11 December 2018

EnergyAustralia Pty Ltd
ABN 99 086 014 968

Level 33
385 Bourke Street
Melbourne Victoria 3000

Phone +61 3 8628 1000
Facsimile +61 3 8628 1050

enq@energyaustralia.com.au
energyaustralia.com.au

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

Lodged electronically: DMO@aer.gov.au

Dear Mr Feather

AER Position Paper – Default Market Offer Price – November 2018

EnergyAustralia is one of Australia's largest energy companies with around 2.6 million electricity and gas accounts in NSW, Victoria, Queensland, South Australia, and the Australian Capital Territory. We also own, operate and contract a multi-billion dollar energy generation portfolio across Australia, including coal, gas, battery storage, demand response, wind and solar assets, with control of over 4,500MW of generation in the National Electricity Market (NEM).

EnergyAustralia welcomes the opportunity to make this submission to the Australian Energy Regulator's (AER) position paper for developing a default market offer (DMO). We acknowledge that the AER has been directed by the Australian Government to develop a mechanism for determining the maximum price of a DMO.

EnergyAustralia supports the need to lower standing offer tariffs for customers most in need. We have committed to a range of targeted action to protect customers who are vulnerable or facing financial difficulties. This includes:

- providing an automatic ongoing 15% discount from 1 January 2019 to concession customers on standing offer tariffs, saving them an average $270 a year on their electricity usage and $145 on gas;
- contacting customers on our hardship program through multiple channels to encourage them to switch to our best in market offer for electricity and gas. Where we have been unsuccessful in gaining their explicit and informed consent, we are applying an automatic discount that reflects our best market offer in each jurisdiction. Recipients are reviewed every 6 months to ensure they receive the best market discount.

For all customers, EnergyAustralia's practice is that we do not move customers onto a standing offer tariff at the end of their benefit term.

Over the past 4 years, we have successfully moved over 200,000 customers off standing offers. This will continue as competitive markets mature. We have also written, at least once in the past year, to all our customers on standing offers informing them that there are better offers available. We will continue to inform all our customers, through all forms of media, of our products and their different benefits.

EnergyAustralia's analysis of its standing offer customers, in New South Wales, suggests that over 70% are located in suburbs with above average income and/or are in coastal areas with a usage profile reflecting a holiday residence. This suggests a DMO may see a wealth transfer between customers that are price sensitive and have shopped around and those who have not.

Therefore, we consider that competition is the best means to place downward pressure on prices. We recognise that market offers are confusing, and we support efforts to introduce a comparison rate to enable customers to compare offers on a "like for like" basis. This should be the first means of seeking to improve outcomes for customers.

The DMO will need to be carefully designed and implemented

The DMO must be set at a level that ensures customers are paying no more than they should, while still enabling retailers to recover costs and continue to compete for standing offer customers.

The DMO should be based on the efficient costs in each jurisdiction, including costs of additional customer protections, a reasonable margin and acquisition and retention costs. However, as the DMO would be set with explicit references to efficient costs, the AER will need to manage the perception that it is a 'regulator approved' price. This may make customers complacent and hamper efforts to engage them in the market.

The DMO price should include a competitive allocation (referred in the ACCC report as 'headroom') to provide a financial gain to customers seeking out a better deal. This is not retailer margin. This component would be fully allocated to customers engaged in the market and shopping around. It is the whole basis upon which competition in the market could still exist. Without it, it is price re-regulation.

Interventions under the guise of reducing prices and profitability in the retail market may not be an immediate concern in the current political climate. Such interventions may, however, if in place over for sustained period, have effects on contracting in the wholesale market. This would undermine investment in new forms of generation and the transition to a cleaner, more reliable and affordable energy system.

Our attached submission elaborates on some of these points and provides constructive responses to the questions outlined in the AER's position paper. We appreciate the AER's consultation on the DMO to date and welcome further opportunities to engage.

If you would like to discuss this submission, please contact Lawrence Irlam 03 8628 1655 or Lawrence.irlam@energyaustralia.com.au.

Regards

Jack Kotlyar
Head of Strategy and Reputation

1. AER proposed methodology

In determining a default market offer (DMO), the AER has proposed a top-down methodology as follows:

- The AER develops a representative customer profile for each distribution zone.
- Based on this profile, prices for all standing and market offers are drawn from Energy Made Easy and Victorian Energy Compare websites using data as at October 2018.
- Prices from all these offers are multiplied by the average customer usage to generate a set of annual bill amounts for all retailer offers for each distribution zone.
- The AER takes the median standing offer bill amount, and the median market offer bill amount, then averages these two amounts. This average is the AER's "reference bill" and in effect operates as the retail price cap for default offers.
- Retailers are free to set whatever pricing structures and levels they choose. This is subject to the reference bill amount not being exceeded when their prices are multiplied by the usage of the AER's representative customer.

We are generally supportive of a top-down method in the initial year. We recognise that the requirement on the AER to determine prices by 1 April 2019, and using published information only, prevents consideration of any alternative in the near term.

Subsequent years

We do not support continuation of a top-down method for subsequent years, namely projecting forward the AER's initial DMO prices in line with cost drivers for the relevant determination period. We consider that a bottom-up costing method would better ensure any price cap accurately reflects efficient costs.

We encourage the AER to begin gathering bottom-up information alongside its interim top-down method. As based on our experience prior to the introduction of contestability with IPART and QCA, a bottom-up approach requires approximately nine months to do well through a regulatory process. We consider that the AER can build on the costing methods that were employed by jurisdictional regulators as market participants are familiar with these methods which have been refined over time.

The AER should also outline the consultation process by which the DMO is determined, for example, whether retailers will be afforded an opportunity to respond to any draft determination for prices in the following year. Ideally the AER's methods would be transparent and provide for a smooth transition in prices so that retailers have certainty when developing their default offers in accordance with the overall price cap. In addition, the relevance of the DMO should be regularly reviewed to determine if it is meeting the policy objectives.

2. Consideration of QCA analysis

While EnergyAustralia does not have a large presence in the unregulated Queensland retail market, we encourage the AER to have careful regard to the QCA's bottom up analysis and work with the QCA when considering the DMO for customers in Energex's network.

More broadly, we encourage the AER to liaise with regulators in jurisdictions where retail price regulation previously existed in order to understand the various methods and data involved.

3. Tariff structures for residential and business customers

The AER is proposing, in each distribution zone, to determine DMO prices for:

- Residential customers – a flat rate tariff and a controlled-load tariff.
- Small business customers – a flat rate tariff.

We consider that a DMO should only apply to a minimum number of tariffs and agree with what the AER has proposed. As most standing offer customers are on flat or control-load tariffs this is a sensible approach to determine a DMO by April 2019.

Our view is that the DMO, as a safety net, should be applied to customers that genuinely face difficulties in engaging in the market. The inclusion of small business customers may not satisfy this objective as businesses have a much greater incentive and capacity to engage in the market. Small businesses (like all customers) will benefit from the development of a reference or comparison rate which will reduce their transaction costs in the market.

The introduction of the DMO will need to accommodate moves to introduce more cost reflective tariffs. In order to minimise volume risk, retailers typically set prices that match the structure of the network tariff to which the customer is assigned. If the DMO exists as a flat rate tariff, it should ideally be only applied to customers that have a flat rate network tariff.

4. Factors to consider in determining DMO prices

The main challenge for the AER will be to ensure prices are cost reflective in all parts of the supply chain. This will need to consider a whole-retailer-approach, that is, ensuring the overall cost to serve reflects what is realistically achievable rather than basing the DMO on the lowest cost for each category. Many businesses have competitive cost advantages in different parts of the cost stack and no one retailer can achieve the lowest cost for all components.

The AER has indicated the DMO should reflect efficient costs, including a reasonable margin, allowance for customer acquisition and retention costs (CARC) as well as costs associated with providing additional features associated with the DMO.

Wholesale pricing and load profile costs

Any approach will need to adequately consider the 'shaping' costs retailers face when purchasing electricity. This reflects the load profile of a retailers' customer base and accounts for the 'peakiness' of their customers' use. As more intermittent generation comes into the wholesale market shaping costs will become increasingly important.

The wholesale component is probably the most challenging as different retailers will have different purchasing strategies to manage the inherent risk of the wholesale market. Any approach will need to balance the costs faced by customers and exposure for retailers. If not appropriately accounted this can impact retail competition and (in the worst case) lead to retailer failure. Both long run marginal costs (LRMC) and market costs have previously provided useful insights in determining wholesale electricity costs as part of regulated or benchmark pricing. We consider that a LRMC of new entrant or at least smoothed market prices over the longer run would be the best approach.

Network costs

The AER is well placed to have a view of network costs and apply these as a direct pass through allowance for retailers. As noted above, the translation of network costs, as they are reflected in specific tariffs for individual customers, should accommodate how these would be reflected in a flat rate tariff structure.

Environmental costs

Similar to wholesale energy costs, retailers will have different contracting arrangements with respect to traded certificates and liabilities for small and large scale renewable generation. As they affect retailer costs, directional information can be taken from legislated liability percentages and traded certificate prices.

Retail operating costs

As highlighted by the ACCC, retail operating costs can differ significantly between retailers. This should include all reasonable costs of running a retail business, such as service costs (i.e. staffing, billing system, hardship assistance, etc), property, financing costs and regulatory compliance.

Separate retail operating costs are set for residential and small business customers. The cost to serve different types of customers can be significantly different and the DMO should be made as cost-reflective as possible.

EnergyAustralia's retail cost categories are impacted by various factors, such as interest rates, vendor costs and national economic conditions. Retailers make decisions on potential cost movements on these items a year ahead when they set annual prices. While retail operating costs form a small portion of the overall retail price, we work hard to continually achieve efficiencies in these areas.

The largest component of retail operating costs is credit costs including bad and doubtful debts. In EnergyAustralia's case, this means carrying a large outstanding debt on behalf of residential customers. Retailers carry the debt cost for the entire delivery chain — wholesale, transmission and distribution — meaning retailers must pay all of these businesses in the delivery chain regardless of whether customers pay their bills.

At any point in time EnergyAustralia has more than 45,000 customers on payment plans and 14,000 customers in our EnergyAssist program. The hardship debt alone carried by EnergyAustralia amounts to more than $20 million and may never be fully paid off due to the challenging circumstances faced by our hardship customers.

EnergyAustralia does not publicly report details of our cost to serve, but we continually attempt to improve it further. Retail operating costs are the most controllable costs for customers. We always attempt to minimise these costs by streamlining systems and processes, reducing inefficiencies and overheads, negotiating better deals with vendors, and attempting to gain better economies of scale (i.e. increasing the size of our customer base helps us reduce the effect of large fixed costs such as IT systems).

There are several upward pressures on retail operating costs, some of which are outside our control, and many of which are associated with large amounts of capital expenditure. The sources of increases in retail operating costs include:

- the substantial burden of regulatory and compliance requirements that are not always in the best interests of customers
- the need to invest in improvements and innovation to remain competitive
- purchasing a customer base or acquiring another retailer, for example, when we acquired the customers of the previous state-owned EnergyAustralia business, we had to pay substantial costs for these customers to be serviced by Ausgrid prior to moving all the customers onto our systems
- increases across network and wholesale costs also increases retail operating costs i.e. the increase in working capital costs, bad debt and hardship costs.

Generally, we would expect retail costs associated with providing default offers to be passed through to customers. We would expect to engage with the AER in the event it wishes to assess specific retailer costs, for example whether they are controllable or affect retailers equally.

Customer acquisition and retention

We support the allowance for ‘headroom’ in setting the DMO. This accords with the objective to minimise the impact on competition for engaged customers by making them indifferent to market and default offer prices. It also reflects the practice of jurisdictional regulators in wanting competition to develop in tandem with price regulation. The amount of headroom reflects the type of retailer or market environment the regulator is trying to encourage. For example, IPART decided to set electricity prices suitable for a stand-alone retailer to make the price level suitable for a new entrant. It also set the wholesale energy component using inputs and assumptions that assessed the costs of electricity generation in NSW using the latest generation technologies and that only looked at the costs of supplying those NSW electricity customers on regulated prices. An allowance for headroom ensures retailers are still able to make better offers to customers and, in turn, reward customers for engaging in the market. The allowance also acts as an incentive for retailers to innovate to make different products and services available to meet customer needs.

Allowance for a reasonable margin

The methodology will need to allow for a reasonable margin to account for the funds retailers invest in supplying electricity. Calculation of any margin should account for risks associated with retailing and what businesses within the supply chain are allowed (e.g. distribution and transmission businesses) and businesses with similar profiles in other industries (e.g. telecommunications).

Energy retailers expect to obtain a margin which they consider represents a reasonable return on investment, the risk involved in seeking that return and the prevailing market conditions.

Incorporating forecast changes in the main input costs

The AER proposes to account for any potential changes to underlying costs by using publicly available information on the direction and magnitude of any changes for 2019-20. This approach will need to consider that retailers operate with a range of cost structures and serve different customer types. The AER will also be operating with imperfect information and likely under time constraints and will need to use its judgement.

5. Setting the DMO, including selection from within upper and lower bounds

The primary challenge for the AER in setting the DMO using information from market and standing offers is that there is a wide spread of prices for both sets of offers. This creates a risk that any single DMO amount will be below the efficient costs of some retailers but may also not be low enough to address concerns around high prices.

We consider that, under a top down method, the DMO should not undercut market offers. There are various methods that would ensure this outcome. We suggest that the AER take the median of standing offers only. Setting the DMO as the median of standing offers decouples the DMO from market offers and avoids any strategic pricing by retailers.

Using the median of standing offers may or may not adequately address concerns that standing offer prices are too high, particularly by reference to available market offers. Noting that there is a wide spread of market and standard offers, the AER could conduct further investigation into offers as at October 2018 to determine whether observations are outliers or anomalies and be disregarded, including as they affect the AER’s use of judgement. For example, Figure 3 in the AER’s position paper suggests the DMO would be below some of the market offers of five retailers, whereas a DMO set as the median standing offer would be below the market offer of only one retailer only (and this offer, at face value, appears to be implausibly high).

If the AER uses averages of standing and market offers as an interim method, we suggest the use of a simple average rather than weighting prices by market share. Alternatively, the AER could use the average standing over the last three years.

We acknowledge the AER is limited to publicly available information. Conceptually it is also a reasonable starting point to presume that market offer prices reflect competitive outcomes. However, this presumption should be validated if possible, particularly as retailers will engage in different pricing strategies at particular points in time, including repricing in line with costs that may not be uniform across the market.

That said, any price produced by an independent regulator with some reference to 'efficiency' may be seen as a benchmark price and create expectations of where market prices should be in the minds of various stakeholders.

6. Setting the consumption benchmark

The AER has proposed to calculate the annual bill amount for each available standing offer and market offer based on a consumption benchmark. For residential customers on a flat rate, the AER proposes to use data from the Economic Benchmarking Regulatory Information Notices (RIN).

We suggest that usage data for any benchmark or representative customer for each distribution zone by drawn from the AER and Victorian Government's comparator websites. Other data sources, for example the AER's RINs, have been developed for different purposes and may not be suitable. That said, consumption information from the AER's RINs has been subjected to verification and assurances as to its accuracy and may be preferable on this basis.

7. How should the DMO be specified

The AER proposes that the DMO price be presented as an annual bill amount, which standing offers tariffs applied to the customers expected usage, cannot exceed. We support this approach.

However, given that the DMO is intended to be a maximum, retailers can set their default offers using different (lower) prices. This may create some confusion for customers:

- At the commencement of the AER's determination, all customers on standing offers would be moved onto a retailer's default offer, which could be cheaper than the DMO.

- When presenting market offers, retailers will be required to present the customer a 'comparable' reference bill based on the AER's DMO usage benchmark.

- Also, when presenting market offers, any discounts must be expressed relative to the AER's reference bill.

For simplicity, it seems likely that retailers would set default prices to align exactly with the DMO maximum bill amount.

8. Duration of the DMO price determinations

We are supportive of DMO determinations lasting one year, with timing aligned to approved network prices. Retailers require sufficient (at least 6 to 8 weeks) notice of distribution tariffs prior to the corresponding retail price cap being set.

There are two timeframes to consider:

- **The initial default rate —** This is period in which retailers should be given notice of the final calculation method, opportunities to input and notice of the final default price for each distribution zone. This period will naturally be longer than in future determinations to give retailers adequate time to work out how the default rate will work in practice and is necessary to revise pricing strategies, customer communications, marketing collateral, contact centre staff training, web content (including Energy Made Easy) and compliance registers.

- **Ongoing default rate —** Consistent with former and current state-based retail regulatory regimes it is reasonable to allow 8 weeks for final default rates for each distribution zones. Retailers require this period to input the default rate into pricing strategies, update marketing collateral and prepare customer communications. We note that electricity network tariffs are set as final around 8 weeks prior to their effective date, and that final regulated prices would be needed at the same time. This could be challenging to manage.

Scope to reopen a determination

We consider that there should be scope to reopen a DMO determination. This is consistent with jurisdictional methodologies. Noting the time and administrative burden involved in making a mid-year price adjustment, the AER may wish to consider doing so subject to an event satisfying some materiality threshold. Some examples which have the potential to materially change the costs that retailers incur include:

- Unexpected changes in a law or regulation, or a decision by a regulatory body that materially changes any price or cost component across the market.

- An unpredicted closure or change in market structure affecting wholesale market prices.

- The late setting of environmental scheme policy, including targets or compliance percentages or policy changes that affect market prices.

- The imposition, removal or change in application, calculation or interpretation of a relevant tax.