GRATTAN Institute

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Default market offer draft determination: a pragmatic approach to a delicate balancing act

Response to the Australian Energy Regulator's draft determination on a default market offer price for electricity retailers

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There are no restrictions on publication of this submission or requirements for anonymity. The submission contains no personal information of third party individuals.

Summary

- The Australian Energy Regulator's approach to setting a default market offer (DMO) will significantly affect the overall policy outcome. A low price cap could harm competition, while a high price cap will provide little benefit to disengaged consumers currently paying high prices on standing offers.

- The AER has proposed a pragmatic approach to this delicate task. Setting the 2019-20 DMO at the midpoint between the median standing offer and the median market offer appears to strike a reasonable balance between setting the DMO too high and too low.

- Risks to competition remain from any form of price cap, however. The DMO should, if anything, err on the high side. Customers are currently moving off high standing offers to lower market offers, and so the risks of setting a DMO that is too high are, in practice, modest. The same is not true of setting the DMO too low. Damage to competition, once done, takes a long time to fix.

- To guard against the risk of setting the DMO too low, we propose an additional sense-check be incorporated in the AER's proposed methodology. The DMO should be set at the 90th percentile of market offers if this is higher than the value determined through the proposed methodology. This would reinforce the primary role of markets, rather than regulation, in setting retail electricity prices. In general, there is no obvious reason disengaged customers should receive prices lower than customers generally pay on market offers.

- The DMO will need to be set on a different basis in future years. Continuing with the same methodology would result in a 'ratchet' effect that inexorably took standing offers towards the level of the median market offer. One approach to guard against this would be to exclusively use the 90th percentile of market offers to set the DMO in future years.

1 Introduction

This submission from Tony Wood and Guy Dundas of the Grattan Institute responds to the Australian Energy Regulator's request for submissions on its draft determination on a default market offer price for electricity retailers.

The submission provides high-level comments on how the default market offer price should be implemented in its first year (2019-20), and some considerations on how it should be implemented in future years.

Grattan Institute is an independent think-tank focused on Australian domestic public policy. It aims to improve policy outcomes by engaging both decision-makers and the broader community.

2 General comments

The AER has been given the task of developing a default market offer (DMO) price that acts as a price cap for standing offers applied to customers who have not chosen a retail market offer. It is not the place of the AER to question the Commonwealth Government's prior policy judgements. But in this case, the AER's implementation role involves significant discretion, and will significantly affect the ultimate policy outcome. And so comments on the merits of the policy are necessary.

A high price cap will not achieve the Government's objective of reducing prices for disengaged customers. But a low price cap brings substantial risks to the investment environment, and therefore to long-term prospects for workable competition in both retail and wholesale electricity markets.

There is no 'right answer' to setting the DMO. But in our view the balance of risks supports erring on the side of a higher rather than a lower DMO. Customers are currently moving off high standing offers to lower market offers, and so the risks of setting a DMO that is too high are, in practice, modest. The same is not true of setting the DMO too low. Setting prices at or below the true cost of supply will substantially damage competition. This damage, once done, takes a long time to fix.

Erring on the side of a higher regulated price is consistent with the past practice of state regulators. They commonly allowed 'headroom' in their determinations by setting a conservatively inflated regulated price. This ensured that retailers could recover their true cost of supply and compete for customers, while also giving disengaged customers a reasonable safety net.

Like state regulators before it, the AER must use the discretion it has been given to strike a balance between the need to protect disengaged customers and to allow for viable competition. All indications are that the AER has carefully handled the discretion it has been given, and is aware of the risks inherent to the task.

But additional sense-checking of the outcomes for the 2019-20 determination would further reduce the risk of setting the DMO too low (section 3). And a different approach to setting prices for 2020-21 and beyond is required to sustain competition into the future (section 4).

3 The AER's proposed approach

3.1 A top-down methodology is pragmatic and appropriate

The AER's proposed top-down calibration of the DMO based on observed prices – flagged in its October Position Paper – is pragmatic and appropriate. Bottom-up estimates based on cost components of retail prices are time-consuming, complex and contentious. A bottom-up approach was unlikely to be feasible in the time available.

Bottom-up approaches also imply false precision. Many cost components, particularly retail costs, wholesale hedging costs, and the costs of complying with environmental schemes are difficult to estimate at arms-length (noting that state-based regulators developed methodologies for these tasks over many years).

3.2 The proposed use of standing and market offers strikes a sensible balance

Any top-down calibration is arbitrary. There is no in-principle basis on which to critique the AER's choice of the mid-point between the median of standing offers and the median of market offers in each distribution zone (the 'midpoint methodology').

We consider the AER's proposed approach strikes a sensible balance. It ensures that standing offers will generally reduce, while ensuring that they do not reduce below a cost-reflective level (as represented by the median market offer). This is important, given we presume that the Commonwealth Government wishes to preserve the primary role of competition in setting retail electricity prices.

3.3 Sense-check the DMO against high market offers

The AER's proposed approach is a good starting point. But a further sense-check would reduce the risk that the DMO is set too low. This, in turn, will reinforce the primary role of competition, rather than regulation, in setting retail electricity prices.

The AER's proposed DMO should be compared to high market offers. If the proposed midpoint methodology delivers a DMO that is lower than the 90^{th} percentile of market offers, the DMO should be set at the higher of these two values.

In our view a disengaged customer should not receive protection over and above what an engaged customer can reasonably achieve in the market. To the extent that a standing offer customer is 'vulnerable' as well as 'disengaged', mechanisms to target specific barriers, such as language or disability, will be better than reducing all standing offers. And if governments are concerned about high standing offer prices being paid by low-income (concession) customers, targeted mechanisms – such as the bulk market offer for concession customers adopted in South Australia – can assist these customers to move to better offers.

3.4 Monitor the policy for unexpected outcomes

The AER has flagged that it intends to monitor the outcomes of introducing the DMO, including how market offers change in response. We have heard arguments that a reduction in profits from high standing offers will be offset by increased margins and profits from currently low-priced market offers.

The evidence suggests that overall retail margins are too high in Australia.[1] And there is no reason to expect that the profit pool available to retailers is fixed, and that reduced margins on standing offers will automatically be recovered from market offer customers. This being the case, the suite of retail pricing policies, including the DMO, should reduce average margins across all customers and not simply redistribute them.

In turn the AER's monitoring should look at how average (customer-weighted) margins move over time. Doing this precisely requires the AER being given information-gathering powers it currently lacks. The Government has put legislation to the Parliament that would provide the AER with these powers, but this legislation has not been passed. Until such time as the AER does have these powers, it may need to draw on work done by the Australian Competition and Consumer Commission using its information gathering powers. In particular the ACCC's work in monitoring electricity prices will assist the AER to assess overall effects of the DMO on retail margins and prices.

[1] Wood T, Blowers, D and Moran, G (2017), *Price shock: is the retail electricity market failing customers?,* Grattan Institute, https://grattan.edu.au/report/price-shock/; Thwaites, J, Faulkner, P and Mulder, T (2017), *Independent Review into the electricity and gas markets in Victoria*; ACCC (2018), *Restoring electricity affordability and Australia's competitive advantage: Retail Electricity Pricing Inquiry Final Report*.

4 The future of the default market offer

The AER's proposed methodology has been, as far as we can tell, set with only 2019-20 in mind. The AER has not given any indication that it intends to use the same methodology in future years.

It would not be appropriate to replicate the AER's 2019-20 approach in future years. It has an in-built 'ratchet' mechanism that would inexorably reduce the gap between standing and market offers. The median 2019-20 standing offer will be lower than the median 2018-19 standing offer due to the implementation of a DMO based on the midpoint mechanism. This would require a further reduction of the DMO price (all else being equal) in 2020-21. The same would occur in each future year, reducing standing offer prices inexorably toward the level of median market offers.

This ratchet would damage competition in the long-term. This would be highly undesirable and would go beyond what we understand to be the policy objectives of the Commonwealth Government in establishing the DMO.

There is no ideal methodology for future years. A bottom-up estimate will be feasible with the additional time available, but remains complex, risks seducing policy makers with a false sense of precision, and ultimately does not help to resolve broader policy questions on the respective roles of competition and regulation in setting prices.

We suggest retaining a simple top-down methodology, but calibrated differently to that proposed for 2019-20. A possible approach would be to set the DMO based solely on upper-bound market offers, for example, at the 90th percentile of all market offers. To ensure that the calculation of the 90th percentile market offer genuinely reflects what market offer customers are paying and cannot be readily 'gamed', it should reflect the number of customers on each offer, rather than treating each market offer as equal irrespective of the number of customers on that offer. If this approach is not practical, it may be simpler to exclude offers that do not have a specified minimum number of customers on them.

This approach would probably need to allow for adjustments based on known regulatory cost changes from year to year – such as changes in network tariffs or in environmental scheme compliance costs.

Alternatively, the Commonwealth Government (in consultation with affected state and territory governments) could reconsider the desirability of having a DMO at all. A DMO is likely to be initially effective in resetting standing offer prices at more politically acceptable levels, but may have limited utility beyond 2019-20.

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