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7 December 2018

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

By email: DMO@aer.gov.au

Dear Mr Feather,

Position Paper: Default Market Offer Price

Simply Energy welcomes the opportunity to provide feedback on the Australian Energy Regulator's (AER) Position Paper on the Default Market Offer Price.

Simply Energy is a leading second-tier energy retailer with over 660,000 customer accounts across Victoria, New South Wales, South Australia, Queensland and Western Australia. As a leading second tier retailer focused on continual growth and development, Simply Energy actively supports open market competition and is committed to ensuring affordable energy services are available to customers.

Retail price de-regulation has given many Australians more choice than ever before. Nevertheless, the prevailing industry practice of using standing offers as a base rate for setting market discounts has emerged as a concern as they do not meet consumers' needs. For this reason, the Commonwealth Government has tasked the AER with developing:

- a default offer that can be used as a safeguard for standing offer customers; and
- a reference rate that can be used as a common baseline by industry to advertise market discounts.

These tasks should be viewed independent of each other and therefore can be progressed separately.

Reference rate

Simply Energy supports the use of reference rates to better assist customers choose an energy plan that suits their needs, and to promote customer confidence in that choice once made.

To this end, Simply Energy is working with the Australian Energy Council to develop a reference rate approach to enable customers to better compare offers. This would see customers provided with headline figures for retailer offers that are easily comparable.

Simply Energy considers that a reference rate approach to enable consumers to better compare offers addresses the policy concerns without the risks to the long-term interests of consumers from price capping or other forms of retail energy price re-regulation.

The Australian Energy Council's proposal is now being developed in consultation with Government and has widespread industry support. Should it be finalised in the coming weeks it will obviate the need for the AER to develop a comparison reference rate and be available for implementation in the near term.

Default offer

In light of the Australian Energy Council's work, a default offer is not needed to progress implementation of a reference rate. Conversely advancing multiple reference rates could actually be counter-productive. This means the AER's work on the default offer can focus its role as a safeguard offer and take a prudent approach that will minimise any consequential flow-on effects to the wider market. With this in mind, the remainder of Simply Energy's submission focuses on evaluating:

- the issues with setting a 'bottom up' default offer;
- a more preferable approach to developing the default market offer; and
- ways of addressing the potential shortfalls that may be encountered in implementing the default market offer.

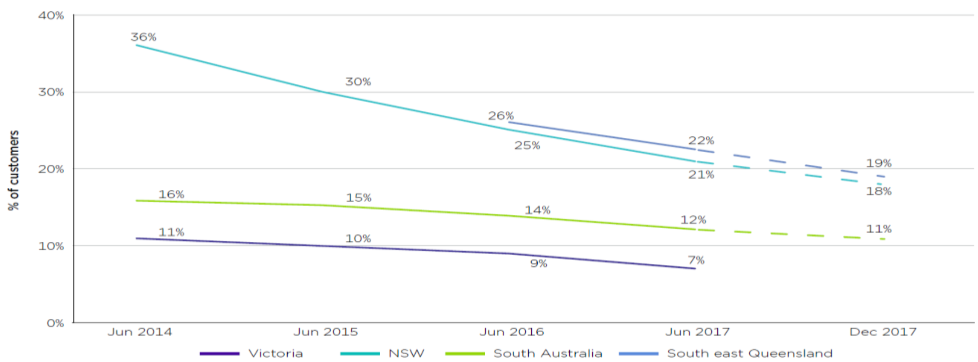
<u>Issues with setting a 'bottom up' default offer</u>

Open markets are dynamic and as they evolve, competitive tension generally leads to positive price outcomes for consumers. While there will always be those who wish to pay lower prices for a service or commodity, the self-correcting nature of a market means that prices tend to be reflective of how much the average consumer is willing to pay.

Regulated prices, on the other hand, are generally used to replicate competitive market outcomes where competitive tension does not exist or is ineffective. To function effectively, regulated prices need to be set at a level that allows businesses to recover the efficient costs of service delivery, while ensuring customers are not quoted excessive regulated rates. This is a difficult balance to achieve and the effect of getting the price wrong can impede future competition and innovation, to the long-term detriment of consumers. Indeed, international experience of re-regulating retail pricing in electricity has been generally negative.

Therefore, this type of market distortion must be avoided in establishing a default offer, given this would impose an unacceptable risk in seeking to safeguard a very small - and declining - percentage of customers across the NEM who remain on standing offers (as illustrated below in Figure 1).

Figure 1: Number of standing offer customers by jurisdiction



Source: ACCC analysis based on AER data; ESC Victoria data.

Note: The dotted lines indicates a six-month gap between figures (rather than 12 months). Figures for Victoria for December 2017 are not included as the ESC Victoria only reports annually. Figures for south east Queensland prior to June 2016 are not included as reporting to the AER for Queensland only commenced in the 2015-16 financial year.

Source: ACCC, *Restoring electricity affordability and Australia's competitive advantages: Retail Electricity Pricing Inquiry - Final Report*, June 2018, 244.

In recognition of this, Simply Energy encourages the AER not to build its own cost stack in setting the default market offer given this will lead to overly subjective "commercial decisions" being made by the AER which may not reassemble the actual market. Rather, Simply Energy considers that the default offer should be set at a reasonably proportionate level above the average market price in each de-regulated supply area.

Certainty of approach

To build consumer confidence and understanding, Simply Energy is of the view that certainty is required around how the default offer will be set going forward. Once an approach has been implemented, for the duration of its application, it should not be subject to unexpected or significant change without appropriate consultation with the industry.

It is important to keep in mind that the default offer should not artificially reduce electricity prices in a manner that does not reflect the true underlying costs of servicing energy consumers. This will create financial distress amongst retailers with wider consequences. Such outcomes would only tend to lower competition and could also lead to higher energy prices in the long term.

<u>Setting the default offer</u>

Simply Energy supports the use of the median of each retailer's best generally available offers in a distribution supply area plus a reasonable risk premium for servicing non-market contract customers.

Setting the default market offer

In calculating the median cost per distribution area, Simply Energy considers that only the best generally available offers from each retailer on the Government energy comparison websites should be considered. Online, win-back, and retention offers should not be considered as part of this assessment, as these offers have different acquisition costs and would distort any assessment of the market's actual cost to serve.

Simply Energy agrees with the AER that the most effective way to calculate the default offer is to base it on the mean yearly usage of residential and business customers in each distribution supply area. This will provide retailers with the ability to tailor the default offer in line with their commercial cost drivers. However, Simply Energy considers the most effective usage benchmark would be the mid-point on consumption profile on the Basic Plan Information Document for the relevant supply area, as these figures are already used and understood by industry participants.

Further, Simply Energy considers that individual default offers will need to be set for each distribution area. Average electricity usage by geographic area can vary considerably based on several regional-specific factors. These factors include the availability of natural gas, the density and types of dwellings (house or apartment), the types of business (commercial or industrial), climate and socio-demographics of the households or the business trading within the general supply area.

Calculating the risk premium

Given that the customers on a default offer are generally going to be those who are unknown to their retailer or may be those who have poor credit histories, Simply Energy considers that retailers should be allowed to recover a reasonable margin to cover the associated risk of bad debt or other market costs in providing for a regulated offer. This is important as otherwise a retailer is unable to manage the counterparty risk from customers at sites where the retailer has an obligation to supply.

In building a reasonable risk premium, Simply Energy considers that the following factors should be considered:

- **Customer profile:** those customers who are likely to be signed up on a default offer will tend to be unknown consumers of an occupied site or customers with a poor credit history, who retailers are required by regulation to supply. This, in turn, means that retailers have a much higher risk of incurring bad debts through servicing such customers.

- **Identifying unknown consumers:** as a replacement for standing offer contracts, retailers will continue to incur higher costs in servicing unknown customers supplied under a default market offer. There are additional costs in making contact with unknown customers in terms of making following-up communications and potentially initiating disconnection procedures as required.

- **Network costs:** a margin will need to be built in to the default offer risk premium to allow for any network tariff charges that cannot be fully passed on to the customers.

- **Wholesale costs:** only revising the default offer every 12 months provides for certainty in terms of costs incurred by average consumers on a default offer. That said, wholesale pricing volatility means that even with use of physical and financial offsets fixing pricing for 12 months may leave retailers exposed, particularly if uncontrolled events lead to a substantial increase in energy spot prices.

- **Headroom margin:** while unnecessary given current developments, if the default offer was considered for use as the basis for retail discounts, then there needs to be sufficient headroom built in to the overall cost stack to allow retailers to innovate and incentivise customers to look at switching to a market offer.

Through making allowance for the above factors, Simply Energy considers that market participants will in effect retain the ability to set retail prices and manage risk, but still be able to recover a reasonable risk premium on their default market offers (reflecting the role of the default market offer as a safety net for customer who are not on market offer contracts). In terms of varying the default of this, the risk premium could be indexed on a yearly basis based on observed market trends to ensure the price reflects prevailing market conditions.

As a starting point, Simply Energy considers that the above factors would need to allow for at least 20 per cent margin above the median price. Worked examples based on a two to three person household on a flat tariff without solar with all discounts included are outlined below to illustrate the reasons why. These worked examples use results from EnergyMadeEasy, as at midday 6 December 2018.

Elizabeth, South Australia, 5112

- The best prices on offer range from $1,920 to $3,060 per year (includes retailers whose best offers are standing offers).

- The median of these prices is $2,020.

- By adding an additional 20 per cent to the median of the best prices on offer, the annual default price would be approximately $2,424, which is $94 more per year than the highest market offer currently available in this supply area and $636 less than the highest ‘best offer’, which happens to be a standing offer.

Darlinghurst, New South Wales, 2110

- The best prices on offer range from $1,550 to $2,470 per year (includes retailers whose best offers are standing offers).

- The median of these prices is $1,680.

- By adding an additional 20 per cent to the median of the best prices on offer, the annual default price would be approximately $2,016, which is $36 more per year than the highest market offer currently available in this supply area and $454 less than the highest 'best offer', which happens to be a standing offer.

Overall, Simply Energy considers that its proposed approach meets the policy intent of the default market offer, while protecting the interests of non-market offer consumers. In effect, allowing a risk premium above the median of best offers would preserve the current market structure, while still acting as a safeguard to ensure retailers are only able to charge a reasonable amount above median market offer rates to those customers who are not on a market retail contract. That being said, there are some potential implementation issues that will need to be overcome in providing for the default market offer.

Overcoming potential implementation issues

Simply Energy considers that there are likely to be two main concerns with the proposed approach outlined above, which are:

- setting a default offer for 12 months creates undue commercial risk as retailers cannot adequately respond in the event of unforeseen whole price increases; and
- setting a risk premium above the average market offer price means that vulnerable customers who fail a credit check or are disengaged from market will continue to be penalised.

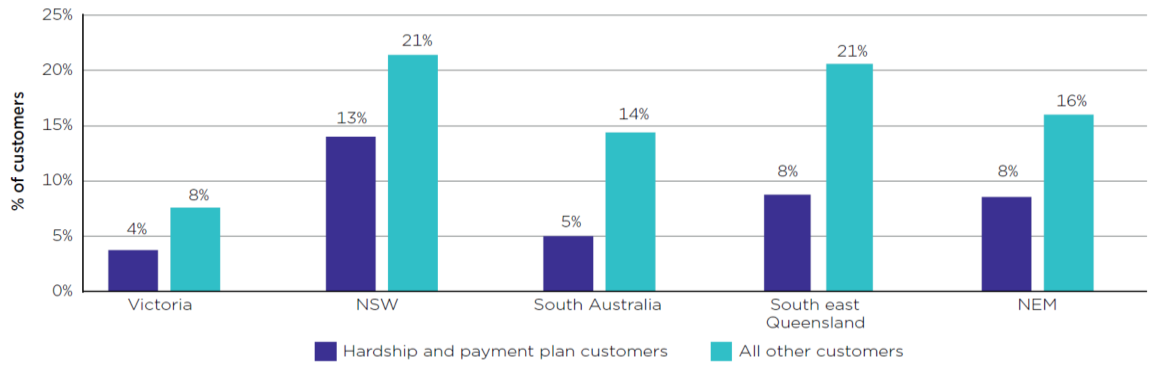
Managing commercial risk

To overcome any potential issues with commercial risk, Simply Energy recommends that the mechanism used to implement the default market include a prescribed set of circumstances in which retailers can request the AER adjust the default offer to account for an extreme market pricing event such a weather event causing a prolonged generation shortage that leads to a step increase in wholesale prices.

Vulnerable consumers

Simply Energy also acknowledges that in setting the default offer there may be concerns about the effect on vulnerable customers. Simply Energy would, however, like to emphasise that recent market research conducted by the ACCC has shown that vulnerable customers are less likely to be on standing offers (and therefore the default offer) than other energy consumers. This can be seen in Figure 2 below that shows the percentage of standing offer customers on hardship or payment plans compared to other customer types. In view of this, Simply Energy is of the view that vulnerable customers will not be disproportionately affected by the approach Simply Energy is putting forward.

Figure 2: Residential non-solar customers on standing offers as at 30 June 2017

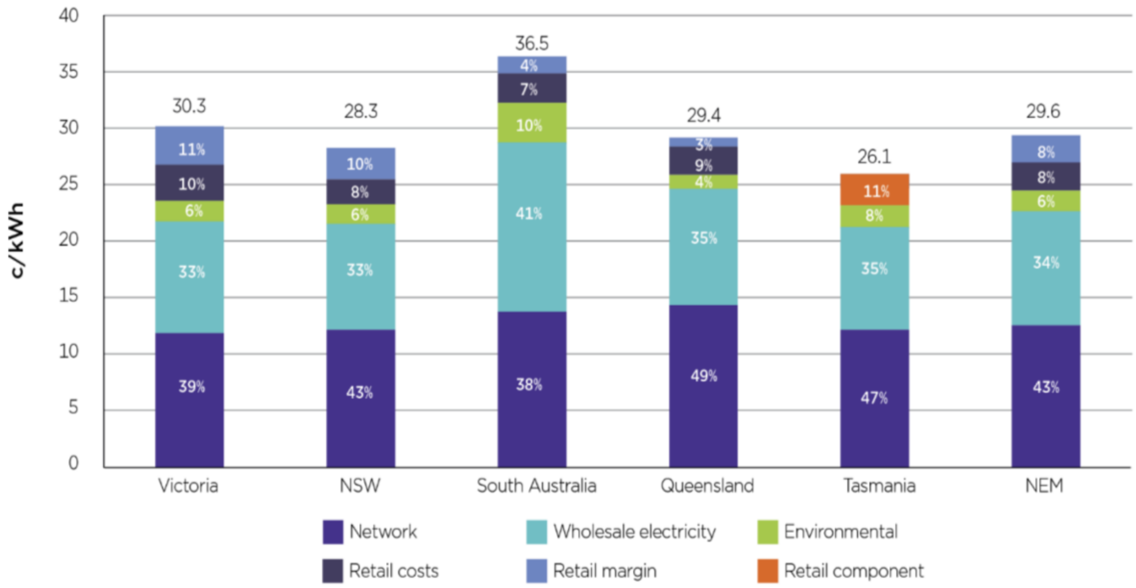


Source: ACCC analysis based on retailer data.

Simply Energy considers that vulnerable customers are a separate class of consumers that need tailored assistance. For this reason, Simply Energy actively encourages these consumers to take up market offers. Simply Energy also ensures customers in hardship to receive their pay-on-time discounts while they continue to meet the conditions of any payment plan. It is, therefore, Simply Energy's position that vulnerable customers will receive superior and more appropriate assistance from industry-led initiatives than any form of regulated offer.

From a wider market perspective, it should also be kept in mind that the default market offer is one aspect in ensuring consumer interests are upheld into the future. As is evidenced from Figure 3 below, retail margins only make up a small proportion (in most case less than 10 per cent) of the total energy cost stack. This means there is only so much that can be achieved in terms of constraining retail prices before the market becomes commercially unviable, particularly for smaller participants.

Figure 3: Energy price stack across the NEM



Source: ACCC monitoring of electricity supply in the National Electricity Market, 7.

Simply Energy would, therefore, encourage the AER to look take a holistic approach to driving greater cost efficiencies in terms of wholesale, network and government pricing costs to ensure the market and, in turn, the default offer reflects the reasonable costs of providing energy services into the future.

Conclusion

Simply Energy would like to emphasise that any regulated default offer will always be an estimate, and as such imperfect, and should not be seen as providing a perfect substitute for market derived outcomes. Simply Energy, therefore, encourages the AER to use a median of prevailing market offers plus risk premium as the base for setting a regulated default offer.

As a leading Australian energy retailer, Simply Energy ultimately sees itself as having a shared responsibility to working towards developing a market that meets the long-term interests of all energy consumers. For this reason, Simply Energy looks forward to continuing to work with relevant bodies to improve market outcomes for all consumers.

Simply Energy welcomes further discussion in relation to this submission.

To arrange a discussion or if you have any questions please contact Anthony O'Connell, Senior Regulatory and Compliance Officer, on, telephone, (03) 8807 5134 or at Anthony.OConnell@simplyenergy.com.au.

Yours sincerely

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