

# Default Market Offer Price

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## Submission — Australian Energy Regulator March 2019

### Introduction

The Australian Chamber of Commerce and Industry (Australian Chamber) welcomes the opportunity to provide comment on the AER's Draft Determination for the Default Market Offer Price (DMO).

Rising electricity costs are a major impost on business. Australian businesses are feeling the strain of the rapid increase in electricity prices over the past decade. Higher electricity prices impact on the day-to-day costs of doing business and overall profitability.

With many businesses adversely affected by rising electricity prices, the Australian Chamber supports efforts to introduce measures that will reduce electricity costs for business. However, we do not believe increasing regulation around electricity prices is the best approach to solve the problem.

Increased regulation of electricity prices in what is already a competitive market will be counter-productive. Regulation of power prices through a DMO, effectively introducing a price ceiling, will increase risks to electricity retailers, reduce the dispersion of retail electricity products that are available to consumers and lessen competition in the market. Ultimately, this is expected to lead to an increase in the cost to customers.

### Standard offer prices

The Australian Chamber agrees that the standing offer of many electricity companies is too high and does not appear to represent the cost of supplying electricity to customers.

Analysis by AEMC observed that consumers on the standard offer price typically pay more for their electricity than other customers. Electricity retailers were found to intentionally increase standard offer prices as a strategy to make inactive low value customers into high value customers, or prompt them to move to another retailer.<sup>1</sup> Raising the standard offer price also increases the attractiveness of discounted prices or other market offers, which are typically benchmarked against the retailer's standard offer price.

There are a range of reasons why customers have been defaulted to the standard offer price. This may include circumstances where a consumer has moved into 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 was switched through a retailer of last resort event.<sup>2</sup>

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<sup>1</sup> AEMC *Advice to COAG Energy Council: Customer and competition impacts of a default market offer*. December 2018 p. iii

<sup>2</sup> AER *Draft Determination – Default Market Offer Price*. February 2019 p.18

The draft determination indicates that on average in each distribution zone, 22% of local area retailer customers are on standing offers and this share is on a steadily decreasing trend.<sup>3</sup> Based on current trends it is expected that fewer than 10% of residential customers will be on standing offers in the next two years in all jurisdiction.

AEMC found there are specific groups of customers who remain on standard offers, particularly rural customers and small business customers.<sup>4</sup> Small and family-owned businesses often lack the time and resources to research and negotiate a better price for their electricity, particularly given marketing of discounted prices can be quite complex and confusing. As a result, many small business customers are defaulted and/or remain on the standard offer price. These customers are often those that are least able to afford higher prices.

Measures should be put in place to protect small business and to ensure that the price they pay for their electricity is not excessive. However, this can be achieved without a heavy-handed regulatory approach that will distort the electricity pricing system and impact on all electricity users.

## Default market offer

The Australian Chamber considers the DMO pricing approach proposed by the AER is a step too far. Increasing regulation raises the risk in the market, reduces the electricity company's ability to control prices and is likely to reduce market dispersion and narrow the range of pricing products provided available to consumers.

The DMO effectively places a cap on the price the electricity companies can charge. While it will lower the cost to some inactive consumers on standing offers, it also risks raising the cost of electricity for active customers on discounted market offers.

As a matter of principle, the Government's aim should be to increase competition in the market and lessen the regulatory burden on business. The introduction of the DMO is a retrograde step for the retail electricity market, signalling a move towards centralised price fixing.

Centralised price fixing carries with it a range of economic consequences, due to the Government's inability to accurately pick the point at which the market naturally balances supply and demand. The information asymmetries faced by the regulator, limit its ability to make judgements about the efficient cost elements of a particular retailer, thus its ability to set the DMO with any accuracy.

AEMC in its advice to the COAG Energy Council noted that jurisdictions without price regulation experience higher levels of price dispersion, with the introduction of more restrictive regulations benefiting some customers to the detriment of others. The United Kingdom example provided by AEMC shows that price regulation through a temporary default cap involved price compression with a significant reduction in price dispersion, narrowing the price gap between the standard tariff and lowest tariff, with the lowest tariff increasing considerably.<sup>5</sup>

Overall, the Australian Chamber is concerned that taking a heavy-handed regulatory approach, through the introduction of the DMO, is likely to stifle competition in the market, with many customers likely to end up paying more for their electricity.

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<sup>3</sup> *ibid* p.17

<sup>4</sup> AEMC *Advice to COAG Energy Council: Customer and competition impacts of a default market offer*. December 2018 p. ii

<sup>5</sup> AEMC *Advice to COAG Energy Council: Customer and competition impacts of a default market offer*. December 2018 p. iv

## AER's proposed approach to determining the DMO

In setting the DMO, the AER has adopted a top-down approach, with the DMO set at a level between the median of the standing offer prices within an distribution region and the median of the market offer prices. This approach requires a level of judgement by the regulator in selecting the appropriate point within the specified range for the DMO price.

The top-down approach to determining the DMO is simple and transparent. It uses publicly available information from the Energy-Made-Easy website, and does not require the collection of a large amount of detailed financial information from electricity retailers and complex calculations to determine the DMO price.

Although the top-down approach to the DMO is pragmatic, it is neither robust nor an accurate means of determining the efficient costs or the efficient market price. This point was made by the ACCC and noted in the draft determination.<sup>6</sup>

In the short term, the DMO will achieve the objective of lowering most retailers' standing offer price. Selecting a DMO price between the median of the standing offer price and the median of the median market offer price will naturally result in a price that is lower than most standard offer prices on which the calculation is based.

However, the Australian Chamber is concerned that over the long term it will lead to a convergence of pricing, narrowing the range of standing offers and market offers available to customers. Capping the standard offer price as the maximum price electricity retailers can charge, reduces the incentive and the means for service providers to segment the market and develop alternative pricing products for customers.

The alternative bottom-up approach provides a more accurate measure of the cost of providing the electricity to the customer, but is far more data intensive. As the AER notes, it also carries a risk of regulatory error, as it requires regulators to apply judgement in relation to the various cost stack elements.<sup>7</sup> In addition, the bottom-up approach will take a long time to implement. The data required to support a bottom-up approach to calculating the DMO is not currently available and it is likely to take a considerable amount of time to put in place the framework for collecting and reporting this information.

The Australian Chamber is not proposing the bottom-up approach as the preferred approach to determining the DMO. While it provides a more accurate estimate of the efficient cost of providing electricity to a retail customer, there is a very high cost of generating the necessary detailed data to support this calculation. The costs of this data collection and increased regulation may be passed onto customers through higher prices.

## Maintaining a workable competitive market

There is currently a relatively high level of competition in most energy markets, with a wide range of electricity pricing products available. Customers who are active in the market and are prepared to shop around, are typically able to negotiate a price for electricity that is best suited to their requirements and consumption patterns. Electricity retailers have also made some effort in recent times to contact residential customers to advise them of alternative market offers that are better

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<sup>6</sup> AER *Draft Determination – Default Market Offer Price*. February 2019 p.36

<sup>7</sup> *ibid* p.41

suited to their needs. As a result, there is a relatively low share of hardship customers on standing offers.<sup>8</sup>

AEMC advice to the COAG Energy Council on the customer and competition impact of the DMO was far from supportive. AEMC determined that the retail electricity market is workably competitive, with no evidence of excessive retail margins. It was noted that the ACCC REPI made no reference to inefficient retail margins or that retailers are earning excessive profits. The proliferation of offers, high churn and extensive marketing were shown to demonstrate the existence of a competitive market.

AEMC noted that within this workably competitive market retailers use segmentation to compete, deploying significant resources to segment existing and potential customers into different categories. AEMC raised a number of short-term risks of the introduction of the DMO indicating the high level of segmentation suggests that retailers' response to the introduction of the default tariff is likely to be changes to their (discounted) market offers. Where the DMO is set below the retailers standing offer, the retailer would attempt to recover lost revenue by raising market offer prices applying to other customers. Similarly, ACCC analysis of retailer profitability and pricing behaviour, observed it is likely that retailers will respond to the introduction of the DMO by attempting to increase market offers.

AEMC identified three long term structural effects in their analysis of the introduction of a default offer:

- Increased risks to retailers driving higher finance and overall costs
- Lower levels of innovation, particularly price based innovation, leading to less available products and services.
- Decreased competition due to higher barriers to entry and changes in consumer.

The Australian Chamber is concerned that the introduction of a DMO will decrease competition in the market. Setting a price cap will decrease the price dispersion, with lower priced market offers available to customers likely to increase. Therefore, customers on lower priced market offers would be worse off. Given only 22% of customers are on the standing price and this is likely to fall to 10% over the next 2 years,<sup>9</sup> AER's attempt to bring down the price for the 10% to 20% of customers on the higher standard offers, has the potential to increase prices for the 80% to 90% of customers that are on discounted or negotiated market offers.

## Unintended consequences for small business

If the introduction of the DMO leads to a reduction in price dispersion, with a narrowing of the price gap between the standard offer and lowest tariff as the AEMC predicts, it is will have the greatest impact on energy intensive small businesses in the large customer market. This includes manufacturers, printers, food processors, bakeries, commercial laundries, irrigators, etc.

Electricity costs are a high proportion of the total costs of these businesses, so they are highly sensitive to increasing electricity prices. These businesses are typically very active in seeking and negotiating the best market offer to meet their needs and consumption patterns.

While the introduction of the DMO price will lower the price of electricity for inactive small businesses that are currently paying the standard offer price, it is important for the AER to be aware

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<sup>8</sup> AEMC Advice to COAG Energy Council: *Customer and competition impacts of a default market offer*. December 2018 p. iii

<sup>9</sup> AER Draft Determination – *Default Market Offer Price*. February 2019 p.17

the introduction of the DMO will also have the unintended consequence of raising the electricity price for a large number of energy intensive small businesses. In South Australia, for example, there are over 5,000 businesses in the large customer market, most of which are small businesses.

The Australian Chamber is greatly concerned that increased regulation of the retail electricity market through the introduction of the DMO price will have unintended consequences for energy intensive small business. These businesses are already struggling to remain competitive and stay in business, due to the substantial rise in electricity prices over the past decade. Further increases in energy prices for these customers may force many of them out of business.

## Increasing transparency

There are other options available that could achieve a similar result in putting downward pressure on retail electricity prices without heavy-handed regulation, such as increasing the transparency of market prices.

Other features of the market, such as embedded networks, restrict competition and inflate the electricity prices paid by small businesses. While we note that embedded networks are outside the scope of the DMO pricing regime, releasing small businesses from embedded networks and enabling them to negotiate market offers directly with retailers, is another means of reducing electricity costs to some small business customers.

Increasing the transparency of market prices would involve a similar approach proposed to determine the DMO, without taking the next step of a setting regulated price ceiling. The AER could collate and publish the full range of prices offered by retailers in each distribution zone. This data could then be used to calculate and publish on a regular basis, the median standing offer and median market, and set a reference price for each distribution zone. Energy retailers would then be required to compare their standard offer and market offer prices against the reference price.

The AEMC in its advice to the COAG Energy Council noted that greater transparency of pricing will increase pressure on retailers to set their standing offer prices at reasonable levels.<sup>10</sup> It will also facilitate greater competition in the market as retailers will be watching each other and customers will be increasingly aware of the price differentiation between retailers.

The South Australian Government submission on the DMO Position Paper also proposed a form of reference price which establishes a base that all offers can be measured against, but without the need for the AER to set a regulated maximum price.<sup>11</sup>

The Australian Chamber considers increased retail electricity price transparency with a non-cap reference price for comparing standard offers and discounted and alternative prices, will achieve a similar outcome without the need to introduce a price ceiling, and the associated risk of heavy-handed regulation.

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<sup>10</sup> AEMC *Advice to COAG Energy Council: Customer and competition impacts of a default market offer*, December 2018

<sup>11</sup> SA Minister for Energy and Mining, *Submission to AER on Default Market Offer Position Paper*, 14 December 2018, pp. 1-3.

## Conclusion

Increasing regulation through the introduction of the DMO price, effectively a price ceiling, is a step too far in what is already a competitive market. Increasing regulation in the manner proposed through the DMO price is likely to stifle competition, rather than improve it.

The AER should be looking at measures to enhance competition in the market and reduce the need for regulation. We recognise that the AER is already taking steps to increase the transparency of retail electricity prices and encourage more consumers to be more active in the market through enhancement of the Energy-Made-Easy website.

The Australian Chamber consider that the result the AER is seeking to achieve with the DMO can be more effectivity achieved without a heavy handed regulatory approach through greater transparency of pricing.

The Australian Chamber considers that the cost associated with the high level of regulation the DMO represents, far outweigh its benefit. The market intervention through the DMO price will raises the risk in the market, reduce market dispersion and narrow the range of pricing products provided available to consumers.

The Australian Chamber believe that regulation should only be applied in situations where a competitive market does not exist. This is not the case in the retail electricity sector.



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### About the Australian Chamber

The Australian Chamber of Commerce and Industry speaks on behalf of Australian Businesses at home and abroad.

We represent more than 300,000 businesses of all sizes, across all industries and all parts of the country, making us Australia's most representative business organisation.

Telephone | 02 6270 8000

Email | [info@australianchamber.com.au](mailto:info@australianchamber.com.au)

Website | [www.australianchamber.com.au](http://www.australianchamber.com.au)