ENERGY CONSUMERS AUSTRALIA

A Suite 2, Level 20, 570 George Street
Sydney NSW 2000
PO Box A989
Sydney South NSW 1235
T 02 9220 5500
W energyconsumersaustralia.com.au
@energyvoiceau
in /energyconsumersaustralia
f /energyconsumersaustralia

ABN 96 603 931 326

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Stephanie Jolly
General Manager, Market Performance
Australian Energy Regulator
By email: DMO@aer.gov.au

RESPONSE TO THE AER'S DEFAULT MARKET OFFER PRICES 2022-2023 DRAFT DETERMINATION

Dear Stephanie

Energy Consumers Australia welcomes the opportunity to provide feedback to the Australian Energy Regulator (AER) on its Draft Determination for the Default Market Offer Prices 2022-23.

We submit that in the Final Determination:

- the retail margin be of a magnitude similar to those used in the regulated standing offers of other jurisdictions. This is because:
    - There is still significant competition and innovation in these jurisdictions despite their standing offer prices including a lower retail margin
    - The implied margins returned under previous default offers are not relevant to today's market conditions or Default Market Offer (DMO) objectives
    - Customer acquisition and retention costs, which are a significant component of innovation costs, are already accounted for in the cost stack.
- the retail margin should be the same for small business and residential consumers. This is because any difference in the cost to serve has been accounted for in other elements of the cost stack.

Further detail on our thoughts on the AER's Draft Determination is set out below.

Energy Consumers Australia supports the adoption of a bottom-up methodology

We believe the proposed shift to a bottom-up approach when setting the DMO will ultimately result in positive outcomes for consumers and commend the AER for this change in methodology.

Our submission to the AER's Options Paper highlighted the need to amend issues around information asymmetry that existed in the previous indexation approach. Under this approach, retailers had little incentive to report increased productivity to the AER, resulting in stakeholders such as ourselves being left with no true understanding of retail costs.

This lack of transparency exists within an atmosphere of distrust in the sector with our Energy Consumer Sentiment Survey (ECSS) revealing only 53% of consumers believe energy companies do the best thing by their customers[1]. The bottom-up method can strengthen trust in the sector by disclosing to stakeholders the costs faced by retailers. Further, we support the decision by the AER to rely on data from the Australian Competition and Consumer Commission (ACCC), which we consider a robust and accurate source, to calculate the true retail costs.

[1] ECA Energy Consumer Sentiment Survey December 2021

Energy Consumers Australia considers the retail allowance is unjustifiably high

The DMO was introduced in 2019 in response to findings from the ACCC's 2018 Retail Electricity Pricing Inquiry (REPI). This report found that:

> "*standing offers, which were originally intended as a **default protection** for consumers who were not engaged in the market, were **unjustifiably high**… The ACCC found that the standing offer is no longer working as it was intended and is causing **financial harm to consumers**."*[2]

We must not forget this historical context. We acknowledge that the DMO is to be set at a level that maintains incentives for consumers to engage with the market and to allow room for competition and innovation. However, when describing the DMO's objectives, the AER's Final Determination for the DMO 1 stated that "the key reason for the introduction of a DMO" is "to reduce the unjustifiably high level of standing offer prices for consumers who are not engaged in the market."[3] So our view is that first and foremost, the DMO should be viewed as the mechanism for protecting disengaged consumers from unreasonable retail prices, or specifically, **unjustifiable retail margins**.

As we show in this submission, the various DMO objectives can be met with a lower margin than those used in the Draft Determination. As such, we consider that the AER's chosen retail margin of 10% for residential customers and 15% for small business customers is unjustifiably high and therefore does not best meet the DMO's objectives. The reasons for our view are provided below.

There is still significant competition and innovation in other jurisdictions with standing offer regulation

The Essential Services Commission (ESC) in Victoria, the Independent Competition and Regulatory Commission (ICRC) in ACT and the Office of the Tasmanian Economic Regulator (OTTER) all use a retail margin between 5.3% and 5.7% for standing offer customers in their regions.

The Draft Determination states that giving a retail allowance of a similar magnitude would lead to lower competition and innovation in the DMO regions[4] however, the basis for this statement is unclear. Our analysis, provided below, shows that in these regions, there is actually considerable and equitable competition.

Analysis of retail competition in the South Australian market

The AER's analysis has found that the implied margin returned on South Australian residential DMO customers with a controlled load was 1.3% and without a controlled load, 4.2%.[5] The AER states that it would not be confident that retail allowances this low would maintain incentives for competition, innovation, and investment.[6]

However, St Vincent de Paul's tariff tracker[7] provides data on the nature of retail competition in this jurisdiction. It shows that there is considerable competition in the SA market, with 26 retailers available to consumers (as of June 2021).

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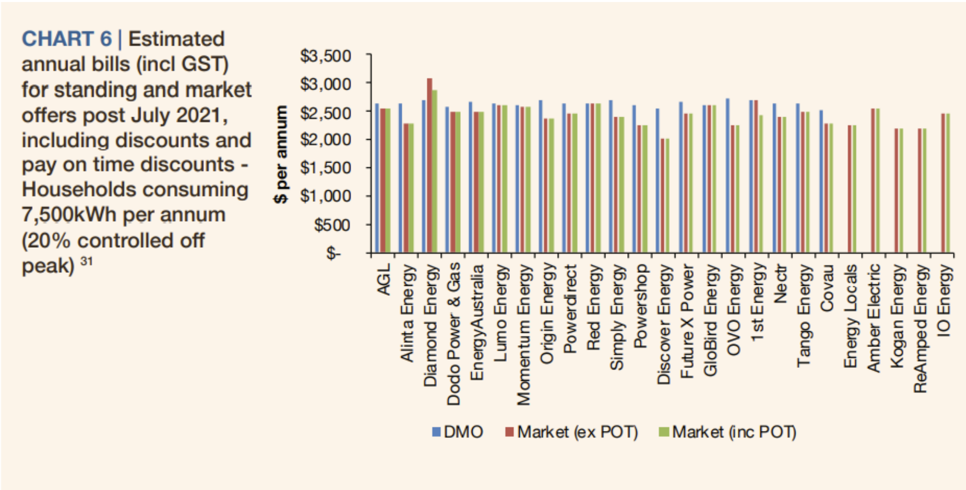
2 AER Default Market Offer prices Options Paper 2022-23, p. 9. (Emphasis added)
3 AER Final Determination – Default Market Offer Prices – April 2019, p. 7
4 AER - Default Market Offer - Draft price Determination 2022-23 - 18 February.pdf p. 45
5 AER - Default Market Offer - Draft price Determination 2022-23 - 18 February.pdf p. 42
6 AER - Default Market Offer - Draft price Determination 2022-23 - 18 February.pdf p. 44
7 St Vincent de Paul Society – South Australian Energy Prices July 2021

They also find that most retailers offer prices significantly lower than the DMO, even for DMO customers with a controlled load (see Figure 1). St Vincent de Paul's analysis also shows households on the DMO in SA could have saved $585 if they switched to the best market offer. This shows that there are still very large incentives for standing offer customers in this region to switch.

Figure 1: SA estimated annual bills



Source: St Vincent de Paul Society Retail Tariff Tracker

Analysis of the retail competition in the Victorian market

The Victorian Default Offer (VDO), which includes a margin of 5.7%, has a similar purpose to the DMO. It is described as a "simple, trusted and reasonably priced option that safeguards customers unable or unwilling to engage in the retail electricity market"[8].

The Essential Services Commission has made comments that they consider this margin does not hamper competition in the market:[9]

"In relation to the scope for competition in the market we note setting prices at efficient costs is consistent with competition and does not preclude innovation that may lead to customers accepting market contracts that offer a better deal for them than the Victorian Default Offer. Likewise, it does not prevent retailers, who can lower their costs, from attracting customers by making cheaper market offers available."

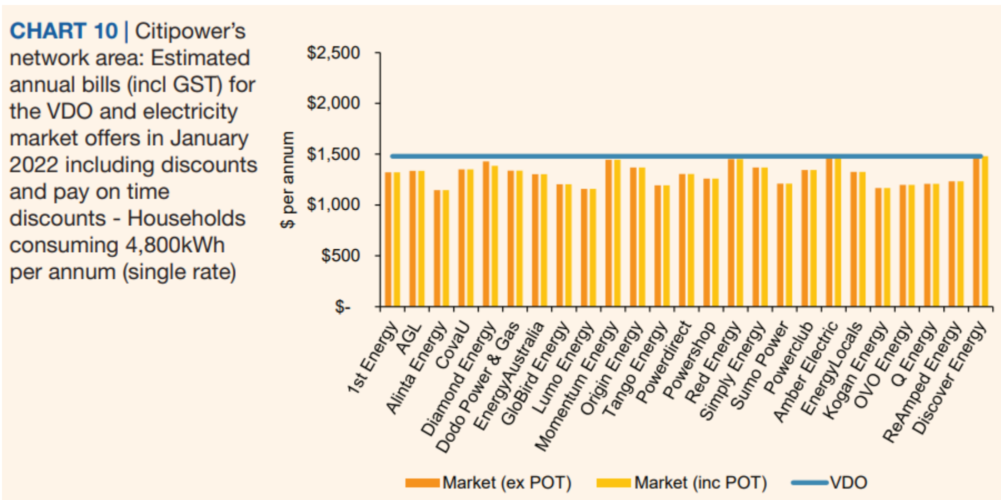
Similarly, in their view, it does not preclude innovation:[10]

"Powershop's submission suggested that the amount included in the Victorian Default Offer for acquisition costs should be increased to support innovation. We consider that retailers are provided with profits through the retail margin which they can choose to reinvest in innovation."

[8] Victorian Default Offer to apply from 1 July 2019, pp. 8-9
[9] Victorian Default Offer 1 January 2022 - final decision p. 72
[10] Victorian Default Offer 1 January 2022 - final decision p. 40

These views are also supported by the research evidence. In Victoria, 25 separate retailers exist within each of its five networks.[11] This is similar to the number of retailers in SA, Queensland and NSW. Further, Figure 2 shows that most of the market and standing offers provided by these retailers are priced well below the VDO, suggesting retailers are still able to innovate and offer low-priced offers, despite the lower retail margin. The same applies to small businesses where 16 retailers exist in Victoria's Citipower network[12].

Figure 2: Citipower estimated annual bills

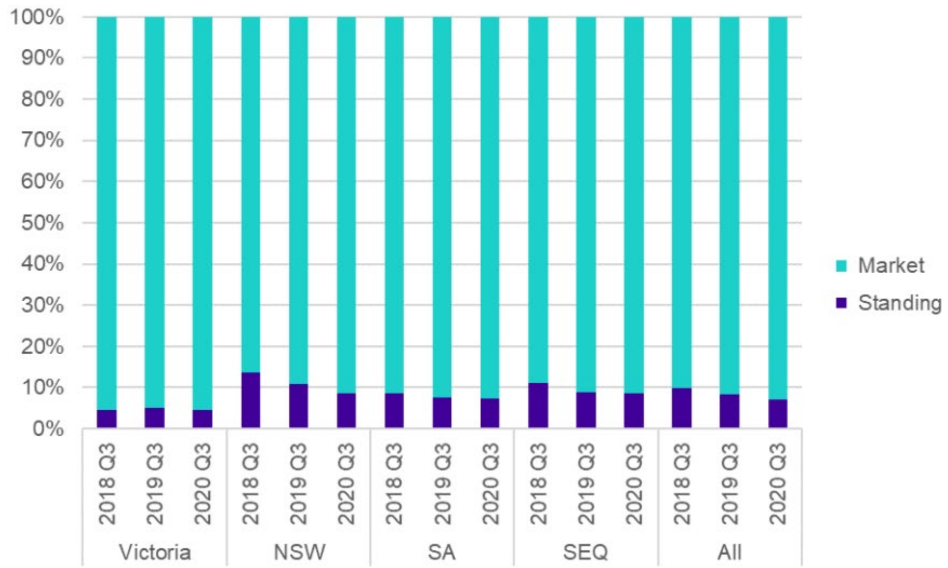


Source: St Vincent de Paul Society Retail Tariff Tracker

We also note that compared to customers in the DMO jurisdictions, there is a greater proportion of customers on market offers in Victoria[13] (Figure. 3). This suggests there is still a strong incentive for consumers to engage in the market and switch to market contracts in this state. We note that the ACCC's Inquiry into the National Electricity Market May 2021 report also suggests that lower retail margins do not equate to greater disengagement with the market, which seems to be an assumption underlying the Draft Determination[14].

[11] St Vincent de Paul Victorian Energy Prices January 2022 p. 18
[12] ECA Analysis of small business retail energy bills in Australia p. 41
[13] ACCC Inquiry into the National Energy Market May 2021 Report p. 18
[14] ACCC Inquiry into the National Energy Market May 2021 Report p. 18

Figure 3: Proportion of residential customers on market and standing offers



Source: ACCC Inquiry into the National Energy Market May 2021 Report

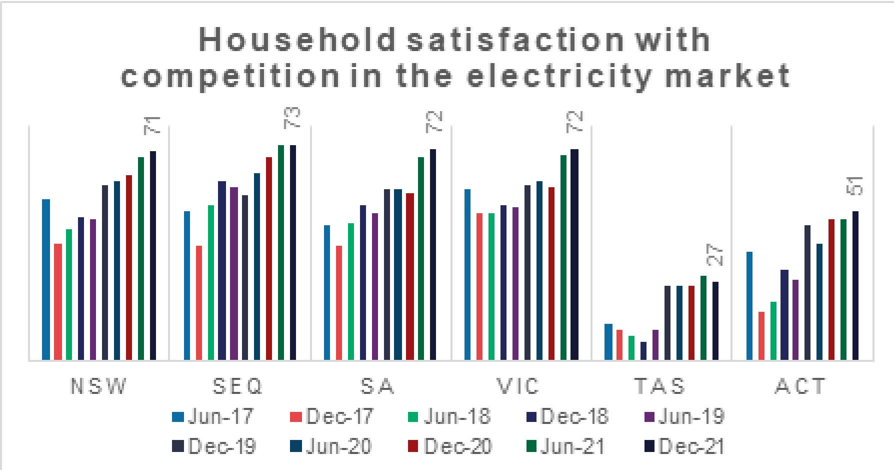
Consumer views about the level of competition in their jurisdictions

Our regular consumer sentiment surveys[15] track consumer views on the level of competition in the electricity market. Figure 4 shows the percentage of households in each jurisdiction who gave a positive rating to the level of competition in the energy market in their area. As shown:

- Consumer satisfaction with competition is similar across the larger jurisdictions. We find that even with the lower margins in South Australia and Victoria, consumers in these jurisdictions are equally satisfied with the level of competition.
- There has been significant improvement in consumer satisfaction with competition in Tasmania. This has likely been a result of the new entrants in the Tasmanian market (Tasmania had only one retailer in 2018, but now has seven).
- There has been significant improvement in consumer satisfaction with competition in ACT. Similarly, there has been a large growth in the number of retailers in ACT, with consumers now having the choice between 13 retailers.
    - This is supported by the AER's report on the performance of the retail energy market and energy businesses which identified an increasingly competitive market in ACT due to the decrease in customers on standing offers and the growth in the number and choice of retailers[16].

[15] ECA Energy Consumer Sentiment Survey
[16] AER Annual retail market reports 2020-21, p. 21

Figure 4: Household satisfaction with level of competition



Source: ECA Energy Consumer Sentiment Survey

These findings call into question the position in the Draft Determination that a lower retail margin for standing offer prices would equate to a reduction in competition. In particular, we note the significant number of new entrants to the Tasmanian and ACT energy market, despite the lower standing offer margins in these jurisdictions.

Implied historical margins are not relevant to future allowances

It would appear that the approach most heavily relied upon to set a retail allowance of 10% and 15% in the current Draft Determination was to examine past determinations. We do not consider that previous determinations act as the most accurate or relevant source of information for the AER to consider when determining retail margins for DMO 4.

The initial DMO allowance, which has been subsequently adjusted each year, was set based on average market and standing offer prices 4 years ago, without consideration of underlying retail costs. This initial DMO 1 price was set as the midway point between the median standing and market offer, suggesting that the ‘unjustifiably high’ standing offer prices identified by the ACCC in 2018 remained, to an extent, built into the DMO 1.

The AER acknowledged in its Options Paper[17] that these previous market conditions may no longer be relevant to today's environment. We would agree with this position. Further, the AER has viewed the implied margins given to South Australian residential customers to be too low, while the margins given to NSW small business customers to be too high. In light of these concerns, we would question the use of these implied margins in determining the DMO for the future.

[17] AER Default Market Offer prices Options Paper 2022-23, p. 33

Innovation costs are already accounted for under customer acquisition and retention costs

The AER's retail cost allowance includes customer acquisition and customer retention costs. Such costs are a significant component of innovation in the sector, with the rise of customer loyalty programs such as mobile phone apps, reward points and movie ticket deals.

Given that these costs are already provided for in the DMO 4, we would consider this presents further reason to allow for a margin consistent with that of other jurisdictions. We note that in justifying its chosen 5.3% margin, the ICRC stated that:

> *"retailers incur costs relating to customer acquisition and management but maintains that it remains appropriate not to include an additional separate competition allowance because the Commission, via its allowed retail operating cost structure, is currently allowing retailers to recover relevant costs relating to customer acquisition and retention."*[18]

We see no reason why this argument wouldn't apply to the AER's DMO 4.

Allowing for higher margins on small business customers is not justifiable

We are concerned that the Draft Determination allows retailers to acquire a 5% higher margin on small business customers. We are not aware of any other regulated standing offers which allow retailers to recover a higher margin on small businesses and believe this is unjustifiable for several reasons.

The Draft Determination includes an implied retail allowance for small business customers ranging from 17.1% to 20.3%, significantly higher than for residential customers. However, as mentioned previously, we do question the relevancy of previous retail margins when determining DMO 4.

COVID-19 has placed immense pressure on small businesses, many of whom may be experiencing financial hardship for the first time. In addition to this, the ACCC has raised concerns about a high proportion of small businesses on the DMO[19]. Considering this, the DMO objective to protect these consumers from unjustifiably high prices has only grown in significance. A higher margin risks failing to meet this objective and placing greater financial pressure on already vulnerable consumers.

The Draft Determination set out that the reason for providing a higher profit margin may potentially be due to a difference in risk. However, we have not seen evidence of a higher risk of serving small business customers. If this risk were to exist, then we expect the magnitude of the risk to be quantified to show why an additional profit margin of 5 percent is likely to be necessary.

Concluding remarks

We commend the AER's move to a bottom-up methodology when setting the DMO and consider this a step forward in ensuring an energy market that protects consumers from unjustifiably high prices. However, a retail margin as high as 10-15% has the potential to negate the positive impacts of this decision and we question whether this can be considered 'reasonable'.

If the AER is to proceed with its decision to allow for a significantly higher retail margin than of other jurisdictions, we question how this will be communicated to the consumers who live in them. Consumer trust in the sector continues to be low, a factor likely to be worsened by this decision unless effectively explained. As we outlined above, we do not consider this position has been adequately justified.

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18 Standing offer prices for the supply of electricity to small customers, p.17

19 ACCC Inquiry into the National Energy Market May 2021 Report.

One way to increase trust in this decision would be to indicate that these margins would progressively transition towards more appropriate, lower margins over a period of years. This would also be consistent with the AER's chosen approach to smooth the transition to the chosen margins over time.

We would also recommend that in the future, the AER consider the approaches of other states with regulated standing offers and whether their lower retail margins have impacted competition to an extent which would fail to meet the DMO objectives. That said, our findings would suggest they have not. We therefore believe greater consideration should be given to the approaches of other jurisdictions, with reliance on historical margins declining over time.

Lastly, we ask the AER to consider the significant planned transmission and distribution investment to occur over the coming years, in addition to the likely increases in wholesale costs. Such factors will contribute to upward pressure on retail prices, putting increased pressure on hardship customers. These are important to consider as, given that the DMO allowance is calculated as a percentage of total costs, the profit per customer in dollar terms will increase without any justification for doing so. Consumers will likely not accept this and would request the AER to act to make energy prices more affordable for them during the transition towards a renewable energy system.

We note that in ACT in 2017, the ICRC reduced the retail margin from 6.04% to 5.3% in response to increases in energy purchasing costs. This change ensured the dollar value of the retail margin remained at a "reasonable" level.[20] We therefore recommend the AER take a similar approach for DMO 5 and subsequent years.

If you have any questions about our comments in this submission, or require further detail, please contact Ashley Bradshaw by email at ashley.b@energyconsumersaustralia.com.au.

Yours sincerely

Jacqueline Crawshaw
Director Policy, Energy Services and Markets

[20] ICRC Retail electricity price investigation 2020-24, p. 49