Submission to AER Options Paper

Methodology to be adopted for 2022-23 determination of the DMO

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About the Public Interest Advocacy Centre

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit legal centre based in Sydney.

Established in 1982, PIAC tackles barriers to justice and fairness experienced by people who are vulnerable or facing disadvantage. We ensure basic rights are enjoyed across the community through legal assistance and strategic litigation, public policy development, communication and training.

Energy and Water Consumers' Advocacy Program

The Energy and Water Consumers' Advocacy Program (EWCAP) represents the interests of low-income and other residential consumers of electricity, gas and water in New South Wales. The program develops policy and advocates in the interests of low-income and other residential consumers in the NSW energy and water markets. PIAC receives input from a community-based reference group whose members include:

- Affiliated Residential Park Residents Association NSW;
- Anglicare;
- Combined Pensioners and Superannuants Association of NSW;
- Energy and Water Ombudsman NSW;
- Ethnic Communities Council NSW;
- Financial Counsellors Association of NSW;
- NSW Council of Social Service;
- Physical Disability Council of NSW;
- St Vincent de Paul Society of NSW;
- Salvation Army;
- Tenants Union NSW; and
- The Sydney Alliance.

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Introduction

The Public interest Advocacy Centre (PIAC) welcomes the opportunity to respond to the Australian Energy Regulator's (AER) Options Paper, Default Market Offer prices: Options paper on the methodology to be adopted for the 2022-23 determination (the Paper).

PIAC strongly supports the principle and role of a Default Price mechanism. The Default Market Offer (DMO) and reference price have delivered essential protection for consumers and much needed discipline for the market, and should be retained.

In previous DMO processes PIAC has provided detailed argument and evidence in support of a stronger default price, based on efficient costs, including reasonable margin. This included evidence that consumers continue to be left worse off by a market for an essential service that is not operating in their long-term interests.

People continue to pay more for an essential service than is necessary or efficient in circumstances where they should be protected. This includes those on standing offers and market offers with expired terms and conditions.

People comparing their offer to the DMO are being misled as to the value and fairness of their offer, as the DMO intentionally represents a price well above the efficient cost to supply. The DMO and reference prices could be helpful information for consumers, but their effectiveness depends on how they are formulated and applied. That effectiveness is undermined by the approach and method currently employed. This is not in the interests of consumers.

PIAC strongly supports this review reassessing the way the objectives and role of the DMO is defined, considered, and applied. This must be grounded by the interests of all consumers, the essentiality of electricity services, the impact of the market on consumer vulnerability, and realistic expectations of competition.

The resulting DMO should be more strongly focussed on an efficient cost to serve with a benchmarked margin which is sustainable for retailers that are efficient in their operations and provide good services and supports for their customers. There should be no additional allowance for customer acquisition and retention beyond this margin. An additional allowance does not reflect a consumer benefit. A DMO based on efficiency is likely to be more accurately and fairly derived through a 'bottom-up' assessment of costs.

Background and legislative context

The AER has an obligation, recognised in the Paper, to 'protect the interests of consumers by enforcing the National Energy Retail Law (NERL). The AER's reference for determining the interests of consumers and how they must be protected and promoted is clearly stated in the objective of the NERL, and the National Energy Retail Objective (NERO).

> the objective of this Law is to promote efficient investment in, and **efficient operation and use of**, energy services for the **long term interests of consumers of energy** with respect to **price**, quality, safety, reliability and security of supply of energy.

The objectives of other instruments the AER may have reference to, such as the Competition and Consumer (Industry Code—Electricity Retail) Regulations 2019 (the Code) are secondary to the NERO. These objectives must be framed by and refer to the NERO and the key principles it defines. The NERO should be paramount in reviewing the DMO.

The Code defines the AER's role in relation to the DMO in Part 3 -15[1]. The key aspects relevant to this review are:

- 'The AER has the function of determining the matters required or permitted by the rest of this Part to be determined by the AER'.
- the AER must have regard to:
    - the principle that an electricity retailer should be able to make a reasonable profit,
    - the costs considered should include the cost of serving small customers and the cost of acquiring and retaining small customers, and
    - any other matters the AER considers relevant.

The AER clearly has scope to determine what is required to fulfil its role under the Code. Specifically:

- The AER is directed to ensure that its decisions leave scope for reasonable retailer profit. But it has discretion to determine what constitutes 'reasonable' profit and is required to refer to the NERO in doing so.

- The AER is required to consider the costs of serving small customers, including retaining and acquiring them. But it has discretion as to what is involved in this consideration, what weight it gives to those costs in its considerations, and how its decision will reflect that consideration. It is required to support the NERO in undertaking this.

In both respects the AER's discretion must be guided by its primary objectives to protect and promote the interests of consumers in its decisions.

Applying the objectives of the DMO with reference to the NERO

The NERO is the explicit and enduring reference for the AER in considering how to implement the objectives of the Code, and how to apply its discretion in areas where the Code empowers it to do so.

The Paper refers to 'guidance' provided by the Australian Competition and Consumer Commission (ACCC) in a submission to the AER as part of the DMO determination[2]. Nonetheless

[1] https://www.legislation.gov.au/Details/F2020C00687
[2] AER page 10.

the AER has responsibility for applying the DMO in accordance with the NERO in determining what is in the interests of consumers. There is no requirement for the AER to consider the 'interests of competition' or 'engagement in the market', despite how any opinion of the ACCC is interpreted. Contestability and market engagement are mechanisms intended - and that have failed - to deliver good outcomes for all consumers.

The DMO and competition

Being essential, electricity use has impacts on the health, wellbeing and financial sustainability of households.

Competition in the market can be used to deliver good outcomes for some consumers, with the right rules, incentives and protections. But the assertion competition is inherently better at delivering service outcomes is outdated, unrealistic thinking and not supported by the experiences of consumers in the energy retail market.

Contestability in retail electricity was intended to efficiently deliver an essential service at lower cost to consumers. Instead, deregulation predicated on the effectiveness of competition resulted in prices so 'unjustifiable'[3] price regulation had to be reintroduced.

Measures of competition should be assessed on whether and how it is contributing to good outcomes for people. Market metrics such as number of retailers or offers, customer churn and dispersion of prices are indicators of negative consumer experience and outcomes – confusion, pressure, poor choices, inefficiency, and excessive prices, rather than positive ones. There is no legislative or regulatory requirement for the AER to use these indicators, or prefer or enable contestability for its own sake, in determining the DMO.

A better measure of the effectiveness of competition is the number of financially vulnerable people paying more than the lowest price for an essential service, which should be zero.

Correcting an irrational incentive assumption

The formulation of the DMO to date has been based on acceptance that price dispersion in essential services is not only acceptable but desirable. It assumes that prices for defaults must remain higher than necessary to provide a loss-averting incentive for consumers to enter the competitive market and seek a fairer price. Facilitating price dispersion to provide an 'incentive to switch' is irrational logic that intentionally makes consumers worse off to provide the theoretical potential for some to be better off.

If all consumers actually responded to this incentive – where 100% of consumers switch every 12 months – costs would be inflated for all consumers and result in all consumers paying more and being worse off. The current market structure is a prisoner's dilemma where the hope and possibility of benefit is held up as the reason to play. But the possibility of benefit cannot be realised by all.

3 Preventing unjustifiable standing offer prices is a stated objective of the DMO.

When we accept the reality that most consumers will not switch every 12 months as they would be required to do to get a fair offer, we are accepting that we intentionally leave most consumers worse off simply to retain the potential for some to be better off. That is manifestly not in the interests of all consumers.

It is not acceptable to create an 'engagement' incentive by intentionally leaving consumers worse off.

Market competition and engagement, working in the consumer interest, should involve a positive incentive to engage. It should involve consumers protected by a fair value offer for an essential service, choosing to engage in a market competing to offer them additional value.

The retail market and what it delivers for consumers

Selling an essential service means a retailer draws from a guaranteed pool of customers who must purchase. The number of new retailers entering the NSW market in 2020-2021 indicates businesses see opportunity to profit from selling electricity, even during a pandemic, and even if their share of the market is very small. PIAC notes that this appears to contradict the contention of many retailers that current circumstances and regulations threaten their viability.

The 'Big 3' retailers (Origin, AGL and Energy Australia) still dominate with 81% of the retail electricity market share. In Essential Energy's area, the legacy retailer, Origin, retains about 50% of the market share.[4] Only 20% of consumers voluntarily switch in any given year. The majority of people are now on market offers. The relatively small proportion of consumers switching retailers means that for many consumers who appear on the 'market offer', statistics show they would be on deals with expired benefits and are likely to be on terms equivalent to the standing offer. This is recognised in the Paper, but not highlighted as an issue of central relevance to the DMO and questions of its role and formulation.

The entry of a number of new retailers into the market may be in part a consequence of an inefficiently high DMO. Because the DMO is intentionally higher than the efficient cost to serve, a retailer, no matter how small its customer base, is guaranteed a high proportion of customers – those on standing offers and those on expired market offers that default to similar terms – delivering a greater margin.

Having 40 retailers operating in NSW is not a consumer benefit in any case. It is worse still if any of those retailers are not delivering better services and prices for all their consumers. More retailers in the market indicates businesses calculate there is a margin to be made, even in a market bloated with the overheads of 40 businesses selling for the most part exactly the same product.

Switching: The 'confusopoly' and the mirage of consumer benefit

The potential benefit consumers can derive from the competitive market is mostly unrealised and over-estimated. The AER has intentionally set defaults well above an efficient price to drive consumers into the market. The assumption is that engagement with the market will allow them to

4 Mentioned by Essential Energy during a deliberative forum on 27 October 2021.

benefit from substantially better value offers. Setting aside the circularity of this logic, whether most consumers can realise the supposed benefit from engagement with the market should be considered in structuring the DMO.

Reporting on the retail market indicates switching has marginally increased and, similar to the experience in Victoria, now hovers around an annual rate of 20%. There is no evidence there is more than a relatively small proportion of 'active' consumers making up the bulk of the switching figures.[5] It is likely that many of the people who switched in 2019-20 switched again in 2020-21. For the majority of consumers (about 80%), switching retailers is not an activity they regularly take part in.

Many consumers may have switched in the last few years and then remained on their current offer on the assumption it is a 'good offer'. Retail practices mean these consumers are likely to be on expired benefit offers or other defaults that are equivalent to a standing offer, even though they appear in the 'market offer' statistics. The AER has recognised this in their current review of the DMO,[6] though they have not sought to quantify the number of impacted consumers.

Many people are not aware they are expected to regularly check and update their energy offer in order to pay a fair price. For most who are, it is an unwelcome chore at best, and at worst a frustrating and confusing exercise that can seem impossible. For some, it induces fear they will be disconnected, have a less reliable supply or pay higher costs.[7] The accumulated burden on people increases every year. More and more aspects of their lives require high levels of understanding and 'engagement'. Energy switching is often deprioritised, not because people are happy with their arrangements, but because other issues take priority.

People who have not switched must not be considered 'disengaged'. For many, not switching is an expressed preference. It is a response to their perceptions about the role of energy and a means of prioritising and coping with the issues they must deal with. They may rightly assess that any potential financial benefit gained from switching is often short lived and negated by the effort it takes or 'hidden' costs. And they are right: some market offers have less suitable conditions than standing offers,[8] leaving consumers worse off.

Examining the structure of retail offers indicates even those who do switch and are on market offers are not likely to be realising the assumed benefits a survey of publicly advertised offers might suggest[9].

PIAC looked at Energy Made Easy (EME) and putting in some basic information[10] without a bill and found 758 available plans. From the top 10 least cost plans, PIAC found a dizzying number of options to navigate:

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5 Independent Review into the Electricity and Gas Retail Markets in Victoria (2017), 38.
6 Australian Energy Retailer, 'Default Market Offer prices: Options Paper on the methodology to be adopted for the 2022-23 determination (and subsequent years)' (2021), 11.
7 Nicholls, Larissa and Dahlgren, Kari, 'Consumer Experiences Following Energy Market Reforms in Victoria: Qualitative Research with community Support Workers, Final Report' (2021), 8.
8 Such as a financial penalty for missing a direct debit payment.
9 Bruce Mountain https://theconversation.com/i-chose-the-electricity-retailer-offering-the-best-deal-for-my-home-thats-not-what-i-got-171676
10 A four person household in Minto, NSW with a smart meter, current retailer unknown. Energy Made Easy accessed on 9 November 2021.

- Two had membership fees (one is for $77.94 for the first six months and the other is $80).

- Two offers were flat rates whilst the remaining offers had time of use rates, three of which have seasonal time changes. For some offers there are three different time of use rates, spread across five different times (peak, off-peak, shoulder, weekend peak and weekend off-peak).

- Move in/reconnection fees ranged from $0 to $87.25.

- Disconnection fees for moving out of premises ranged from $0 to $87.25, whilst one listed a different fee for disconnection for non-payment.

- Some also listed reconnection fees separately, ranging from $42.68 to $73.92.

- Three offers had direct debit dishonor fees ranging from $7.50 to $11.00, whilst one offer had a cheque dishonor fee of $11.00.

- Four offers included late payment fees ranging from $12.00 to $16.00.

- Four listed credit card payment fees, ranging from 0.36% to 1%.

- Two had payment processing fees. One 0.17% and 0.45% and the other is for 3%.

- One included a 20% discount.

- One had an NRMA membership listed as an inducement.

The range of factors to assess does not include the variation and combination in supply charges and usage rates, which often vary between the deal as advertised and the deal offered at the point of sign-up.

Most consumers would be at a loss to meaningfully navigate this complex mess of information to confidently make the best choice for them. The AER cannot assume the numbers of consumers on market offers, translates to consumers better off. The nature of retail offers means they are likely to default to something equivalent to the DMO, and erroneously assume they are on a good deal.

For many switching may not mean selecting the best possible offer due to the complexity of the structure of offers and the sheer number of offers available. For others the selection of an offer from a comparator site, even EME may not result in them actually being on the offer they believe they have selected. There is no transparency to show that the terms of the offers listed on EME (which the AER uses to determine the potential benefit available to consumers) are the terms actually offered to consumers when they sign-up.[11]

[11] https://theconversation.com/i-chose-the-electricity-retailer-offering-the-best-deal-for-my-home-thats-not-what-i-got-171676

All of these elements of retail competition, the retail market, how deals are structured and offered, and how people interact with them, must be considered when assessing the DMO and how to ensure it operates to protect and promote the interests of consumers. It is perfectly reasonable for retailers to offer deals with varied terms, complicated benefits, additional fees and other options that consumers may value. It is not reasonable or acceptable for consumers to be forced to navigate and decode them simply to pay a fair and efficient price for an essential service. To protect consumers and to promote their interests, the DMO must be an efficient fair price they default to when no other choice is made.

Impact of the default market offer (DMO)

PIAC strongly supports the role of default pricing in improving outcomes for all consumers. However, the current design of the DMO is not in the best interests of all consumers. PIAC supports formulating the DMO in the basis of efficiency and considers the experience of the DMO to date demonstrates this would deliver better outcomes for consumers and the market.

The DMO has had positive outcomes for all consumers and particularly for individual consumers on standing offers. Following the introduction of the DMO:

- Standing offers have generally remained within level of the DMO, ensuring fewer consumers are paying exorbitant prices for their electricity service compared to before the DMO. Those benefiting may also include people on market offers with expired terms and benefits, who are likely to default to terms equivalent to the standing offer.

- Median market offer prices decreased across all distribution zones and customer types, representing an 'overall' improvement in market price outcomes for consumers.

- The spread of market prices decreased, indicating less excessive prices, less extreme 'loss-leader' pricing, and less 'subsidy' between consumers.

- The prevalence of conditional discounting has decreased, with increased competition that is not exclusively price-based.

These outcomes demonstrate that default pricing has positive outcomes. Still at question is whether the form of the DMO, and how it is applied, are delivering the best outcomes for consumers.

A strong default, constructed to represent efficiency (including reasonable margin) is in the long-term interest, and would deliver better outcomes for consumers. Such a DMO would:

- Properly protect consumers on standing offers. Ensuring those who remain on these offers pay no more than is necessary to efficiently deliver them a service at a price that includes a margin that is 'sustainable' for a retailer providing services that benefit their customers.

- Properly protect the large number of consumers on market offers with terms and benefits that may have expired. These people have made choices to select a market offer and for whatever reason, have now ended up on terms they typically did not explicitly consent to.

Ensuring they remain on terms allowing them to pay no more than is necessary to efficiently deliver an essential service would still ensure the price is 'sustainable' for the retailer.

- Clearly and practically indicate what is 'fair value' for an essential service. This would help ensure all consumers need pay no more than fair value, but also give them a consistent value comparison for other offers. Offers above the DMO and reference price are now clearly 'premium' and must demonstrate value to the consumer.

- Be a strong and efficient cap on default offers for an essential service, not a cap on prices. Market offers should still have scope to be above (potentially even well above) the DMO and reference price: These should clearly be premium offers and must demonstrate value to consumers through innovative terms and additional value services and products. The costs of customer retention and acquisition can be appropriately recovered through these offers.

- Provide a strong incentive to retailers to understand consumers and create offers that they value. Rather than simply loss-leading to undercut competitors for a largely homogenous essential product, retailers would have an incentive to develop services and products consumers value, and which could attract a premium over the default. This could be done because consumers are protected by the 'fair and efficient' default and have a clear comparison.

- Genuinely create competition where consumers have real choice that operates in their interest. Rather than requiring them to engage in a market that intentionally confuses and misleads them in an attempt to pay a fair price, they have the choice to engage to find services they value more.

- Reduce the structural impact of the market on consumer vulnerability. By ensuring the default is fair and efficient and reducing the burden on consumers, the market evens the terms (and risks) of engagement for consumers.

In the remainder of this paper PIAC provide response to selected questions from the Paper.

Responses to options paper questions

Question 1: What is the most appropriate approach to estimating retail operating costs under a cost-based approach?

PIAC supports using ACCC inquiry data to determine indicative retail costs.

Question 4: Is the DMO protecting customers from unjustifiably high prices? If so, why?

The DMO does not protect consumers from unjustifiably high prices. The DMO intentionally creates a retail pricing comparison which does not represent an efficient cost to serve, including a reasonable margin. The AER's guidance for determining what is a 'justifiable' price for consumer protection and reference must be efficiency, as detailed earlier in relation to the legislative context for the DMO.

Intentionally setting the DMO above any estimation of efficiency ensures any consumers on a standing offer are paying more than is necessary for an essential service. This is not justifiable on any reading of consumer interest.

The DMO indirectly determines the prices consumers on market offers with expired terms are paying. Switching data and established retail practices suggest that consumers in these circumstances may constitute up to 70% of all electricity consumers in NSW (that is all consumers not including the approximately 30% of consumers who remain directly on standing offers or have not switched in the past 12 months). Intentionally setting the DMO above an efficient price ensures these consumers are paying more than is necessary for an essential service. This is not justifiable on any reading of the consumer interest, as detailed in relation to the legislative context for the DMO

The DMO serves directly as the reference price comparator for all energy offers. Intentionally setting the DMO above an efficient price misinforms consumers regarding the relative value of offers in the market, including the offer they may be on. This leads to many consumers remaining on or selecting offers that leave them paying more than is necessary for an essential service. This is not justifiable on any reading of the consumer interest.

The DMO does not currently protect consumers from paying unjustifiably high prices for an essential service, but a basis on efficient cost to serve (including reasonable margin) would correct this.

Question 5: What factors are relevant in considering whether a price is excessive?

PIAC considers any default price above the efficient cost to serve, including a reasonable benchmarked margin, excessive. A reasonable benchmarked margin in this case is sustainable for retailers that are efficient in their operations and provide good services and supports for their customers.

Question 6: What other factors should we consider when assessing the DMO allowance required to incentivise customers to engage in the market?

Protection of the interest of consumers in accessing a fair and efficient price for an essential service must be the primary consideration. It is not acceptable for this fundamental interest to be qualified by or contingent on ‘engagement in the market’. It is a contradiction of the consumer interest to intentionally inflate the prices any (or most) consumers pay and leave them worse off, in an attempt to manufacture a particular form of consumer engagement with the retail market. It is irrational to intentionally create disadvantage just to provide consumers with an incentive to attempt to overcome it.

A DMO should support consumers while providing incentives for retailers to create value and meaningful choice for consumers. This would protect consumers access to an essential service and leave them to engage in the market when it is in their interests.

Question 7:Should the margin above efficient costs in the DMO price be consistent across all DMO regions and customer types?

Any margin above efficient costs should be consistently applied regardless of customer type or region.

Question 8:What is an appropriate DMO margin to achieve policy goals?

An appropriate retailer margin would not exceed the 5.7% set by the Essential Services Commission Victoria. This represents a reasonable return on investment above the efficient cost to serve and provides ample return on the provision of a default service. Importantly this margin in the DMO should not be a reflection of the potential margin for any particular retailer. It is simply the margin allowed to be incorporated into the DMO. A retailer may generate greater margin by offering premium services, bundled services or other market offers demonstrating value to consumers. Allowing for a fixed, efficient margin in the DMO provides a 'guaranteed return' while retaining an incentive for retailers to seek efficiencies in their cost to serve. Importantly it provides a real incentive to create revenue through new and innovative products that demonstrate additional value and choice to consumers.

Question 13: How long should we retain the methodology we adopt in this review?

The methodology should be retained for three years with a review of objectives, methodology and outcomes at the end of this period. The next three years are a period of transition to significant changes in the energy market, with material reforms to how the market operates. It is appropriate to conduct a comprehensive review in 2024-25 to align with this and prepare to respond to any changes.

Question 20: If TOU network tariffs are included in our assessment, should we use a simple weighting of customers on each tariff type across all jurisdictions? or a separate weighting for each network area?

It is appropriate to use a simple average weighting across all jurisdictions at this time.

Question 24: Should the DMO 4 methodology include an allowance for advanced meter costs? And if so, is the proposed approach above viable to calculate and account for its cost?

The DMO methodology should not include an allowance for advanced meter costs. There is no transparency regarding how metering costs are incurred or recovered. It is possible some costs are incurred up front, some incorporated into general charges, and some recovered as part of departure fees. Without a consistent and transparent understanding of what advanced meter costs are, or how they are recovered, it is not appropriate to introduce a specific allowance for them

The AEMC is currently undertaking a comprehensive review of the regulatory framework for metering and considering costs and responsibilities. The AER should wait for this process to conclude before considering the question of advanced metering costs in the DMO.

Question 25: Do you support our use of DNSP data, cross-checked with other sources, to determine annual residential usage?

PIAC supports this approach.

Question 29: Would you prefer we reflect TOU usage in annual usage estimates or calculate annual usage based on flat rate usage, given most customers are flat rate customers?

It is acceptable to base annual usage estimates on flat rate usage. Most consumers remain on flat rates. Continuing to use annual usage based on flat rate usage may be simpler and more practical, while sacrificing little in detail accuracy.

Continued engagement

PIAC welcomes the opportunity to meet with the AER and other stakeholders to discuss these issues in more depth.