Etrog Consulting

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

19 November 2020

Dear Mr Feather

Retail electricity prices review – Determination of default market offer (DMO) prices 2021-22

Please find attached a submission from Etrog Consulting to the AER's Position Paper on the DMO for 2021-22.

This submission is being made to support advocacy by a stakeholder group of thirteen community sector organisations in Queensland. Further details regarding this stakeholder group are contained in the attached submission.

The key matters raised in the submission are:

- The AER's ongoing refusal to calculate retailers' efficient costs results in lack of transparency in the DMO calculations, and makes it impossible to determine whether the objective of protecting customers from unjustifiably high standing offer prices is being met. This is notwithstanding the fact that the ACCC's recommendation on which the DMO is based clearly stated:
    - *The AER should be given the power to set the maximum price for the default offer in each jurisdiction. This price should be the efficient cost of operating in the region, including a reasonable margin as well as customer acquisition and retention costs.*

  It is not possible for the AER to set a DMO price that is the efficient cost of operating while it refuses to identify efficient costs, and refuses to set the price to be the efficient cost of operating, even though that is exactly what the ACCC said it should do.
- The DMO calculation should take into account the efficiency improvements that would be expected from an efficient retailer.
- In regard to COVID-19, the AER's Position Paper only focuses on retailers' costs, including how they may have increased due to COVID-19, and not on consumers' ability to pay for electricity due to COVID-19. The paper even goes so far as to consider adding to customers' energy costs to start 'pay back' before the pandemic is over. This is not equitable. It will adversely affect vulnerable households impacted by COVID-19, and is therefore not appropriate at this time.

We look forward to having the opportunity to discuss this submission further with the AER.

David Prins

Director, Etrog Consulting Pty Ltd

RESPONSE TO AER POSITION PAPER

Prepared for:

Australian Energy Regulator (AER)

Default Market Offer 2021-22

Prepared by:

Etrog Consulting Pty Ltd

Melbourne

Australia

+61 403 444141

dprins@etrogconsulting.com.au

www.etrogconsulting.com.au

Date: 19 November 2020

Author(s): David Prins

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The information in this report is of a general nature. It is not intended to be relied upon for the making of specific financial decisions.

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The views expressed in this document do not necessarily reflect the views of Energy Consumers Australia.

COMMISSIONING OF THIS SUBMISSION

This submission is being made to support advocacy by a stakeholder group of thirteen community sector organisations in Queensland. Further details regarding this stakeholder group are contained in Appendix A.

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EXECUTIVE SUMMARY

Introduction

This submission has been prepared by Etrog Consulting Pty Ltd on behalf of a stakeholder group of thirteen community sector organisations in Queensland. Further information on the formation and composition of this stakeholder group can be found in Appendix A. This submission responds to a position paper on the Default Market Offer (DMO) for 2021-22, which was published by the AER on 20 October 2020.[1]

Background

The DMO came into effect on 1 July 2019. The DMO limits the price that retailers can charge electricity customers on default contracts known as standing offer contracts. A customer might be on a standing offer for various reasons.

The AER's role is to determine the maximum price that a retailer can charge a standing offer customer each year. The AER refers to this as the DMO price.

The AER's DMO price determination applies to residential and small business customers on standing offers in distribution regions where there is otherwise no retail price regulation – South Australia, New South Wales and south-east Queensland and whose standing offer is of a tariff type for which the AER determines a DMO price.

The DMO price for each area also acts as a 'reference price' for residential and small business offers in that area. When they are advertising or promoting offers, retailers must show the price of their offers in comparison to the DMO reference price. This aims to help customers more simply compare the price of different offers.

The *Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019* (Regulations) set out the legislative framework for the DMO.[2]

- In April 2019, the AER published its first DMO price determination, which set the DMO price for 1 July 2019 to 30 June 2020. The AER refers to this as the DMO 1 determination.[3]
- In April 2020, the AER published its second DMO price determination, which set the DMO price for 1 July 2020 to 30 June 2021. The AER refers to this as the DMO 2 determination.[4]

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1 Documentation on the AER's determination of the DMO for 2021-22 can be found on the AER website at https://www.aer.gov.au/retail-markets/guidelines-reviews/retail-electricity-prices-review-determination-of-default-market-offer-prices-2021-22

2 See https://www.legislation.gov.au/Details/F2020C00687

3 Documentation on the calculation of the DMO for 2019-20 can be found on the AER website at https://www.aer.gov.au/retail-markets/retail-guidelines-reviews/retail-electricity-prices-review-determination-of-default-market-offer-prices

4 Documentation on the calculation of the DMO for 2020-21 can be found on the AER website at https://www.aer.gov.au/retail-markets/guidelines-reviews/retail-electricity-prices-review-determination-of-default-market-offer-prices-2020-21

- The AER is now in the process of determining DMO prices for 2021-22. The AER refers to this as the DMO 3 determination.

COVID-19

The AER's Position Paper only focuses on retailers' costs, including how they may have increased due to COVID-19, and not on consumers' ability to pay for electricity due to COVID-19. The paper even goes so far as to consider adding to customers' energy costs to start 'pay back' before the pandemic is over.[5] This is not equitable. It will adversely affect vulnerable households impacted by COVID-19, and is therefore not appropriate at this time. We also note that it is likely that the customers on standing offers include a high proportion of vulnerable households with the least capacity to pay, who for various reasons did not engage with the market to take up a market contract.

The AER has reported that from May 2020 its Customer Consultative Group (CCG) is meeting more regularly as the CCG COVID-19 Working Group. This group will meet monthly to provide the AER with timely information about the impacts of COVID-19 on energy consumers.[6] At the time of writing, the AER has not published any communiqués or meeting notes from this Working Group; we have requested that they be published. In the meantime, we understand that the Working Group is looking at issues regarding debts being accumulated by customers and retailers' COVID-19 related costs. We suggest that these costs should be ring-fenced from the DMO for the time being.

Going forward, consideration needs to be given to

- The amounts of any (net) additional costs incurred by retailers;
- A fair sharing of COVID-19 additional costs as between shareholders and customers;
- Appropriate timeframes for any additional cost recovery from customers, dovetailing with when the economy recovers;
- Affordability issues that might arise for customers from cost recovery at a time that they are still suffering financially and emotionally due to COVID-19; and
- Appropriate government or other concessions that may be needed to help vulnerable customers cope with any additional cost recovery.

In regard to the DMO, there may be a case for these matters to be considered through the CCG COVID-19 Working Group and ultimately by the AER Board.

Policy objectives of the DMO

The AER's position paper on DMO 3 maintains that a key policy objective for the DMO as being to "prevent retailers charging unjustifiably high standing offer prices".[7] However, somehow that mutates to an objective that "the DMO price must reduce unjustifiably high standing offer prices".[8]

5 See Position Paper section 3.2.4 Retail costs and step changes

6 See https://www.aer.gov.au/about-us/stakeholder-engagement/customer-consultative-group

7 See DMO 3 Position Paper page 8 (October 2020)

8 See DMO 3 Position Paper page 12 (October 2020)

There is an important distinction between *preventing retailers charging* unjustifiably high standing offer prices and *reducing* unjustifiably high standing offer prices.

The AER's interpretation of the DMO could quite happily allow retailers to continue to charge unjustifiably high standing offer prices, as long as they are reduced from the level at which they were set before the DMO came into being. It is impossible for the AER to know whether the prices are unjustifiably high while it fails to define what that term means, and fails to identify what would be a level of efficient prices.

We do not believe that this is a reasonable outcome for consumers, or that it is what was intended in recommendation 30 from the ACCC's Retail Electricity Pricing Inquiry (REPI) final report 'Restoring electricity affordability and Australia's competitive advantage' on which the DMO is based.

We also continue to be disappointed in the AER's assertion that "the DMO is not aiming to identify efficient costs" and that "The DMO price is not intended to be an accurate reflection of retailers' efficient costs."

This flies in the face of recommendation 30 of the ACCC's REPI final report, which stated:

> *The AER should be given the power to set the maximum price for the default offer in each jurisdiction. This price should be the efficient cost of operating in the region, including a reasonable margin as well as customer acquisition and retention costs.*

It is not possible for the AER to set a DMO price that is *the efficient cost of operating* while it refuses to identify efficient costs, and refuses to set the price to be the efficient cost of operating, even though that is exactly what the ACCC said it should do.

Our preferred methodology for calculating the DMO

Our preferred methodology for calculating the DMO is that the AER can and should identify efficient costs for all cost components, and base the DMO on efficient costs, in order to meet its policy objectives.

The AER should build a cost stack for Network, Wholesale, Environmental and Retail costs and margins to establish DMO 3. This will establish efficient costs, as envisaged for the DMO based on recommendation 30 from the ACCC's Retail Electricity Pricing Inquiry (REPI) final report 'Restoring electricity affordability and Australia's competitive advantage' on which the DMO is based.

One of the problems that arises with the AER's approach is the lack of transparency that results. Much has been written about the importance of transparency in regulation, and we are sure that the AER and its Board emphasises the importance of transparency in its decision making proposes. However, the AER's refusal to identify efficient costs in calculating the DMO not only fails to achieve the ACCC's recommendation 30, but also results in further lack of transparency in the AER's decision making.

However, if an indexing approach is to be used, then it is imperative that a downward adjustment should be made to reflect increased productivity.

The AER should not approve positive step changes until it has processes for all of the following:

- Determining retailers' efficient costs as a precursor to determining that any step change is "material";
- Applying productivity improvements to retailers' costs; and
- Identifying and analysing possible negative step changes in retailers' costs.

1. INTRODUCTION

This submission has been prepared by Etrog Consulting Pty Ltd on behalf of a stakeholder group of thirteen community sector organisations in Queensland. Further information on the formation and composition of this stakeholder group can be found in Appendix A. This submission responds to a position paper on the Default Market Offer (DMO) for 2021-22, which was published by the AER on 20 October 2020.[9]

This submission also takes into account presentations and discussion that took place at a public forum held online on 29 October 2020, in which we participated. We thank the AER for answering the questions we posed at that forum. We also commend the AER for the online "webinar" format of the forum. Online forums attract more participants than the in-person forums that used to take place pre-COVID, and which did not used to allow for telephone or video conference facilities. Advantages of the online format over an in-person forum include lower costs for the AER and participants, less time commitment in busy schedules (saving travel time and costs), and lower GHG emissions.[10] All these are contributing to the higher levels of participation that we are now seeing. We request that post-COVID (or under "COVID-normal") when in-person meetings might again become commonplace, that the AER and other regulatory and market bodies, governments and industry generally should continue to offer high-quality online options for attendance at public forums and other meetings.

The remainder of this report is structured as follows:

- Section 2 provides background to the AER's Position Paper and this response.
- Section 3 discusses the policy objectives for the DMO.
- Section 4 sets out our preferred methodology for the AER determination of the DMO.
- Section 5 provides answers to each of the 21 stakeholder questions posed in the AER's Position Paper.

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9 Documentation on the AER's determination of the DMO for 2021-22 can be found on the AER website at https://www.aer.gov.au/retail-markets/guidelines-reviews/retail-electricity-prices-review-determination-of-default-market-offer-prices-2021-22

10 Consumer organisations alongside other organisations are these days taking their carbon footprint very seriously. The AER must also be cognisant of that in its engagement processes and other activities.

2. BACKGROUND

The DMO came into effect on 1 July 2019. The DMO limits the price that retailers can charge electricity customers on default contracts known as standing offer contracts. A customer might be on a standing offer for various reasons, including the following:

- The customer has never taken up a market offer in the years since retail competition was extended to all customers.
- A customer may fall back onto a standing offer if they do not enter a new market contract when their existing market contract ends.
- A customer may specifically ask a retailer for a standing offer rather than a market offer, even though they have market offers available to them.
- A customer may move into premises where the electricity is already connected and not immediately contact a retailer. In those cases, the customer will be on a standing offer until they regularise their contractual position by contacting a retailer and moving to a market offer.
- A customer may be transferred to a retailer of last resort if their existing retailer fails before transferring its customers to another retailer.

The AER's role is to determine the maximum price that a retailer can charge a standing offer customer each year. The AER refers to this as the DMO price.

The AER's DMO price determination applies to residential and small business customers on standing offers in distribution regions where there is otherwise no retail price regulation – South Australia, New South Wales and south-east Queensland and whose standing offer is of a tariff type for which the AER determines a DMO price.

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11 See https://www.legislation.gov.au/Details/F2020C00687

12 Documentation on the calculation of the DMO for 2019-20 can be found on the AER website at https://www.aer.gov.au/retail-markets/retail-guidelines-reviews/retail-electricity-prices-review-determination-of-default-market-offer-prices

- The AER is now in the process of determining DMO prices for 2021-22. The AER refers to this as the DMO 3 determination.

COVID-19

A word count indicates that the term COVID-19 appears 39 times in the AER's Position Paper. It is disappointing that all these appearances refer to what effect COVID-19 may have had on retailers' costs. There is not a single reference to what effect COVID-19 may have had on consumers' ability to pay for electricity due to COVID-19. This is notwithstanding the fact that the whole purpose of the DMO is to act as a consumer protection measure.

This is in contrast to other initiatives of the AER, such as the AER *Statement of Expectations of energy businesses: Protecting customers and the energy market during COVID-19*.[14] The current such Statement (updated November 2020) states in its initial paragraph:

> *The COVID-19 pandemic continues to have a significant impact on the Australian community and our stakeholders. Many people have been affected by dramatic changes to their lives, businesses, income and working arrangements, and those of their friends, families and communities. The pandemic continues to influence energy use and the ability of customers (including small businesses eligible for the JobKeeper payment) to pay their bills.*

The Statement includes the AER's priorities, which focus on supporting "the needs of customers – both residential and SMEs – in vulnerable circumstances, particularly where this can minimise debt and hardship, and ensure that all households and small businesses can access the energy they need."

The AER's priorities also include "being responsive to the rapidly evolving pandemic situation, and preparing for our recovery".

Underlying the AER's Statement of Expectations, there is clear implication that now is the time to focus on customers' needs. When recovery comes, it will be the time to recoup spending that was needed during the pandemic. The Australian economy as a whole has taken a huge hit because of our response to COVID-19. Governments and regulators alike have, correctly, not yet focused on how Australian consumers and taxpayers will eventually 'pay back' these costs. Now is still the time to focus on supporting the Australian community, rather than on 'pay back'.

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13 Documentation on the calculation of the DMO for 2020-21 can be found on the AER website at https://www.aer.gov.au/retail-markets/guidelines-reviews/retail-electricity-prices-review-determination-of-default-market-offer-prices-2020-21

14 See https://www.aer.gov.au/publications/corporate-documents/aer-statement-of-expectations-of-energy-businesses-protecting-customers-and-the-energy-market-during-covid-19

This is why we are disappointed that the AER's Position Paper only focuses on retailers' costs, including how they may have increased due to COVID-19, and not on consumers' ability to pay for electricity due to COVID-19. The paper even goes so far as to consider adding to customers' energy costs to start 'pay back' before the pandemic is over.[15] This is not equitable. It will adversely affect vulnerable households impacted by COVID-19, and is therefore not appropriate at this time. We also note that it is likely that the customers on standing offers include a high proportion of vulnerable households with the least capacity to pay, who for various reasons did not engage with the market to take up a market contract.

The AER has reported that from May 2020 its Customer Consultative Group (CCG) is meeting more regularly as the CCG COVID-19 Working Group. This group will meet monthly to provide the AER with timely information about the impacts of COVID-19 on energy consumers.[16] At the time of writing, the AER has not published any communiqués or meeting notes from this Working Group; we have requested that they be published. In the meantime, we understand that the Working Group is looking at issues regarding debts being accumulated by customers and retailers' COVID-19 related costs. We suggest that these costs should be ring-fenced from the DMO for the time being.

Going forward, consideration needs to be given to

- The amounts of any (net) additional costs incurred by retailers;
- A fair sharing of COVID-19 additional costs as between shareholders and customers;
- Appropriate timeframes for any additional cost recovery from customers, dovetailing with when the economy recovers;
- Affordability issues that might arise for customers from cost recovery at a time that they are still suffering financially and emotionally due to COVID-19; and
- Appropriate government or other concessions that may be needed to help vulnerable customers cope with any additional cost recovery.

In regard to the DMO, there may be a case for these matters to be considered through the CCG COVID-19 Working Group and ultimately by the AER Board.

15 See Position Paper section 3.2.4 Retail costs and step changes

16 See https://www.aer.gov.au/about-us/stakeholder-engagement/customer-consultative-group

3. POLICY OBJECTIVES OF THE DMO

Last year, in its DMO 2 process, the AER set out a key policy objective for the DMO as being to prevent retailers charging unjustifiably high standing offer prices.[17]

We pointed out in submissions to the AER:[18]

- The AER had not shown that the DMO had prevented retailers charging unjustifiably high standing offer prices; and
- The AER's own evidence that the DMO 1 price was well above efficient costs proved that DMO 1 did not meet the policy objective of preventing unjustifiably high standing offer prices.

The AER's position paper on DMO 3 maintains that a key policy objective for the DMO as being to "prevent retailers charging unjustifiably high standing offer prices".[19] However, somehow that mutates to an objective that "the DMO price must reduce unjustifiably high standing offer prices".[20]

There is an important distinction between *preventing retailers charging* unjustifiably high standing offer prices and *reducing* unjustifiably high standing offer prices.

The AER's interpretation of the DMO could quite happily allow retailers to continue to charge unjustifiably high standing offer prices, as long as they are reduced from the level at which they were set before the DMO came into being. It is impossible for the AER to know whether the prices are unjustifiably high while it fails to define what that term means, and fails to identify what would be a level of efficient prices.

We do not believe that this is a reasonable outcome for consumers, or that it is what was intended in recommendation 30 from the ACCC's Retail Electricity Pricing Inquiry (REPI) final report 'Restoring electricity affordability and Australia's competitive advantage' on which the DMO is based.

We also continue to be disappointed in the AER's assertion that "the DMO is not aiming to identify efficient costs" and that "The DMO price is not intended to be an accurate reflection of retailers' efficient costs."

This flies in the face of recommendation 30 of the ACCC's REPI final report, which stated:

17 See DMO 2 Position Paper pages 9, 12 and 20 (September 2019), Draft Determination pages 25 and 43 (February 2020) and Final Determination page 27 (April 2020)

18 See *Default Market Offer Price (2020-21)*, response to AER position paper, Etrog Consulting, 17 October 2019 and *Default Market Offer Price (2020-21)*, response to AER draft determination, Etrog Consulting, 9 March 2020. Those submission set out our concerns on the policy objectives for the DMO and their achievement (or otherwise) in far more detail then we set out here. All the points previously made do, however, still apply.

19 See DMO 3 Position Paper page 8 (October 2020)

20 See DMO 3 Position Paper page 12 (October 2020)

> *The AER should be given the power to set the maximum price for the default offer in each jurisdiction. This price should be the efficient cost of operating in the region, including a reasonable margin as well as customer acquisition and retention costs.*

It is not possible for the AER to set a DMO price that is *the efficient cost of operating* while it refuses to identify efficient costs, and refuses to set the price to be the efficient cost of operating, even though that is exactly what the ACCC said it should do.

4. OUR PREFERRED METHODOLOGY FOR CALCULATING THE DMO

4.1. IDENTIFY EFFICIENT COSTS FOR ALL COST COMPONENTS

As advised in our previous submissions, our preferred methodology for calculating the DMO is that the AER can and should identify efficient costs for all cost components, and base the DMO on efficient costs, in order to meet its policy objectives.

The AER should build a cost stack for Network, Wholesale, Environmental and Retail costs and margins to establish DMO 3. This will establish efficient costs, as envisaged for the DMO based on recommendation 30 from the ACCC's Retail Electricity Pricing Inquiry (REPI) final report 'Restoring electricity affordability and Australia's competitive advantage' on which the DMO is based.

One of the problems that arises with the AER's approach is the lack of transparency that results. Much has been written about the importance of transparency in regulation, and we are sure that the AER and its Board emphasises the importance of transparency in its decision making proposes. However, the AER's refusal to identify efficient costs in calculating the DMO not only fails to achieve the ACCC's recommendation 30, but also results in further lack of transparency in the AER's decision making. We have pointed this out in previous submissions. In the current position paper on DMO 3 the AER rejects the addressing of variances by stating among other reasons "The DMO price is sufficiently high that an under-estimation of costs should not impact on retailers' ability to recover costs for standing offer customers." Given it is not known by what amount the DMO is higher than it ought to be, neither stakeholders nor the AER can know whether the DMO price is already sufficiently high to absorb other costs or not. This is not a satisfactory outcome for any stakeholder.

4.2. OUR VIEWS ON INCREASING RETAIL COSTS AND MARGINS BY CPI EACH YEAR

As outlined above, our preference is for retail costs to be calculated for DMO 3 using a bottom-up approach rather than indexing from the previous year.

However, if an indexing approach is to be used, then it is imperative that a downward adjustment should be made to reflect increased productivity. All businesses should increase productivity. Productivity is critical for the long-term competitiveness and profitability of any business.[21] This is not only in the competitive environment. The AER has itself recently recognised increased productivity in the electricity distributors, which are not subject to competition.[22] Gas network businesses Evoenergy and AGN SA both also included productivity improvements in recent submissions.

21 See for example https://www.aigroup.com.au/productivitycentreframe/pdf/productivitycentre/profit-from-your-productivity.pdf

22 See https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/review-of-our-approach-to-forecasting-opex-productivity-growth-for-electricity-distributors

The need for increased productivity is clearly particularly strong in the competitive retailing sector because in competitive markets businesses that cannot implement efficiencies ultimately go out of businesses because they lose market share to those who are more efficient who can compete more effectively.

The introduction of retail competition in energy markets was and still is intended to drive efficiencies in retail operating costs. It is through increased efficiencies that customers benefit from retail competition. The efficiencies that retailers manage to achieve would be applicable both to standard offers and market offers.

We are pleased that the AER has now confirmed that publicly available information appears to support the view that improvements in retailers' efficiency are leading to reduced retail costs over time, and expect that this will be taken into account to drive down prices in DMO 3 if the AER continues to index costs.

Any adjustment for efficiency should be considered independent of any step changes, which are discussed further in section 4.4 below. It should measure the overall efficiency improvements that would be expected to be made by efficient retailers, such as through implementation of electronic billing, chat bots on websites, and other productivity improvements. Importantly, the overall costs of the retailer are not the issue here; to the extent that the overall costs include step changes they should be considered separately – as discussed in section 4.4 below.

4.3. Our views on including Customer Acquisition and Retention Costs (CARC) in the calculation of the DMO

The DMO price is a cap on what is essentially the standing offer and is regarded as a safety net. On that basis, it is our view that then CARC should not be included, as there is no need to actively recruit and retain customers to a default offer. It is these customers' prerogative not to engage in the market, and therefore they should not have to pay the costs of others who choose to engage with the market. People on standing offers and those who do not shop around do not get the benefit of the activities relating to these costs.

However, we are also aware that the ACCC recommendation 30 explicitly stated that CARC should be included in the DMO calculation.

4.4. Step changes

The AER has set out that its criteria for its step change framework are:

- There is an exogenous change in a retailer operating environment that is mandatory and would be incurred by an efficient and prudent retailer within the relevant DMO determination period;
- The change will lead to a material overall change in the retail costs of an efficient and prudent retailer; and
- The change in retail costs is not compensated in other parts of the AER's forecast or in other DMO cost elements.

We read these criteria as being symmetrical. Step changes can be positive or negative.

We have some difficulties with the AER's framework, for the following reasons.

1. ***There is already headroom in the DMO framework to allow for additional retail costs***

   As discussed in section 4.1 above, it is likely that the DMO is already set at a higher level than is appropriate. The AER alludes to this by writing:

   > *While we have not defined 'materiality' in this context, our intention is that incremental and minor cost changes would not meet the criteria for consideration. The DMO price is sufficiently high that costs of this nature will not impact on retailers' ability to recover their costs to service standing offer customers, and do not require a specific adjustment.*

   Without knowledge of how high the DER is as against the level at which it should be set, it is not possible to know whether a step change is material or not in the AER's current non-transparent framework. The AER needs to determine efficient costs before it can determine that any step change is "material".

2. ***Lack of adjustment for efficiency in retail costs***

   As discussed in section 4.2 above, there is a need for efficiency adjustment to be included in the DMO 3 calculations. While efficiency and step changes are separate matters, allowing for positive step changes without allowing for productivity improvements seems to be unbalanced and inappropriate.

3. ***Lack of symmetry***

   As noted above, we read the AER's criteria for its step change framework as being symmetrical. Step changes can be positive or negative.

   While possible positive step changes have been identified, there seems no process for identifying negative step changes.

   We see an incentive for retailers to propose positive step changes. We do not see an incentive for retailers to propose negative step changes. Consumer interests are unlikely to have enough detailed knowledge of retailers' operations to identify potential negative step changes. We see no evidence that the AER has sought to identify negative step changes.

In summary, the AER should not approve positive step changes until it has processes for all of the following:

- Determining retailers' efficient costs as a precursor to determining that any step change is "material";
- Applying productivity improvements to retailers' costs; and
- Identifying and analysing possible negative step changes in retailers' costs.

The AER also specifically asks about possible adjustments to DMO 3 to allow for recovery of additional costs to retailers arising from COVID-19 and Consumer Data Right. We suggest that those are handled as for other possible step changes. We set out above what we believe would need to be achieved before step changes can be approved.

In its discussion of COVID-19, the Position Paper mentions that “reported retail cost to serve and customer acquisition and retention costs to 30 June 2020 are still decreasing, in line with observed trends in recent years”. The AER also questions whether retailers’ operating costs may have reduced due to staff working from home. The AER should consider implementing these as negative step changes, to meet one of the criteria we set for approving positive step changes. Or, better, re-evaluate retail costs in total using a bottom-up approach.

Specifically in regard to COVID-19, please also see our comments in section 2 above regarding the appropriateness of recovering COVID-19 costs from customers at this time.

4.5. ANNUAL USAGE ESTIMATES

For DMO 3, the AER intends to retain the same annual usage amounts adopted for DMO 2.

We refer the AER to the comments we made in a previous submission,[23] where we questioned the assumptions the AER made about the annual energy consumption of an average residential customer with controlled load in the Energex area. We have not been able to reconcile the figures used by the AER, and again suggest that the AER should check its annual usage estimates across all businesses, and Energex in particular.

We are also concerned because all the consumption data used in DMO 2 was derived “pre-COVID”. Clearly all the data used then is now out-of-date and needs to be revised. COVID changed residential and small business consumption figures, and also various government post-COVID PV and other stimulus packages have been announced, which will affect electricity usage in 2021-22.

In regard to the calculation of wholesale costs of energy, the AER has said: “AEMO’s ESOO has incorporated demand forecasts that include the projected impacts of the COVID-19. Since the Consultant uses the forecasts provided by AEMO in the ESOO, any resulting change in demand will be considered through the methodology.”[24]

Those forecast changes should also be incorporated in the AER’s DMO 3 estimates of annual usage amounts for application of DMO 3.[25]

4.6. NETWORK PRICES

The AER proposes as follows:

> *For DMO 3, all the network distribution zones are within the regulatory control period, and are not undergoing a revenue reset.*
>
> *To assess the change in network costs in 2021-22, we propose to consider the network tariffs proposed by the network business in their 2021-22 pricing proposals. Network businesses must submit these by 30 March each year.*

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23 See *Default Market Offer Price (2020-21)*, response to AER draft determination, Etrog Consulting, 9 March 2020, section 4.6

24 See DMO 3 Position Paper page 32 (October 2020).

25 See DMO 3 Position Paper section 4.1 (October 2020).

> *If the AER has approved these proposals at the time of finalising the DMO calculations in late April, it will be straightforward to use the final published prices.*
>
> *If the AER has not approved the prices, we propose using the submitted network pricing proposals, noting that these may change before they are finally approved.*
>
> *If the pricing proposals are delayed due to some reason, and/or they are undergoing a more detailed assessment than usual, we would have regard to latest available indicative network tariffs.*
>
> *To calculate DMO prices for the Draft Determination, we intend to use indicative network tariffs for 2021-22 submitted as part of the 2020-21 pricing proposals as the best available information at the time of publication of Draft Determination.*

The AER also notes:

> *Under the Regulations, AER is required to make its Final DMO determination by 1 May each year.*
>
> *The AER is undertaking work to consider how the timing of network pricing proposals and how these can be better aligned with the DMO process.*
>
> *We note the Australian Energy Council (AEC) is also considering this issue.*

We accept that under the current Regulations the AER is not able to be certain that the network pricing that is used in the DMO is the final pricing that retailers will face. We accept that the AER's proposal is the best given the circumstances. We also commend the AER in its efforts to align timeframes better in future.

5. ANSWERS TO STAKEHOLDER QUESTIONS IN THE AER'S POSITION PAPER

This final section of our submission provides answers to the 21 stakeholder questions posed in the AER's Position Paper. Where we largely agree with the AER or do not have strong views or where the issue is relatively straightforward, the response that appears here is not discussed earlier in this submission; we have reserved the commentary above largely for those issues where we have disagreements with the AER's proposed methodology for DMO 3 or where there is significant complexity.

Question 1: Do you agree with the principle that forecasts and assumptions from previous DMO determinations should not be retrospectively amended to reflect actual information?

Answer 1: We agree with the AER's statement that the DMO should be a forward-looking instrument, based on the best information available at the time. As such, it should not be amended retrospectively. However, as discussed in section 4 above, the way the AER calculates the DMO does not reflect best information available in regard to a retailer's efficient costs, because it does not even attempt to estimate efficient retail costs. The DMO should estimate efficient costs each year, rather than build on a previous year's index.

Question 2: Does our assumption of a risk averse retailer building their hedge book from the time of the first trade recorded by ASX Energy remain appropriate, or is a shorter period justified? What is an appropriate period and why?

Answer 2: Retailer hedging strategies have evolved considerably since this method of estimating wholesale purchase costs was first proposed by regulators 10 or more years ago. Many large retailers are nowadays part of organisations that include generators – often called "gentailers" – where wholesale energy purchase risk sits at the generator's trading desk, while the retail arm receives a simpler "transfer price" for energy from the generator arm.

These trading desks buy and sell energy – they are not just "book building".

The methodology deployed for hedging in the DMO calculations is a feasible method but by no means prescriptive. Retailers should be able to trade more efficiently than this method suggests, either by operating more sophisticated trading or by contracting with a counterparty that is more sophisticated and therefore able to offer more competitive hedging to the retailer.

The AER's Position Paper states: "Observable trades recorded by ASX Energy generally commence 36 months prior to the start of the relevant period, although the large majority of trades (typically around 98 per cent) occur in the 24 months prior to the start of that period." Given that is the case, it could be argued that a shorter 24 month period would be more appropriate. However, market liquidity and trading patterns change over time, and on balance it is preferable to maintain stability to leave this aspect of the methodology unchanged.

Question 3: Does the Consultant's 95th percentile estimate remain appropriate, given the hedging strategy? What alternative percentile could be applied and what would the justification be?

Answer 3: Hedging to the 95th percentile is a feasible strategy for a retailer to manage its wholesale energy purchasing. As discussed above, the methodology deployed for hedging in the DMO calculations is a feasible method but by no means prescriptive. Retailers should be able to trade more efficiently than this method suggests. This is the case for hedging to the 95th percentile, but may not be the case if that percentile is changed. Maintaining that position is transparent. It shows that the AER is giving due regard to allow for risk in the wholesale energy cost calculations where there is risk to be managed, while allowing only efficient costs in retail costs where there are not the same risks.

Question 4: Do you agree with our proposed approach to assign ancillary service charges to each state, rather than smeared across the DMO jurisdictions?

Answer 4: The AER's Position Paper states: "A few stakeholders noted that FCAS charges are paid at a NEM regional level and passed on by retailers to the relevant retail customers in that region. We consider moving to a NEM regional-based allocation would more closely reflect the actual manner in which the ancillary costs are incurred by retailers. Therefore for DMO 3, we propose to forecast ASC separately for each NEM region."

It was our understanding that FCAS charges are recovered from retailers on a NEM wide basis, and not by region. The AEMO website states: "For the purpose of FCAS payments and recovery, the market is treated globally. Hence, for the purpose of recovery, participants are treated equally, regardless of region."[26]

Though that is shown as the current information on the AEMO website, it is dated 2015, so may not be current. This is something that the AER should check with AEMO. If FCAS payments are now recovered from retailers based on regional costs incurred then the change should be made to forecast ancillary services costs separately for each region. Alternatively, if the AEMO guide remains correct, then the costs should continue to be calculated NEM wide.

Question 5: What are the implications of differentiating between residential and small business load profiles to forecast wholesale costs?

Answer 5: The energy consumed by customers without interval / smart meters[27] is based on the Net System Load Profile (NSLP) for the purposes of settlement in the NEM. This is an aggregated load profile for basic meters that does not distinguish between small business and residential customers. To the extent that the DMO is applied to customers with basic meters, the NSLP continues to represent the best reflection of the energy for which the customers' retailer is settled in the NEM.

As more interval meters are deployed, and the customers with those meters are settled in the NEM based on their actual half-hourly data, the NSLP will become less relevant.

26 See *Guide to Ancillary Services in the National Electricity Market*, p.12, available at https://aemo.com.au/en/energy-systems/electricity/national-electricity-market-nem/system-operations/ancillary-services

27 These meters are often referred to as "digital meters" in Queensland.

On that basis we support the AER investigating how to segment customers to estimate load profiles that are not dependent on the NSLP, and to consult on the findings. One way to segment the customers may be on the basis of separating residential customers from small business customers, but that is by no means the only possible segmentation method. The AER should consider and consult on the potential for a range of segmentation options to be used.

Question 6: Do you agree with our proposed approach to continue using the DMO 2 wholesale energy cost forecasting methodology?

Answer 6: Yes

Question 7: Do you agree with our proposed approach to continue using the DMO 2 environmental costs methodology?

Answer 7: Yes

Question 8: Do you agree with our proposed approach to continue using the DMO 2 network costs methodology?

Answer 8: This is answered in section 4.6 above.

Question 9: Is it reasonable to apply a productivity factor to the DMO? What is the evidence retailers' costs are decreasing or increasing?

Answer 9: This is discussed in section 4.2 above.

Question 10: What form should any productivity adjustment take?

Answer 10: We leave it to the AER to propose the adjustment and the form it takes. It should represent the evidence of the productivity improvements that would be expected from an efficient retailer, and should be significant.

Question 11: Do you agree with our proposed approach to continue using the DMO 2 step change framework?

Answer 11: This is discussed in section 4.4 above.

Question 12: What will be the impact of COVID-19 on retailer costs in 2021-22? Are any retailer costs decreasing due to COVID-19?

Answer 12: This is also discussed in section 4.4 above.

Question 13: What is the basis for estimating any cost impacts? Please provide information to assist with estimating cost changes associated with COVID-19.

Answer 13: This is also discussed in section 4.4 above.

Question 14: What impact will meeting CDR obligations have on retailer costs in 2021-22? What is the basis for estimating any cost impacts? Please provide relevant cost information to assist with estimating cost changes associated with CDR.

Answer 14: We will review any cost estimates that the AER believes should be subject to stakeholder consultation.

Question 15: Aside from CDR and COVID-19, are there other regulatory or operating environment changes that are likely to materially increase or decrease retailers' costs to serve customers in 2021-22?

Answer 15: Our answer is to refer to ongoing productivity improvements that should be expected from efficient retailers.

Question 16: Do you agree we should we retain the same annual usage amounts used for DMO 2? If not, what alternatives are more appropriate and what are their benefits?

Answer 16: This is discussed in section 4.5 above.

Question 17: What is the appropriate level of detail to include in the daily usage profile? What are the risks and benefits of a simple TOU profile compared to a detailed one?

Answer 17: We agree with the AER that in considering whether to increase the level of detail in the daily profile, the AER needs to determine whether the benefit in doing so outweighs the cost of the additional complexity.

Question 18: Do you agree our DMO 2 approach to advanced meter costs remains appropriate for DMO 3?

Answer 18: The AER's approach is predicated on there being a significant margin between the median market offer (the AER's proxy for retailers' efficient costs) and the DMO price enabling retailers to recover any additional costs they may incur to supply customers with advanced meters and to supply solar customers. We have objected to the AER's use of the median market offer being a proxy for retailer's efficient costs and the setting of the DMO at an undisclosed non-transparent level. However, while that remains, we agree that there should be no additional cost allowances.

Question 19: If not, what is the evidence that advanced metering costs are impacting retailers' abilities to recover their costs to serve standing offer customers?

Answer 19: N/A

Question 20: Is it reasonable to increase the DMO price for flat rate standing offer customers to take account of the higher costs of advanced metering?

Answer 20: It is not reasonable. See our answer to question 18 above. Further, smart metering should reduce retailers' costs. If the benefits of advanced metering do not exceed the costs, there is something seriously wrong with the advanced meter rollout program. Retailers' costs should be decreased where there is advanced metering in place, not increased.

Question 21: Do you agree our DMO 2 approach to costs to supply solar customers remains reasonable?

Answer 21: Please see our answer to question 18 above.

APPENDIX A: COMMISSIONING OF THIS SUBMISSION

This submission to the AER is funded by Energy Consumers Australia (www.energyconsumersaustralia.com.au) as part of its grants process for consumer advocacy projects and research projects for the benefit of consumers of electricity and natural gas.

The grant has been provided to support advocacy by a stakeholder group of thirteen community sector organisations in Queensland in 2020-21 in regard to consumer engagement and advocacy on regulated network and retail electricity prices in Queensland.

The intended outcomes of the project that is supported by the grant include:

- Robust submissions to regulatory decision making processes that take place in 2020-21 that set regulated network and retail electricity prices in Queensland, including tariff structure reform processes.
- Ensuring that Queensland-based consumer and community organisations are well informed and understand the reforms so they can support their own community organisations and each other in their own client advocacy.
- Enhancing understanding of the implications of these processes and their outcomes on residential customers, particularly those on low incomes or experiencing vulnerability.

The thirteen community sector organisations are:

- Caxton Legal Centre, Queensland
- Council on the Aging (COTA) Queensland
- Energetic Communities Association Inc, Queensland
- Good Shepherd, Queensland
- Kildonan & Lentara Cluster, Queensland
- Laidley Community Centre, Laidley, Queensland
- Multilink Community Services Inc, Queensland
- Queensland Consumers Association
- Queensland Council of Social Service (QCOSS)
- St Vincent de Paul, Queensland
- Uniting Care, Queensland
- Uniting Church, Queensland
- Youth and Family Service (YFS), Logan, Queensland

Representatives of these organisations have participated in a workshop to discuss the AER's position paper and the content of this submission. Representatives of the following five stakeholders have also formed a steering group to guide and review the submission before presentation to the AER:

- Council on the Aging (COTA) Queensland
- Energetic Communities Association Inc, Queensland
- Queensland Consumers Association
- Queensland Council of Social Service (QCOSS)
- Youth and Family Service (YFS), Logan, Queensland