7 December 2018

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

Email: DMO@aer.gov.au

Dear Mr Feather,

**RE: DEFAULT MARKET OFFER**

Origin Energy appreciates the opportunity to provide a submission in response to the Australian Energy Regulator's (AER) position paper for developing a default market offer (DMO) for electricity retail services.

The Federal Government has requested the AER to develop a mechanism for setting a maximum price for the default market offer (DMO) consistent with the ACCC's recommendations. The AER has stated that the policy intent of the DMO price is twofold: first to mitigate the impact of unjustifiably high prices for standing offer customers; and second to provide a consistent reference from which headline discounts can be calculated.

While competition has provided customers with unprecedented levels of choice, we recognise that the market has evolved in a manner where, for many customers, it is challenging to make efficient and effective decisions about the range of available retail offers. We accept that for the full benefits of competition to be realised, customers need to be empowered by better information and engaged by measures which make the experience of switching easy, attractive to undertake, and timely.

We believe that the most effective and sustainable response to promote engagement is not through price regulation but through policies that promote understanding to enable customers to obtain better deals. As equally important, any policy response should avoid penalising those most active and engaged consumers by artificially constraining the best deal these customers could otherwise obtain.

Introducing price regulation carries significant risks to the efficient operation of a market from regulatory error. If the DMO price is set too high, then we would expect more intense competition will compete away any excess margin over time. On the other hand, if the DMO price is too low, then this will more likely reduce dynamic efficiency with losses to consumers. This is a greater risk. Over the longer term, under-compensation resulting from regulatory error is likely to reduce competition, stifle innovation and result in a further diminishing of customer engagement. In this circumstance, competition will be slow to recover to pre-error levels. Furthermore, imposing retail price regulation will not address the material upstream drivers of electricity costs.

A preferable approach would be to establish a DMO as a reference bill for discounting instead of a regulated price; this is likely to deliver benefits with a reduced risk of regulatory error. A reference bill will complement initiatives already put in place through the Prime Minister's retailer roundtable and supporting Rule changes. We believe analysis of the effectiveness of these initiatives are pertinent to the AER's recommendation to Government regarding how a DMO should be applied.

In the event that a DMO price is developed, the AER has indicated that it will apply a top down approach and only explore using a cost-based bottom up approach for future determinations. However, given the potential harm from regulatory error we believe there is a strong case for the AER to adopt a "short form" bottom up method for the derivation of any DMO price to apply for 2019-20. This approach should:

- utilise the outcomes from the Queensland Competition Authority's (QCA) 2019-20 cost-based Notified Price determination for the purposes of developing a DMO for South East Queensland;
- use forecast energy cost data from the QCA process to inform energy costs for all other all jurisdictions;
- involve the AER initiating an arrangement with the ACCC to facilitate the sharing of cost stack data provided by retailers to the ACCC as part of its Pricing Inquiry;
- recognise that the Energy Made Easy data for market offers will need to be adjusted upwards to reflect the weighted price of all market contracts not just offers made during a particular month (ACCC data shows that "all" market offers have a much lower weighted average price than the AER's point in time median); and
- apply for one year only, to be replaced by a more complete and rigorous cost-based assessment if the DMO is extended in future years.

Finally, we believe the application of a DMO price, if introduced, should be a temporary measure that applies for one reset. After this reset, the ACCC's ongoing monitoring role will provide customers and other stakeholders with confidence that prices reflect reasonable costs and returns. If the DMO is applied for more than one year, then given the risk of long-term detriment to the competitive market, the ongoing effectiveness of the DMO price should be assessed on an annual basis against clearly defined assessment criteria developed by the AER.

Origin's responses to specific issues raised by the AER are provided at Attachment A.

We recognise the AER are under tight timeframes. We look forward to working closely and cooperatively to support the AER to complete its review and deliver findings that will achieve an optimal balance between reforms that protect customers while preserving the integrity of the competitive market.

If you have any questions regarding this submission, please contact Sean Greenup in the first instance on (07) 3867 0620.

Yours sincerely

Keith Robertson
General Manager, Regulatory Policy

## Attachment A

*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 AER is faced with tight timeframes to undertake its analysis. Furthermore, it does not possess information gathering powers for its task and has limited time to seek this information voluntarily from retailers. As a result, it has proposed using a "top-down" method that uses observable price-based information.

The AER has indicated that it will explore using a cost-based bottom up approach for future determinations. However, moving from one method (i.e. "top-down") to another (cost-based "bottom-up") may create the risk of a step change in pricing outcomes. To avoid this, we believe that the AER should use actual underlying costs where these are readily available.

One option would be for the AER to consider how the results of its "top-down" method compare with the QCA's pricing determination (preferably over multiple years). Any material differences could be used to guide adjustments to the AER's selection of a point estimate which would also reduce any inconsistency if the AER were to subsequently move to a bottom-up approach.

Another, preferable option, would be for the AER to use the outcomes from the QCA's notified price calculation for 2019-20 to derive the DMO reference bill for the Energex distribution network.

As the AER notes, the QCA applies a cost build up approach that produces estimates of efficient South East Queensland (SEQ) price levels for residential and small business customers. As part of its calculation method, the QCA indicates that cost-reflective prices, and the promotion of retail competition, are important guiding principles in making its price determination. In addition, to satisfy the Queensland Government's Uniform Tariff Policy (UTP), the QCA sets notified prices for small customers in regional Queensland that broadly reflect the expected level of standing offer prices in SEQ. To achieve this, the QCA adds an amount (referred to as the standing offer adjustment) to the estimated efficient costs of supply to account for the expected price differential between lowest offers and standing offers in SEQ.

In terms of deriving an estimate of efficient costs, the QCA's cost build up includes network costs plus energy and environmental costs plus retail costs. While network costs mirror those determined under regulation by the AER for Energex, the derivation of energy and retail costs are forward looking. In particular, the QCA method seeks to represent the hedging costs of a typical retailer using contract prices represented by the observable ASX Energy futures market data. This approach is designed to simulate the wholesale energy market from a retailer's perspective and has been endorsed by the Australian Energy Market Commission (AEMC).[1]

As a result, the QCA method is a forward-looking representation of an average of all market prices. This compares to the AER's proposed method that adopts a point estimate within a range that is drawn from a very small sample of data. We believe the AER's sampling approach increases the risk of regulatory error which we examine further in response to Question 4. We believe this risk could be significantly reduced if the AER adopted the QCA's analysis for the purposes of developing a DMO price for SEQ.

Not only would it reduce the possibility of regulatory error, the QCA approach has been in place for a number of years and is well understood by market participants. We believe the adoption of the QCA method would provide transparency and certainty regarding the DMO and would better enable the AER to capture forecast movements in underlying costs.

[1] See AEMC, Advice of Best Practise Retail Price Regulation Methodology, 2013.

We do not see any impediment that would prevent the AER from applying the notified price developed by the QCA as the basis for the DMO for Energex's network. It would also ensure that the AER method for Queensland was consistent with the Queensland Government's UTP.

*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.*

The ACCC recommended that the DMO replace the existing standing offer contracts. There are a range of different standing offer tariff structures from flat to TOU tariffs. It will be difficult to derive a point estimate to support a DMO for each of these structures. It will also be problematic to administer and is unlikely to improve customer engagement.

For these reasons, the DMO should only apply to flat rate tariff structures and controlled load. We believe applying a consistent structure will provide certainty to retailers and customers and ensure customers better understand the change in their pricing arrangements.

Furthermore, we do not believe that a distribution network should assign a customer to a network tariff that is inconsistent with the DMO tariff structure. This would create a risk mismatch for retailers between the two tariff structures. Furthermore, some of the proposed default network tariffs are overly complicated; for example, Endeavour Energy proposed a default demand seasonal TOU tariff for residential customers installing a smart meter. A DMO that is not simple and easy to understand would entrench confusion and distrust with the industry.

*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.*

Consistent with our views with respect to residential customers, a DMO for small business customers should be a flat tariff.

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

The challenge for the AER in establishing a DMO is to determine a price that meets the policy intent of providing a safety net for unengaged consumers without diminishing the benefits and incentives that accrue from competition.

Specifically, the DMO should allow retailers to recover efficient costs of operating an electricity retail business. We believe the efficient costs of a retail business should include an appropriate retail margin to compensate the business for its investment and the risk it assumes in providing retail services. This is a view shared by the AEMC that suggested that a sufficient amount of costs should be included to allow retail investment to occur.[2]

The ACCC also considered the approach that should be taken to setting the maximum price of the DMO, including whether the default offer price should enable retailers to recover customer acquisition and retention costs. The ACCC considered that the DMO should not exist to be the lowest price, or close to the lowest price in the market. Its purpose is to act as a fall-back position for the disengaged or for those that require its additional protections; not a price to be widely accessed. Ideally, it should only be utilised by a small number of consumers. It must be set above the price for competitive market offers to avoid incentivising consumer disengagement. The ACCC therefore concluded that the DMO price should be between the median market offer price and median standing offer price.

However, the range between the respective median prices is wide which increases the risk of regulatory error. If the DMO price is set too high, then we would expect more intense competition that will compete

[2] AEMC, Advice on Best Practise Retail Price Methodology, 2013, p. 76

away any excess margin. On the other hand, if the AER set the DMO price too low then this will more likely damage competition, reducing dynamic efficiency with longer term losses to consumers. We believe it is a well accepted regulatory approach that, over the longer term, under-compensation resulting from regulatory error is likely to have greater costs for customers and the wider community than 'symmetric' overcompensation.[3]

We believe the AER's approach to deriving a sample size amplifies the risk of regulatory error. The AER propose taking a sample of generally available standing and market offers from Energy Made Easy (EME) and Switch On for October 2018. As a result, this does not capture all market offers nor recognise the customer weighting across offers. This is important because retailers run promotional offers at various times in the year to attract customers. These prices are intended to attract new customers and do not necessarily reflect a sustainable price to maintain customers, rather they reflect retailers' marketing strategies at a point in time and may not have a substantial uptake.

In addition, we understand that for October 2018, retailers commenced including restrictive offers into the EME data set such as retention and save offers. It is not clear whether October includes a complete data set of these offers or over what time EME will be representative of a complete data set. This further highlights the risk of sample errors from such a narrow data selection.

As a result, this introduces significant risk that the AER will determine a price that does not reflect the true market costs or expected forecast changes in underlying costs.

To highlight this risk, we have examined the likely outcome of the AER method against discount analysis contained in the ACCC Pricing Inquiry report. This analysis is set out in table 1. The analysis takes the ACCC's distribution of all market discounts across customers for 2017-18. From the ACCC's data, we are able to take a weighted average of "all" market offers to determine a representative market discount. This results in a weighted average market discount of 20.08% for Victoria; 14.92% for NSW and 8.51% for Queensland.

Consistent with the AER's proposed method, we then derived the median of market offers from EME and Switch On for the month of November 2018 (retrospective data for October 2018 was not available). This resulted in an average market offer of 30% for Victoria; 20% for NSW and 18% for Queensland.

This highlights that the using the AER's sample data for November of point in time discounts significantly understates the actual discounts that apply across all of a retailer's accounts. As a result, the starting point in the AER's method introduces regulatory error which can be compounded if the AER does not accurately apply its regulatory judgment in deriving its point estimate.

For this reason, we propose that to establish its benchmark costs that the AER: broaden its sample to include "all" market offers; adjust its calculation by considering the ACCC weighted averages; and take guidance from the QCA cost-based determination.

[3] Productivity Commission 2013, Electricity Network Regulatory Frameworks, Chapter 8.

**Table 1: Comparison of Average Discount for All Market Offers versus AER Sample**

| Size of the Contract Discount | Percentage of Customers on the Discount Victoria (%) | Percentage of Customers on the Discount NSW (%) | Percentage of Customers on the Discount SEQ (%) |
|---|---|---|---|
| Standing | 6.00 | 15.00 | 12.00 |
| 0% | 7.00 | 4.00 | 8.00 |
| 0-5% | 6.00 | 8.00 | 14.00 |
| 5-10% | 14.00 | 11.00 | 31.00 |
| 10-15% | 7.00 | 17.00 | 29.00 |
| 15-20% | 7.00 | 31.00 | 6.00 |
| 20-25% | 6.00 | 21.00 | 1.00 |
| 25-30% | 21.00 | 2.00 | 0.00 |
| 30%+ | 26.00 | 1.00 | 0.00 |
| | | | |
| Avg Discount of All Market Offers | 20.08 | 14.92 | 8.51 |
| Median of Market Offer Discounts | 30.00 | 20.00 | 18.00 |

Source: Tables 1.8; 1.11; and 1.17 ACCC Electricity Pricing Inquiry – Final Report. Origin analysis of EME and Switch On.

We also consider that establishing a DMO as a reference bill for discounting instead of a regulated price is likely to deliver benefits with a reduced risk of regulatory error. A reference bill will complement initiatives already put in place to support comparability and the presentation of prices offered by retailers. These initiatives include:

- the AEMC Preventing Discounts on Inflated Energy Rates Rule which prohibits retailers from including discounts in market retail contracts where customers would definitely be worse off under the undiscounted market offer than under the standing offer;
- the AER's revised Retail Pricing Information Guidelines (RPIG) which provides guidance on how retailers should present pricing information including percentage discounting;
- AER's Benefit Change Notice Guidelines which requires retailers to notify a small customer through a benefit change notice when their market retail contract benefit is expiring or changing; and
- AEMC Advance Notice of Price Change Rule to apply advance notice to all small retail energy consumers on market and standing offer contracts for both price increases and decreases.

Many of these initiatives are recent and if successful may mitigate the need for more intrusive measures such as a DMO. We believe analysis of the effectiveness of these initiatives is pertinent to the AER's recommendation to the Government regarding how a DMO should be applied.

*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?*

As stated above, the AER's proposed method of taking a sample of one month of data does not accurately represent each retailer's forecast costs because it is drawn from a sample of point in time offers and not all market offers. In addition, the AER's approach of using the median of standing offer prices to set the DMO will, if applied continuously, create a bias towards the previous year's calculation.

This is why when establishing a regulated benchmark, a wider sample is necessary to remove any distortions or biases from a small sample size. Furthermore, consistency in method is a fundamental aspect of providing regulatory certainty. If the AER chose a single month each year as the reference month this would then lend itself to potential gaming. For this reason, we encourage the AER to select a broader sample (i.e. 1 to 2 years if possible) in order to smooth distortions in the data.

We also believe the AER needs to consider the impact of increased smart meter installations on retailer costs. Metering is now an intrinsic part of a retailers' business and therefore costs and the AER ought

to consider the impact of increased uptake of smart meters on retailers' systems and operations in the DMO. To do otherwise could reduce the incentive for retailers to promote the take up of smart meters.

*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.*

As stated, applying a narrow temporal window for its sample creates potential distortions. Subject to the limitations of the AER's method, applying a median of standing offer prices is reasonable.

However, to mitigate regulatory risk, we believe the AER ought to consider a more representative market offer sample. As demonstrated above, this could be sourced from the ACCC cost stack data, the QCA data, or a combination of both.

*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.*

The AER ought to consider the usage and therefore cost dispersion for small business customers. This is much greater than it is for residential customers. As a result, this dilutes the applicability of a reference price for this customer type.

*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.*

We note that the AER applies different consumption thresholds in different assessments. For example, as part of its recent NSW distribution network determination it assumed an average consumption of 5,000kWh for residential customers and 10,000 kWh for small business customers.[4] In the AER's DMO consultation paper it applied an average consumption of 6,130kWh for residential customers.

We believe that the average consumption for a residential customer as used in the DMO consultation paper is representative of actual residential average usage. Furthermore, we believe that the AER should adopt a consistent application of consumption levels in the context of estimating pricing impacts. However, in terms of a small business customer, the range of usage is significant. As a result, applying a consumption benchmark to all customer in this category will be problematic because it is not representative.

*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.*

As per response to question8.

*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 AER's method provides that the AER exercise its regulatory judgment to determine where the DMO price falls within its range. In making this judgement, the selected point should enable retailers to recover a reasonable margin, customer acquisition and retention costs. It is important that the AER is transparent in demonstrating that it has allowed for a reasonable margin; we consider that the AER will need to complete at least a "short form" bottom up assessment to make this judgement. As highlighted in response to question 4, the proposed derivation creates a starting point that includes regulatory risk. As

[4] AER, Draft Decision Ausgrid, Distribution Determination 2019 to 2024 Overview, p. 10.

a result, we believe that the AER ought to err on the side of caution and apply a point estimate that as far as practicable alleviates this risk and converges towards the upper bound of the range.

*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?*

Given the AER's approach will deliver a static outcome at a point in time, it is extremely important that the AER consider the impact of forecast changes in underlying costs. These include the impact of the following:

- AER distribution and transmission network determinations and annual pricing proposals;
- costs associated with the rollout of advanced metering technology;
- how the financial risk of network tariffs that do not align with the DMO will be considered;
- futures prices for the wholesale cost of energy are readily available. However, the AER should acknowledge that each retailer will have a different wholesale energy strategy. To reduce fluctuations that may favour one strategy over another it would be preferable for the AER to look at average cost movements over a duration of 12-24 months;
- many retailers have not passed through the underlying costs of supply for the last three years. This approach is designed to ameliorate fluctuation in underlying costs.[5] For example, most recently, Origin absorbed a 3% cost increase accounting for network and environmental cost increases in NSW. Similarly, from 1 Jan 18 in Victoria Origin provided rebates to customers not receiving a market discount. In considering prices for 2019 the wholesale price of electricity has come down from its peak, but this was more than offset by increases in network charges and government green schemes. Nevertheless, Origin decided to absorb these costs to make sure our residential customers in Victoria do not pay more in 2019. The AER needs to factor such actions in establishing its upper and lower bound ranges;
- historical Large-scale Generation Certificate (LGC) market prices from AFMA; and
- the clearing house price for small-scale Technology Certificates (STCs).

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

The AER has proposed setting a maximum bill, not maximum prices. We support the presentation of a DMO as a reference bill. This will allow retailers to then set their own fixed and variable charges within this constraint. More importantly setting a reference will provide for a consistent anchor for retailers to present discount offers from. This will in empower consumers to be able to effectively compare and rank offers or have a clear idea of what price they will be paying.

*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?*

We believe the application of a DMO price if introduced should be a temporary measure; a market reset that applies for a single year. After this reset, the ACCC's ongoing monitoring role will provide customers and other stakeholders with confidence that prices reflect reasonable costs and returns. If the DMO is applied for more than one year then given the risk of long-term detriment to the competitive market, the ongoing effectiveness of the DMO price should be assessed on an annual basis against clearly defined assessment criteria developed by the AER.

[5] IPART, Review of the Performance and Competitiveness of the Retail Energy market in NSW 2017-18, p. 48.