



SUBMISSION

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Draft Determination of Default Market Offer (DMO) prices

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1. INTRODUCTION

The Australian Energy Regulator (AER) is developing default market offer (DMO) prices, which are to apply from 1 July 2019 for standing offer customers on relevant tariffs, in network distribution regions not subject to state-based price regulation.¹

The DMO prices will also serve as a basis for calculating a reference bill for residential customers and small businesses for each network distribution region, from which headline discounts can be calculated.

This submission is a response from Etrog Consulting Pty Ltd (Etrog Consulting) to the AER's Draft Determination of DMO prices, which has been published for stakeholder feedback.

The Department of Environment and Energy has published a Consultation Paper and Exposure Draft on the *Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019* (the Code), also for stakeholder feedback.

The Code will set a price cap on standing offer prices in electricity distribution regions where prices are not already subject to price regulation, and require retailers to use a common reference point for comparing electricity offers.²

The Code will provide the AER with the power to set the DMO and reference price for households and small businesses in New South Wales, South Australia and South East Queensland.³

Etrog Consulting is a specialist consultancy in energy and utilities, focusing on regulatory policy and the interaction of regulation and competition in energy and water industries and markets. The director of Etrog Consulting, David Prins, who is the author of this submission, has 29 years consulting experience in this field.

Etrog Consulting is not currently engaged by any client on the subject of this submission.

The views put forward in this submission are the views of Etrog Consulting and its author, and are not intended to represent the views of any client of Etrog Consulting.

This submission discusses some aspects of the AER's Draft Determination, which we hope will be of interest and of value to the AER.

1 Documentation on the AER's determination of DMO prices can be found on the AER's website at <https://www.aer.gov.au/retail-markets/retail-guidelines-reviews/retail-electricity-prices-review-determination-of-default-market-offer-prices>

2 Documentation on the Department's Code consultation is available on the Department's website at <https://www.environment.gov.au/energy/electricity-code-consultation>

3 The DMO will not apply in Victoria, where a separate Victorian Default Offer (VDO) is being developed. Documentation on the development of the VDO is available on the website of the Essential Services Commission Victoria at <https://www.esc.vic.gov.au/electricity-and-gas/inquiries-studies-and-reviews/electricity-and-gas-retail-markets-review-implementation-2018/electricity-and-gas-retail-markets-review-implementation-2018-victorian-default-offer>

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Subject to any other client commitments or conflicts, we will be happy to discuss our views further with the AER or with any other stakeholders or interested parties that read this submission.

Etrog Consulting provided a submission to the Department on the draft Code on 12 March 2019. Section 2 of this submission to the AER raises an issue that came to our attention after we completed our previous submission to the Department. Sections 3 and 4 of this submission to the AER largely restate sections 2 and 3 respectively of our previous submission to the Department, as we believe these are relevant to the AER's determination process as well as to the Department's formation of the Code.

2. CLARIFICATION OF THE ROLE OF EFFICIENT COSTS IN SETTING THE DMO

2.1. THE ACCC RECOMMENDED THAT THE DMO PRICE SHOULD BE THE EFFICIENT COST OF OPERATING

Table 3 on page 15 of the AER's Draft Determination sets out recommendation 30 from the Retail Electricity Pricing Inquiry (REPI) final report 'Restoring electricity affordability and Australia's competitive advantage', which was published by the Australian Competition and Consumer Commission (ACCC) on 11 July 2018.⁴

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.

- 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
- The default offer should contain simple pricing, minimum payment periods, and access to bill smoothing and paper bills
- 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.
- 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.

⁴ See <https://www.accc.gov.au/publications/restoring-electricity-affordability-australias-competitive-advantage>

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The ACCC report provided considerable evidence-based analysis to support its recommendations.

2.2. CONFUSION REGARDING THE ROLE OF EFFICIENT COSTS IN SETTING THE DMO ARISES IN THE AER'S DRAFT DETERMINATION

As quoted above the third bullet of the ACCC's recommendation 30 states:

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.

In contrast, on page 36 of its Draft Determination, the AER writes:

The ACCC clarified that the intention of the REPI recommendations is **not that the AER should determine efficient costs, or set the DMO at an efficient price.**

There seems to us to be a clear contradiction between the ACCC's actual recommendation 30 that the DMO should be set at "the efficient cost of operating" as against the 'clarification' that the ACCC's recommendation is "not that the AER should determine efficient costs, or set the DMO at an efficient price".

2.3. OUR RECOMMENDATION

It seems to us to be fundamental to achieving the benefits envisaged from the ACCC's extensive inquiry to get this right. Our recommendation is that the AER should clarify in its final determination the role of efficient costs in the setting of the DMO, and make its final determination accordingly.

3. USE OF THE DMO AS A COMMON REFERENCE POINT FOR CONSUMERS TO COMPARE ELECTRICITY OFFERS

3.1. HEADLINE DISCOUNTS CAN BE MISLEADING

The ACCC's final report set out 56 recommendations to reset the National Electricity Market, boosting competition, reducing costs and improving consumer and business outcomes.

One of the many matters that the ACCC's final report discussed was the fact that retailers set their own price levels from which they calculate advertised discounts, and this made it difficult for consumers to work out which offer would give them the lowest bill. They might assume that a higher discount level (say 10% discount versus 5% discount) would give them a lower bill, but this was not necessarily the case.

The ACCC wrote at length on this matter, including the following quotes which are provided here to give some small insight into this matter:

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The dominant form of competition among retailers has been the advertisement of large headline ‘discounts’ which retailers have observed are an effective and simple way to connect with price conscious consumers. These discounts are highly problematic for several reasons. Each retailer sets its discounts with reference to its own independently set prices (usually standing offer prices) meaning that there is no easy way to compare the headline discount of one retailer to that of another. In many cases, consumers will be better off with offers that have lower discounts attached to them but which have a lower underlying tariff rate.⁵

As retailers are free to set their underlying tariffs, there is not a simple way for consumers to look at two discounted offers and determine that one will likely lead to lower bills than another. In fact, many consumers may assume that the highest discount will lead to a lower bill, when the bill amount will actually depend on the underlying tariffs and any conditions attached to the discount. ...

The ACCC agrees with the proposition that consumers understand discounts as a concept, but is concerned that the current approach to discounting in electricity offers is likely to give consumers a false impression about the best offer on the market.⁶

In our Preliminary Report, we showed that in the Powercor distribution zone in Victoria, the average annual bill (at January 2017) for the offer with the highest discount was \$125 more than the annual bill for the cheapest offer. Figure 13.2 shows the January 2018 figures. In January 2018, there was an \$86 difference between the annual bill for the offer with the highest headline discount (43 per cent) and the annual bill for the cheapest offer (37 per cent discount). However, there was an offer in the market with a 40 per cent discount that was \$333 more expensive per year than the cheapest offer with no headline discount.⁷

Some consumers on a low or no discount offer are paying a lower price per unit of electricity than some customers on an offer with a discount of 20 per cent or more.⁸

Etc.

The ACCC’s recommendation 32 read as follows:

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.

- 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).

5 ACCC, Executive summary, page xi

6 ACCC, Section 13.2.1, page 259

7 ACCC, Section 13.2.2, page 260

8 ACCC, Section 13.2.2, page 261

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- Retailers must calculate all discounts off the reference bill, including win-back and retention offers that have discounts attached to them.
- Headline discounts in advertising must only include guaranteed (unconditional) discounts.

One of the issues with this approach is that for customers whose usage is not exactly at the bill benchmark level for a medium household, the level of discount will still give the customer certainty as to which of several offers will give them the lowest price.

We illustrate this as follows using the AER's Draft Determination for the DMO for the Energex area where a customer using 4600 kWh pa on a residential flat rate tariff would have a reference bill of \$1572 pa.

The figure below shows hypothetical pricing to make a point.

	Tariff		Total bill for different kWh/year					Advertised discount based on 4600kWh		
	c/kWh	\$/year	1000	2000	3000	4000	4600			
Standing offer / DMO	33.00	54.00	\$384	\$714	\$1,044	\$1,374	\$1,572		0.00%	
Market offer 1	30.00	113.40	\$413	\$713	\$1,013	\$1,313	\$1,493		5.00%	
Market offer 2	25.00	264.80	\$515	\$765	\$1,015	\$1,265	\$1,415		10.00%	

We have fashioned, by way of example, in the figure above, a standing offer at the DMO level for the reference bill, and two market offers, both conforming with the Code on the basis of the discount offered at the reference bill level, one showing a headline discount of 5%, and the other showing a headline discount of 10%.

We believe that a customer may still be misled into thinking that the 10% discount offer is the lowest price of the three shown, whereas it can clearly be seen from the figure above, as shown in bold in the figure:

- The standing offer (0% discount) is the cheapest of the three offers for a user of 1000 kWh pa.
- Market offer 1 (5% discount) is the cheapest of the three offers for a user of 2000 or 3000 kWh pa.
- Market offer 2 (10% discount) is the cheapest of the three offers for larger usage customers.

The examples above were created such that the offers with the higher discounts had larger fixed charges (and smaller unit charges) and therefore were more expensive for low usage customers, because of the larger fixed charge component having relatively more impact for smaller usage customers. Other examples can easily be created that illustrate this issue.

The ACCC recognised this issue by stating:

Given that the underlying rates include the discount from the reference bill amount, these documents will need to clearly state that the percentage discount is from the reference bill amount, so that it does not mislead consumers.⁹

⁹ ACCC, Section 13.2.3, page 266

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However, the ACCC did not as far as we can tell provide any example of the sort we have illustrated above, where the percentage discount that is advertised might mislead customers.

3.2. CUSTOMER PERCEPTION OF THE DMO

In recent weeks, we have discussed the DMO with consumers and consumer advocates, and have found that many of them were surprised to discover that the DMO would not solve the issue of higher headline discounts not necessarily indicating that bills would be lower for all customers. They thought, mistakenly, that implementation of the ACCC's recommendation 32 would be sufficient to solve this, when in fact it is not.

Articles in the press have not made this clear.

We note a joint media release from the Treasurer and the Minister for Energy dated 23 February 2019, which stated:

The DMO and reference price responds to recommendations made by the Australian Competition and Consumer Commission (ACCC), and will prevent energy companies from ... benefitting from the confusion created by misleading discounts.¹⁰

The Consultation Paper to which this this submission is a response states:

Requiring retailers to use the DMO as a common reference point for comparing electricity offers will clarify for customers the relative competitiveness of different offers, addressing the current confusion that results from discounts being made off differing base rates, and helping ensure consumers get a better deal.¹¹

3.3. OUR RECOMMENDATION

We of course accept that requiring retailers to use the DMO as a common reference point for comparing electricity offers will go a long way to reducing customer confusion regarding discounts. However, on its own, it will not necessarily go all the way to enable consumers to have full clarity on the relative competitiveness of different offers in relation to each customer's particular circumstances.

We feel that more could be done to communicate the message to customers that they will still not be able to rely on assuming that a higher advertised discount level will give them the lowest prices. Customers need still to look at the details of the offer, including fixed and variable charge components, how long the advertised discount will last, other fees and charges, levels of conditional discounts and whether the customer will be eligible for them, etc.

¹⁰ This media release is available on the Department's website at <https://www.environment.gov.au/minister/taylor/media-releases/mr20190223.html>

¹¹ Consultation paper, page 4

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4. TWO OTHER MINOR TECHNICAL MATTERS

While writing regarding the use of the DMO as a common reference point for consumers to compare electricity offers, we thought it might be helpful to inform the AER regarding two minor technical matters that we have noticed in our review of the Exposure Draft of the Code and the AER's February 2019 Draft Determination of DMO prices.

4.1. TREATMENT OF GST AND COMMUNICATIONS TO CUSTOMERS

Neither the AER's Draft Determination nor the draft Code seems to mention GST. It is unclear whether the figures in the AER's Draft Determination are inclusive or exclusive of GST. Our expectation is that the AER has made use of GST inclusive prices published in *Energy Made Easy*, but this is not clear.¹²

Our recommendation is that the AER's Final Determination should clarify whether figures quoted in its Determination are GST inclusive or exclusive. It may also be helpful for the Code to specify that the prices that retailers publish for comparison should all be GST inclusive, for ease of comparison by customers.¹³

4.2. THE FACT THAT 2020 WILL BE A LEAP YEAR

Both the AER's Draft Determination and the draft Code seem to assume that a year has 365 days. FY 2019-20, which will be the first year to which the DMO will apply, has 366 days. We recommend that the Department and the AER should consider whether this needs to be taken into account and clarified in the Code and/or the AER Final Determination.

¹² In contrast, the draft advice on the VDO recently published by the Essential Services Commission Victoria does make it clear that the proposed VDO prices are GST inclusive, and that GST has been added to GST exclusive price components in the ESC's calculations of the VDO.

¹³ We note the Victorian decision that from 1 July 2019 all tariffs, fees, prices and charges are to be expressed in GST inclusive terms only on bills and related notices, in all marketing material and in any verbal exchange between retailers and customers or prospective customers. See <https://www.esc.vic.gov.au/sites/default/files/documents/building-trust-through-new-customer-entitlements-in-the-retail-energy-market-retail-markets-review-20181030.pdf>