20 March 2019

public interest
ADVOCACY CENTRE

Mark Feather
General Manager, Policy and Performance
Australian Energy Regulator

By email: DMO@aer.gov.au

Dear Mr Feather,

Submission to Default Market Offer Price Draft Determination

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit legal centre based in New South Wales. Established in 1982, PIAC tackles systemic issues that have a significant impact upon people who are marginalised and facing disadvantage. We ensure basic rights are enjoyed across the community through litigation, public policy development, communication and training. The Energy + Water Consumers' Advocacy Program represents the interests of low-income and other residential consumers, developing policy and advocating in energy and water markets.

PIAC welcomes the opportunity to respond to the AER's Draft Determination on the development of a Default Market Offer price (DMO) for retail electricity. While PIAC strongly supports the principle of a Default Price mechanism, we are concerned that the draft determination departs from the initial intent of the ACCC's recommendations which informed this process. More importantly, we are concerned that the draft determination contains assumptions that do not appropriately recognise fundamental disfunctions of the retail electricity market that have resulted in unacceptable consumer outcomes in the delivery of an essential service.

PIAC contends that a properly constituted default mechanism should ensure that consumers would have access to an essential service at a 'fair' price and provide much needed discipline to the market, incentivising competition that delivers more innovation, better consumer outcomes and the more efficient delivery of electricity as an essential service.

The recent release of the Victorian Essential Services Commission Draft Victorian Default Offer (VDO) presents a timely example, with which the AER could align its own default mechanism to ensure more consistent consumer outcomes across all jurisdictions. PIAC considers that the VDO more appropriately reflects the intent of a properly constituted default pricing mechanism, and is more likely to achieve the intended outcomes for consumers and the retail market more broadly. We strongly recommend that the AER align their Default Market Offer mechanism with the draft VDO, as far as is practicable.

The remainder of this submission addresses concerns with the underlying assumptions and principles put forward in the draft determination and the application of these principles and assumptions in the proposed DMO.

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The implications for consumers of considering electricity as an essential service

Electricity is an essential service. While this is, at least conceptually, accepted by all stakeholders involved in the National Electricity Market, there is a fundamental misunderstanding of its implications for the competitive retail electricity market, and how it must work for consumers.

As an essential service, electricity is not a product or service that consumers have the option not to consume or purchase (a choice that is normally an intrinsic tool of competitive market discipline). Access to energy is an essential requirement for a basic, acceptable and healthy standard of living, and for the ability to access social and economic opportunities. Where a consumer cannot afford the electricity they need, they do not have the option not to purchase. This is a crucial, foundational fact, which determines that the key interest for consumers is access to electricity as an essential service. It also determines that it is in consumers interests that essential access is provided affordably at a 'fair' value.

It is informative to refer to the National Energy Objective (NEO) and the National Energy Retail Objective (NERO), which places this interest at the centre of consideration for the rules in the NEM:

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

Crucially, this objective makes no distinction between different groups of consumers, such as those who are engaged or those who are not, and those who are 'able' versus those who are not. This is an implicit statement of equality of the interests of all consumers.

Additionally, the NEO and NERO make no mention of the 'interests of the market' or the 'interests of competition'. This is an implicit recognition that competition, engagement and the market generally, are intended as mechanisms through which the interests of consumers and efficient energy services, may be promoted. These are not ends or objectives in and of themselves, which require explicit consideration except when they promote or facilitate the interests of consumers.

PIAC considers these principles fundamental to discussions regarding a potential DMO mechanism, and contends that the Draft Determination is predicated on assumptions and arguments that do not recognise the implications of regarding electricity as an essential service, and of accurately applying the principles expressed in the NERO and NEO to the operation of the retail market.

Issues with the assumptions and principles in the draft determination

There are a number of overlapping concerns with some of the terminology, assumptions, and principles expressed in the draft determination, which form the basis of how the AER proposes to apply a DMO mechanism. Specifically, those concerns include:

- The draft determination cites avoiding 'unjustifiably high' prices as a key purpose of the DMO. PIAC disagrees with this terminology and the fundamental assumption and rationale that it expresses.

  Electricity is an essential service, and at the level of essential service provision (i.e. where the service is effectively homogenous, qualitatively indistinguishable and where purchase is unavoidable) there is little rational justification for price dispersion or, arguably, any price above the efficient cost of provision. This is particularly true where the efficient cost is not revealed (i.e. where the intrinsic value of the service is not able to be known by the consumer to serve as a basis for choice).

Therefore, in relation to the provision of electricity as an essential service, the role of an effective default price mechanism for consumers is two-fold:

- To ensure that all consumers (as referred to in the NERO and NEO) have equal and fair access to an essential service, provided at a cost that is efficient.
- To serve as a value indicator for both consumers and the market as a whole, providing transparent information regarding the value of electricity as an essential service, by indicating the efficient cost of its provision. This essential service 'value anchor' provides a necessary basis for the creation and pricing of innovative service offerings, including those which may be priced at a premium.

PIAC does not advocate for homogeneity of pricing for all electricity services, merely that the starting point for default pricing should be recognition that all consumers should have equal access to it at an efficient, 'fair' price. With this as a foundation, consumers are free to engage in the market as a choice, when it is in their interests, potentially choosing premium services that deliver qualitative difference in service (beyond price).

- Efficiency has apparently been removed as the primary principle informing the development of the DMO price. The original ACCC recommendation 30 which has formed the basis for the current DMO process, explicitly referred to the need for the AER to set the price point for the default at the 'efficient cost' of service provision in a distribution zone.

  Efficiency has, inexplicably, been removed from consideration, with the draft determination appearing to intentionally set the DMO price well above the 'efficient cost' in order to provide 'room' for discount price competition to continue. The draft determination cites the ACCC's own submission contending that the DMO should not be a 'viable alternative'[1] and that to facilitate effective competition retailers would need room to discount 'well below the DMO'[2]. PIAC strongly disagrees with these statements and the assumptions that underpin them, specifically:

  - As outlined earlier, the DMO can (and should) represent an efficient cost for service that is a viable alternative for any consumer, in whose long term interests the retail market must operate, and to which they can default in any circumstances where they have not expressed an explicit choice.
  - A DMO that represents an efficient cost is not, and does not need to be, the lowest priced product to be effective. A DMO which is priced to cover the efficient costs of the provision of electricity as an essential service (including allowance for a benchmarked, reasonable margin) serves as a proxy for the intrinsic or 'fair' value of that essential service, provided in the interests of consumers. Crucially, being 'efficient' it also operates in the interests of the NEM as a whole in that in representing the efficient cost of the service, it accounts for constituent costs (including retail margin) while retaining a market discipline for long term efficiency – something which is absent in the current operation of the retail market.
  - A DMO that represents an efficient cost may reduce the scope for discount based, price-only competition in the form that it currently operates. However, it is untrue that loss-leading discounts particularly, and price-based competition generally, are the only (or even most preferable) form of competition. A default mechanism that provided consumers with an efficient cost option (and efficient cost indicator) would provide added incentive for retailers to develop innovative product and service offerings (potentially for a price premium), and demonstrate their value to consumers. In this way a DMO should serve as an incentive for competition that

1 ACCC. Letter of submission to the AER Default Market Offer Price: consultation Paper, December 2018. P.2
2 Ibid

more effectively serves consumers' interests by delivering competition on 'quality' and difference of service, not merely price.

- PIAC strongly disagrees with the narrow focus upon standing offers as the only issue in need of redress in relation to retail pricing, behaviour and consumer impacts. Standing offers are, as recognised in the original REPI recommendations, not working in the interests of consumers, and are worthy of abolition. However, focusing only on those with the 'standing offer' label, fails to recognise that these poor outcomes are also being experienced by many consumers who are currently on market offers, because:
    - While they are technically still on market offers, the headline benefits (such as the discounts which theoretically differentiate standing offers from market offers) have expired while their contract or 'market offer' has not (that is, they have not defaulted to a standing offer). Where 'benefit periods' typically have a 6-12 month duration, market contract periods are increasingly 'evergreen' meaning that a consumer does not revert to a standing offer, but does lose the headline benefits of their market offer. This means that any consumer who has not 'switched' within a 12-month period, is likely to be experiencing conditions which are functionally equivalent to a standing offer[3].
    - They are on market offers that involve conditional discounts for paying on time that they do not, and are not able to, realise (which is the case for many vulnerable consumers). The REPI report demonstrates that between 10-50% of consumers on market offers (with an average of nearly 30%)[4] are not meeting the conditions of their offer and not receiving their discount. Accordingly, these consumers are effectively standing offer customers. They are often worse off than standing offer customers when lost discounts and accrued penalties are incurred.

  In PIAC's view, the focus must be on the outcomes for all consumers, regardless of the label attached to the offer that they are currently on. The opacity of actual costs involved in all offers (both market and standing offers) is a fundamental problem that not only delivers poor outcomes that are not in the interest of consumers, but it allows distorted competition that facilitates widespread inefficiency, and acts as a disincentive for qualitative innovation.

  For example, anecdotal evidence suggests that tier 1 and 2 retailers intentionally target their largest 'loss leading' discounts at high-churn consumers in a deliberate attempt to 'strip' value out of these consumers. Knowing that these consumers churn regularly to chase the lowest prices, these retailers target them with the biggest discounts (often not publicly available) in the knowledge that they are unlikely to remain as customers, and that if and when they churn to another retailer, they will represent a significant cost to that retailer. This practice is facilitated by the opacity of retail costs (across both market and standing offers), and a system which enables internal cross subsidy by the majority of consumers (in excess of 70%) who switch less than once every 12 months. PIAC does not consider this form of competition to be sustainable, in the interests of consumers, or delivering appropriate outcomes in the market.

  A properly functioning default offer that represented an efficient price for all consumers would ensure that consumers would default to a 'fair' priced offer that represented efficient costs. Such a mechanism would significantly reduce the scope and incentive for practices such as that outlined above, and would provide an incentive for retailers to operate more efficiently, and develop innovative and qualitatively different service offerings for consumers.

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3 Even in Victoria, the jurisdiction with the highest switching or 'churn' rates, this represents some 74% of consumers based on information from the REPI

4 ACCC, Retail Electricity Price Inquiry: Final Report. June 2018. Pp230-280

That is, it would better align retailer incentives to compete with the interests of consumers and the NEM as a whole.

- PIAC strongly disagrees with the rationale, outlined in the draft determination[5], that a default must not be priced efficiently, because such a 'fair value' price would remove the incentive for consumers to engage in the market. This argument is based on fundamentally flawed assumptions:
    - That engagement is an intrinsic good in and of itself, that needs to be maximised by effectively ensuring that some (or most) consumers are structurally disadvantaged by paying prices for an essential service that are in excess of the efficient cost, and indeed in excess of those paid by other consumers.
    - That the potential for monetary benefit is an effective motivator of consumer behaviour and engagement in the retail market. The recent (ongoing) Victorian program offering Victorian consumers $50 to visit the energy compare site has much less impact than expected, not only on the number of consumers switching, but on the number of consumers even visiting the site. That is, the potential for monetary benefit is not effective in overcoming consumers structural assumptions and behaviours in relation to the retail energy market.

      These results are not outliers, and mirror similar experiences in the UK, other international markets and markets for other consumer goods and services, demonstrating that monetary benefit or penalty is not sufficient to overcome entrenched consumer behaviour patterns and assumptions regarding the essential service nature of electricity.

      In this context, ensuring that some (or indeed most) consumers will pay a higher price for an essential service, in an attempt to leave room for them to benefit by engaging, amounts to ensuring that some (or indeed most) consumers will pay more than they need to. PIAC regards this as entrenching inefficient retail pricing, with the burden of this inefficiency borne wholly by consumers, and is contrary to the NERO.
    - The assumption that consumers should have to 'engage' by regular switching, merely to have the potential to receive a 'fair' price for their essential electricity service (even though they are unlikely to know that the price they are receiving is fair, should they receive it). Where the interests of consumers and outcomes for consumers are the priority, and can be achieved through a mechanism that guarantees a fair price by default, engagement is a secondary consideration.
- PIAC does not accept the assertion in the draft determination that the DMO must be priced at a higher than efficient level so as not to have a negative impact upon competition. This rationale appears to be based upon the inherent (and incorrect) assumption in the draft determination that the health of competition in the market is measured by the number of retail participants and the number of offers available in the market.

  Competition is a mechanism, with outcomes for consumers the ultimate measure of its health and effectiveness. Referring back to the NERO and NEO, and 'interests of consumers', where the operation of the retail market demonstrates that the nature of competition is not in the interests of consumers, with respect to price and quality, then there is a strong argument that the market and the nature of competition should be reshaped, not the behaviour of the consumer. In this respect, should a DMO based upon efficient costs of an essential service result in a reduction in the quantity of offers and retail participants, but

5 Page 33 of the AER draft determination

result in improvement of the ‘quality’ of options available and deliver better outcomes for consumers, then it can be said to have improved competition.

PIAC contends that a strong default based upon efficient costs will ensure that a significant proportion of consumers are able to access essential electricity services at a ‘fair’ price, that also provides a reasonable margin to the retailers supplying it to them. A DMO based on efficient costs would also provide necessary information to consumers regarding the intrinsic value of that efficient service, which would serve as a basis for more informed and confident choices in their wider engagement with the retail market. For instance, they would then be aware that any discounts from this price were a ‘low cost offer’, and any deals offered at a premium should involve a qualitatively better or different service. This would place the retail electricity market on a similar footing to effectively competitive markets.

PIAC contends this would also provide retailers with a greater incentive to offer innovative products and services, by ensuring that they bear more of the risks of not doing so (where consumers currently bear all the risks in relation to engagement with the retail market).

- PIAC strongly disagrees with the argument, perpetuated in the draft determination, that a DMO should only operate as a ‘safety net’ for an undefined (but small) minority of people deemed unable to get satisfactory outcomes from the market. This argument is based upon faulty premises:
    - That the number of consumers getting poor outcomes from the market is small, and in any case a minority. As outlined in relation to the errors in focussing on standing offers, a majority of consumers are likely to be paying above an efficient or fair price for their essential access to electricity.
    - That regardless of the number affected, a significant (opaque) price dispersion in the delivery of a largely homogenous essential service, is not only acceptable but desirable.
    - That the consumer is inherently responsible for ensuring that the retail market operates in their interests, by delivering a service that is efficiently and fairly priced. Further, that if they fail to be able to engage effectively according to the terms set by retailers, then any excess costs that they incur above the efficient price of the retail service, is reasonable.

  In this context the problem is not one of mitigating the impacts upon a small number of the vulnerable, but of addressing the fundamental failure of the retail market to deliver affordable, fair outcomes in the interests of all consumers and their access to an essential service. The DMO is not merely a safety net or back-stop, but a necessary guarantee of a fair price option for all consumers, who have an equal right to access to services that are provided efficiently in their interests.

Response to the proposed DMO

PIAC considers that the issues we have raised with the assumptions and principles expressed in the draft determination require a re-assessment of the function, framework and implementation of default pricing. We strongly recommend that the AER commit to undertake a full review of the principles, purpose and mechanism of default pricing as part of the scheduled review of the DMO within the next 12 months.

In relation to the DMO proposed in the draft determination, PIAC contends that the issues of principle that we have raised in this submission also present immediate opportunities for redress, notwithstanding the time imperatives, and we recommend that the AER undertake to make the following amendments to the proposed DMO approach:

Calculation of the DMO

The draft determination proposes to set the default price at the median point between the median standing offer and the median market offers. PIAC strongly disagrees with this approach, and considers that it results in a price that is well in excess of the efficient cost of the provision of essential electricity services.

While PIAC considers that, in the long term, a bottom up approach is required to set and maintain an efficiently priced default price, the recently released Victorian Essential Services Commission (ESC) draft VDO[6] highlights the potential to amend the top down approach proposed by the AER, to ensure that the price set more appropriately represents the efficient (not lowest) cost of essential service provision.

Specifically, on page iv of the draft VDO advice the ESC note that although their proposed (bottom up) approach results in a default price that is $200 lower than that arrived at by the AER, when the ESC tested their approach with the addition of an allowance of retail 'headroom' a similar default price was arrived at. We note that in the AERs draft determination a default that was simply the median of available market offers would reduce the resulting default price by $200, to a level equivalent to proposed VDO

In its initial recommendations in the REPI, while noting that the final decision was up to the AER, the ACCC advised that the default price should be 'closer to the median market offer than the median standing offer'. Further, PIAC considers it manifestly inappropriate to utilise standing offers in the calculation of a default price in a process that explicitly recognises that standing offers represent 'unjustifiably high' prices[7].

Accordingly, PIAC recommends that the AER re-evaluate their top-down approach by removing consideration of the median standing offers, as the upper bound for the DMO calculation, and simply utilise the median of available market offers.

Expressing the DMO

PIAC has a number of concerns with the way the AER proposes to express the DMO, for the purposes of market and consumer information and comparison.

- The AER proposes only to express the DMO as an indicative dollar bill amount, based upon benchmark usage. However, as a number of stakeholders have commented, this can create a number of unintended and misleading consequences for consumers when it interacts with different usage levels. PIAC recommends, that the AER also calculate and publish the DMO as an indicative c/kwh value to provide a more flexible basis for relating actual household usage to the AERs benchmark household usage
- It is unclear or how retailers will be required to formulate and advertise their 'default offer', in response to the AER specified DMO, and how the default and reference functions of the DMO will interact. The consultation paper on the proposed draft code[8] suggests that, contrary to ACCC recommendation 30, standing offers will not be abolished, but retained and 'capped' as the new 'default', with the AER setting this DMO and retailers being required to ensure their standing offers are at or below the level of the DMO, and that their other market offerings are expressed in relation to the AER DMO.

  PIAC recommends that the AER clarify the terminology that retailers will be required to use in relation to their default offers, ideally referring to their own 'default market offer'. Further, PIAC recommends that the AER refer to the DMO, when published, as the DMO reference price, ensuring a consistent framework of terminology and information.

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6 Victorian ESC Victorian Default Offer to apply from 1 July: draft advice

7 AER. Page 17 of default market offer draft determination

8 Commonwealth Department of Energy & Environment. Competition and Consumer (industry code- electricity retail) regulations 2019

- Requiring retailers to express market offers as a percentage discount in relation to the DMO (which is based upon a benchmarked usage level) and their own 'default offer', potentially results in misleading information to consumers where retailers utilise different combinations of fixed and usage-based tariffs[9].

  Accordingly, PIAC recommends that the AER publish the DMO as an indicative c/kwh, as well as an indicative annual dollar bill amount (based upon benchmark usage). Further PIAC recommend that retailers be required to advertise their other market offers (in addition to their own default offer), not as a percentage variance from the DMO, but as a dollar amount above or below the DMO. Percentages are not well understood as basis for relative consumer information, where consumers are able to clearly understand and choose between offers expressed as a relative bill saving or premium[10].

Continued engagement

PIAC would welcome the opportunity to continue to engage with the AER and other stakeholders to discuss these issues in more depth, and looks forward to providing further detail on the issues explored in this submission. For further engagement please contact Douglas McCloskey.

Yours sincerely,

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9 Etrog Consulting submission to Competition and Consumer (industry Code – Electricity Retail) regulations 2019. 12 March, 2019. p 2-4.

10 The current NSW government energy switch service utilises AER Energy Made Easy information to compare available offers to a consumers current offer as a $ saving or premium.