensland energy market.

The existence of a relevant reference price in conjunction with regular market monitoring by the state's regulator has limited the practice that the ACCC has recommended addressing through the DMO price, that of standing offer prices being inflated for marketing purposes rather than because of costs changes. In summary, a suitable reference price and the impact on a retailer's brand (and potential for Government intervention) has seen such behaviour short-lived and largely curtailed.

<u>Reference Price v Regulated DMO Price</u>

AGL is opposed to the introduction of a regulated DMO price for standing offer customers because it introduces significant regulatory risk into the energy market.

Regulatory risk has a significant impact on investment in energy businesses and subsequently on investment in new generation, new technologies and further product innovation.

AGL acknowledges that the ACCC and AER have both remarked that the DMO price needs to cover the efficient costs of supplying electricity to customers, including marketing and customer acquisition costs as well as a reasonable margin. They also stress that the DMO price should be set to avoid adverse impacts on retail competition and the benefits that are being realised by engaged consumers.

Unfortunately, even if the AER effectively determines a 'Goldilocks price' for 1 July 2019 that minimises initial impacts on retail competition, this does not mitigate the concerns of investors that the regulator or Government may set a regulated price in the future that will negatively impact the market and the long-term viability of energy businesses.

This regulatory risk is significant and uncontrollable for a business. For this reason, AGL cautions against a DMO Price and supports a reference price.

<u>Level of Price Determination</u>

Irrespective of whether a DMO or reference price is chosen, the level must then be determined, and it will impact on the competitiveness of retail energy markets and consumers as noted by the AER. The setting of a DMO price or reference price near the level of current market prices will likely:

- reduce price dispersion and competition as the headline discounts available to customers are reduced to reference the DMO price;
- reduce customer participation in the market with lower customer churn as bill savings no longer outweigh search costs;
- result in the best available market offers increasing in price as competition will no longer sustain market offers that are currently provide little margin;
- discourage further market entry by retailers with returns unlikely to be commensurate with level of risk;
- increase customer confusion during the transition as customers with large discounted products see these being equated to lower benefits, despite their market prices being unchanged. The alternative is a retailer providing its discounted products off the new DMO price which would be financially untenable; and
- constrain the innovation of product offerings and introduction of new technologies.

In comparison, setting the DMO or reference price at a level closer to the median of standing offer prices will alleviate many of these concerns. AGL recognises that some jurisdictional standing offer prices are inflated but believes the AER's calculation of a median standing offer price rectifies much of this issue by making any highly inflated standing offer prices redundant.

Customers on standing offers

When making its determination, it is important the AER also balance the impact of its decision on retail competition with the benefits it is providing to standing offer customers. In this assessment, AGL would caution the AER on relying on the data for standing offer customers provided in the ACCC Retail Electricity Pricing Inquiry which in AGL's experience, is already significantly out of date.

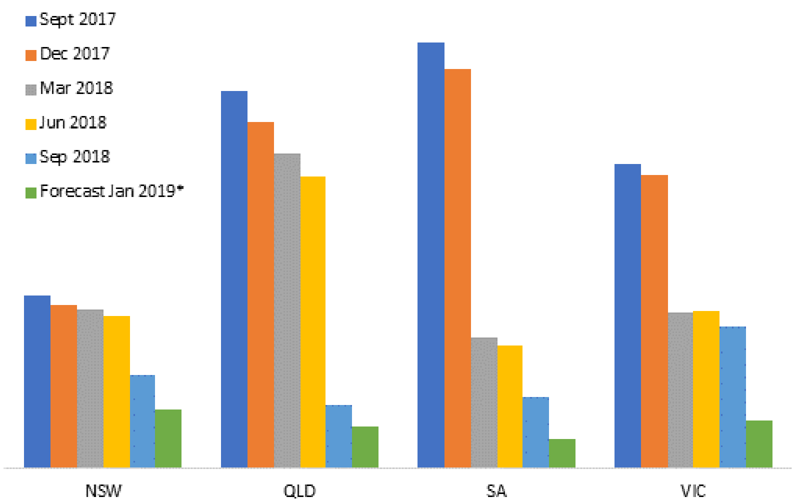
The number of customers on standing offers has been reducing over time as they enter into market contracts, but this has been more pronounced over the last 12 months as indicated in figure A.

This is due to the regulatory changes and commitments to the Prime Minister which has seen greater direct communication to standing offer consumers and increased public awareness.

Furthermore, the number of customers entered into standing offer contracts is limited to customers moving into new premises without contacting their retailer and new connections that are temporarily being put onto standing offers until a market contract can be finalised.

AGL has recognised that some customers have not and may never seek to enter into a market contract and has provided a loyalty discount accordingly. Consequently, AGL has fewer customers on standing offer contracts than ever before and the majority of these are paying energy prices below the published standing offer rates.

Figure A: Customers paying Standing Offer prices (AGL)



Consequently, most of AGL's standing offers customers are likely to see minimal additional benefits from a DMO price.

AGL notes that other retailers are now following suit and providing voluntary benefits to some standing offer customers which raises further doubts on the benefit of a DMO price given the AER has assumed that most standing offer customers are customers of larger retailers due to incumbency.

Although AGL does not support the introduction of a regulated DMO price, we recognise the AER must progress with its consultation and have therefore made specific responses to the questions raised by the AER in the position paper (see attached).

In summary, AGL believes that the AER estimate of a DMO price is highly subjective and the AER need to err on the side of slightly higher prices and ensure that it sustains a competitive energy market rather than seeking to provide a prescribed amount of savings to standing offer customers.

If you wish any further information, please contact me on (03) 8633 6207 or Patrick Whish-Wilson on (02) 9921 2207.

Yours sincerely

Elizabeth Molyneux
GM of Energy Markets Regulation

Attachment 1: AGL Comments on Proposed Methodology

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?

As identified by the AER, the Queensland Competition Authority (QCA) undertakes a comprehensive annual 'bottom-up' analysis of the efficient retail costs in South-East Queensland to determine the price caps for standing offers in Ergon Energy's distribution zone. As part of this process, it estimates all elements of a retail price stack for the future year.

The AER is highly time constrained when selecting its methodology to determine a DMO price and therefore its proposal has obvious weaknesses, namely:

- there is a certain amount of subjectivity in the initial selection process; and
- the proposed DMO price is based on current prices so future costs changes will also need to be subjectively assessed and included.

As such, AGL would encourage the AER to take advantage of the QCA process and price outcomes for southeast Queensland given it does not share these weaknesses.

The AER should also be cognisant of the Uniform Tariff Policy (UTP) in Queensland and AGL supports the AER's intention (as mentioned in the forum on 5 December 2018) to work with the QCA to ensure consistency of notified prices and the DMO price.

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

AGL can confirm that an overwhelming majority of residential customers on the standing offer remain on single rate tariffs and therefore supports the AER approach to focus the DMO price on single rate tariffs in each distribution zone.

Furthermore, any residential customers with associated controlled load tariffs will also be on flat tariffs so AGL proposes that the AER limit the DMO pricing to main residential tariff and exclude controlled load. The benefit to these customers of including controlled load within the DMO pricing is minor when compared to any benefits provided through the single rate tariff. However, the additional complexities introduced are material, especially when you consider the use of the DMO price as the reference price and the additional level of inaccuracies due to variation in consumption and the allocation of consumption between the main residential tariff and associated controlled load tariffs.

AGL also supports the focus on flat rate tariffs for small business customers as more than half of standing offers customers are on these tariffs. However, small businesses have access to a large array of tariffs in each distribution zone including time-of-use and demand-based tariffs (indeed, networks such as Ausgrid are assigning customers from flat network tariffs to demand-based tariffs). They also have a far greater distribution of consumption patterns.

AGL is concerned that this will make the usefulness of the proposed reference bill for small business customers far less relevant.

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?

The AER's proposed top-down approach using current market and standing offer prices in each distribution zone is a relatively simple approach that can be implemented in the prescribed time.

However, the selection of the DMO price becomes a matter of judgement which is concerning to AGL.

The AER has acknowledged that the level of a DMO price and its use as a reference price can affect the development of retail competition setting a price at too low a level would lead to reduced competition in the market and would not be in the long-term interest of consumers. This must be front of mind given the inherent regulatory risk.

AGL accepts that the AER is also seeking to reduce standing offer prices where they are unreasonably inflated so that disengaged consumers are not unduly disadvantaged. However, AGL has highlighted previously that:

- this is a small and reducing number of customers;
- changes to the regulatory framework have been introduced to ensure that this number continues to dwindle; and
- AGL, and other retailers, have introduced significant pricing changes to minimise the impact of standing offer prices on many these customers.

AGL would encourage the AER to therefore balance these objectives appropriately by recognising the potential, long-lasting market damage from getting it wrong while they attempt to provide immediate benefits to a very small segment of the retail energy market.

AGL is especially concerned with the use of judgement in this decision because of the unreasonable expectations being drawn from the ACCC Retail Electricity Pricing Inquiry. The ACCC highlighted significant future retail price reductions given the acceptance of its recommendations but these potential savings were predominantly driven by reforms to the wholesale market and distribution networks, and interventions by state governments. AGL understands the AER is aware of this distinction but we have noted that consumers and consumer groups may be expecting significant and inappropriate price reductions through the DMO price process.

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.

Given the AER's time constraints, AGL believes the proposed methodologies for calculating the upper and lower thresholds from the relevant standing offers and market offers reported in the Energy Made Easy (EME) website are reasonable.

Of course, these are based on energy prices for the current financial year so should not be considered thresholds or limits until the impact of cost changes for the future financial year are considered.

AGL supports the calculation of the median from all offers as it effectively omits any outlying data points from the methodology without the AER having to make further subjective judgements about whether the standing or market offer of any particular retailer is relevant to the process.

The resultant range in each distribution zone will be widely varied due to the varied underlying costs and risks and the subsequent impact on competition in each region.

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

AGL supports the AER utilising the average consumption rates for residential consumers based on assumptions used in the energymadeeasy (EME) website.

Consistent use of these figures will allow comparability of the DMO price and reference price for consumers who utilise the EME website.

As highlighted previously, average consumption figures for small business consumers on flat rate tariffs will rarely be indicative for the DMO and reference price but accessing figures from public benchmarks or the distribution networks themselves would be most appropriate.

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?

The selection of the price for the DMO is subjective and will be largely influenced by the AER's balancing of its competing objectives.

In AGL's view, this balancing decision needs to provide significantly more weight to the functioning of a competitive energy market rather providing a wealth transfer to a small and reducing segment of the market.

In that instance, setting the DMO price at the median standing offer is eminently sensible and will provide bill reductions for any customers that are currently on a retailers' standing offer prices that are inflated when compared to the median. There will be less potential for unintended consequences to occur.

If the AER seeks to reduce price dispersion further and provide additional saving to these customers then it should look to lock in a point in the range that is known and transparent, for example the 80 percentile between the median standing offer and median market offer.

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?

AGL understands why the AER is using observed October 2018 price data for its determination but believes that accounting for expected changes in underlying costs for 2019-20 is not a simple matter.

Information on network costs and environmental schemes is public and therefore easily forecastable but assessing future wholesale energy costs is a significant impediment to the effective operation of this methodology.

AGL cannot support the use of the AEMC analysis of future retail price trends report as it is highly indicative and largely irrelevant to annual price changes.

AGL also has major concerns regarding the AER's preferred approach to use the estimated cost changes only as a factor for selecting its price point within the relevant range of the October 2018 price data. Such a process is unlikely to provide any transparency as to where the AER would have selected the DMO price without consideration of cost changes. It also is unlikely to provide information on what cost changes it has applied, and the weight they were given in its decision making.

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

AGL supports a DMO price which specifies an overall amount. A fully specified tariff with fixed and variable components will stifle innovation and will not reflect the different costs which retailers incur.

The setting of a reference bill requires a reference customer's usage. It is possible that the best choice for a customer with a significantly different consumption from the reference usage may be different from the reference customer. In addition, a customer who 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. However, these do not invalidate the reference bill. The use of reference bills should be accompanied by qualifications on the customer's consumption. Customers with significantly different consumption should be directed to the Energy Made Easy website.

AGL considers the use of a reference bill as an overall amount to be significantly more meaningful to consumers than c/kWh. Furthermore, AGL believes a $ per day figure rather than $ per year has more relevance to consumers although these are easily convertible (for a reference consumer). A $ per day reference will make it easier to compare with other regular costs which customers incur.

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?

AGL agrees that any DMO calculation should be done annually.

Market conditions can change considerable during the year but if any DMO prices are determined with appropriate allowance for uncertainty then this should not cause concerns. However, if the AER was to set DMO prices at current market levels then this would be a significant issue.