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DEFAULT MARKET OFFER PRICES: OPTIONS PAPER ON THE METHODOLOGY TO BE ADOPTED FOR THE 2022-23 DETERMINATION (AND SUBSEQUENT YEARS)

Dear Stephanie,

Energy Consumers Australia welcomes the opportunity to comment on the Australian Energy Regulator's Options Paper on the methodology to be adopted for the 2022-23 determination of the Default Market Offer (DMO). We believe the introduction of the DMO has impacted consumers positively however there are opportunities for improvement that should be considered when determining DMO 4.

Energy Consumers Australia is the independent, national voice for residential and small business energy consumers. Established by the Council of Australian Governments (COAG) Energy Council in 2015, our objective is to promote the long-term interests of energy consumers with respect to price, quality, reliability, safety, and security of supply.

In the past, ECA has supported a top-down approach to setting the DMO. For this review, we support a change in methodology provided it results in positive outcomes for consumers and amends some of the issues we have noted in the past around transparency of retail costs. We believe a bottom-up approach is most likely to achieve the desired outcomes for consumers. Any change should provide consumers with:

- Low prices without compromising competition,
- Transparency of retail costs and an amendment to information asymmetry,
- Assurance that retail margins are consistent with an efficient and effective competitive market structure,
- Price stability.

Background to the Default Market Offer

The DMO was introduced in 2019 in response to the Australian Competition and Consumer Commission's (ACCC) [Retail Electricity Pricing Inquiry](#). The inquiry found that retailers' standing offers had reached unjustifiably high prices and were not acting as an efficient default offer, causing financial harm to consumers. This was a key contributing factor to the low levels of trust in the energy market we were seeing in our [Energy Consumer Sentiment Surveys](#) (ECSS). To amend the issue, the ACCC recommended the AER introduce a default offer which would act as both a maximum price for retailers' standing offers and a reference price for consumers researching market offers.

The DMO is set annually by the Australian Energy Regulator (AER). Currently the methodology used to set it draws upon an indexation or "top-down" approach based on retailers' existing market and standing offers. This year, the AER is revising the methodology used to set the DMO for 2022-23 and subsequent years.



COVID-19 has highlighted the need for the DMO and affordable energy prices

The COVID-19 pandemic and associated public health restrictions have increased the pressure on consumers to pay for essential services such as energy. Energy debt continues to rise with 178,167 residential gas and electricity consumers in debt at the end of Q3 2020/21 compared to 161,117 the same time last year. The number of small business energy consumers in debt also increased over the year, from 17,049 to 22,626¹.

Our inaugural [Energy Consumer Behaviour Survey](#), released in October this year, also revealed how COVID-19 has changed energy usage patterns. Increased energy usage coupled with added debt further highlights the need to keep energy prices low.

- 55% of households that said they were under financial pressure stated that they were cooking at home more since the start of the COVID-19 pandemic.
- 45% are using heating and cooling more,
- 32% are working from home more, 33% are doing other activities at home more,
- 43% are more interested in reducing energy than before²

Many small businesses have been forced to shut for extended periods of time. At the same time, we have seen small businesses shift from standing offers to cheaper market offers at a slower rate than residential consumers. 16% of small businesses remain on standing offers compared to only 7% of households³.

COVID-19 has proven that it is not only those who are traditionally considered financially vulnerable that are in need of protection from high prices for essential services. Increased stress and anxiety associated with loss of work, long periods of lockdown and concerns about health can act as a barrier to engaging with the market. Those who had previously never been considered vulnerable have found themselves in need of assistance for the first time and the DMO plays a part in protecting these consumers from high energy bills.

The DMO has decreased standing and market offer prices

The ACCC identified a number of policy objectives to be met by the DMO. The DMO should reduce the unjustifiably high price of standing offers, allow retailers recover efficient costs and retain competition and incentives for consumers to engage in the market. We believe, in its first years, the DMO has contributed to these positive outcomes. Data from the St Vincent de Paul Tariff Tracker showed that standing offers declined immediately after the introduction of the DMO. Between July 2019 and December 2020, the average price of a standing offer decreased 15% in NSW, 16% in South-East Queensland and 18% in South Australia. We also saw a drop in the price of market offers, with the average market offer bill inclusive of conditional offers decreasing 7% in NSW, 11% in South-East Queensland and 12% in South Australia⁴.

¹ <https://www.aer.gov.au/retail-markets/performance-reporting/retail-energy-market-performance-update-for-quarter-3-2020-21>

² <https://ecss.energyconsumersaustralia.com.au/behaviour-survey-oct-2021/>

³ <https://www.accc.gov.au/system/files/Inquiry%20into%20the%20National%20Electricity%20Market%20-%20May%202021%20report%20v2.pdf>

⁴ https://www.vinnies.org.au/icms_docs/322898_2020_December_-_NEM_Report_-_Towards_a_new_normal.pdf



We are also seeing increased satisfaction in electricity prices. Since the introduction of the DMO, our ECSS results have seen a rise of 17% in the number of respondents reporting value for money. We saw the greatest increase in our most recent survey, released in June, where 70% of respondents were satisfied with the price of electricity, up 13% from the previous survey in December.

This increased satisfaction is also supported by greater confidence engaging in the retail market. Immediately after the introduction of the DMO, the ECSS reported a 7% increase in the number of respondents who felt there was enough easily understandable information in the market⁵.

Changes to the methodology should amend the current information asymmetry in the step-change framework

We have previously noted that there is a significant issue around transparency of retail prices. The indexation approach does not account for any productivity improvement in retail costs yet retailers can claim for increased costs via the step-change mechanism... This has resulted in an information asymmetry where stakeholders such as ourselves are left with little indication of true retail costs.

The ECSS has identified consumer trust in the energy market is low. While our most recent round revealed an increase in the number of respondents who believed the energy market is working in their long-term interest, over half remain neutral or negative (55%). Similarly, only 52% trust that energy companies do the right thing by their customers. These results prove a high degree of distrust in the energy market. Improving transparency of retail prices will help consumers remain confident that they are paying a just price for energy.

The DMO must be set at a level that enables competition and consumer choice

One of the policy objectives identified by the AER in their Options Paper is the need to retain competition in the electricity market. In a market with effective competition, there are incentives to truly innovate, while there is pressure for higher-cost and new entrant competitors to decrease costs in order to compete with the more efficient players.

An excessively low DMO may result in the loss of innovation in the market to the detriment of consumers. Reasonable retail margins have the capacity to allow smaller retailers to enter the market with new and innovative approaches to customer service, increasing choice for consumers. Very low retail margins could result in these smaller retailers eventually exiting the market, reducing overall competition. Retail margins which are set to accommodate inefficient retailers may entrench excess returns for retailers with average and below-average costs, at the expense of the large majority of consumers.

Despite a reduction in price-spread there is still reason to believe the current DMO level has allowed for continued competition through the variety of retailers in the electricity market. In NSW, 16 new retailers entered the market in the past two years and small retailers make up 20% of the market with deals targeted towards solar customers partly driving this.⁶ This comes at a time when price spread is at its lowest, with the St Vincent Tariff tracking Project finding that in NSW the difference between the highest and lowest priced market offer ranges from \$630-\$766, a reduction from the same time in 2018 where the difference ranged from \$850 to \$1040⁷. Similarly, the price-spread for electricity offers in SA was at its lowest since 2012.

⁵ <https://ecss.energyconsumersaustralia.com.au>

⁶ <https://www.ipart.nsw.gov.au/node/1682>

⁷ https://www.vinnies.org.au/page/Our_Impact/Incomes_Support_Cost_of_Living/Energy/NSW/



We believe the level of competition should be balanced in a way that both continues to allow new retailers to enter the market but doesn't overwhelm consumers with choice. In our submission to the 2018 ACCC Inquiry we noted the dangers of an excessive number of potential offers and retailers to choose from. Rather than an example of a highly competitive market, retailers were advertising numerous almost identical offers, leaving it difficult for consumers to identify important differences in offers as they attempted to navigate the market⁸.

In that submission, we argued that, given the material retail costs incurred in corporate overheads and to acquire and retain customers, we should not simplistically assume that more retailers and / or higher churn directly leads to better consumer outcomes.

There is an optimum healthy range for these measures, one indicator of which would be retail margins meeting retailers' cost of capital, without sustained excess returns, as a clear indication of effective competition. Another would be evidence that competitive forces maintain downward pressure on retail cost to serve.

By contrast, if these indicators are ignored, there is a risk of rapidly diminishing returns for consumers as churn and /or the number of retailers offering largely identical offers increases, with few marginal benefits to consumers, but very clear additional costs to ultimately be recovered in consumer bills.

Recent retail market conditions indicate that despite the introduction of the DMO and the reductions in prices for consumers, there is still room for competition – but it is an open question as to whether that level of competition is too high, too low or just right. We support further analysis directed towards finding a level that continues to reduce prices for consumers while simultaneously offering an optimal amount of choice and competition in the market. Transparency on retail costs and retail margins would be consistent with this objective.

The AER should seek to avoid price volatility for standing offers

The DMO should offer a relatively stable price from year to year for consumers. Events such as the COVID-19 pandemic have the potential to cause notable changes in retailers' costs as they deal with issues such as consumer debt or hardship programs as well as changes in usage patterns. However, it also emphasises the need to shield consumers from these changes as they too deal with turbulent times and may be unable to cope with dramatic increases in their energy bills.

Comments on each approach proposed by the AER:

With little analysis on how each of the three options will impact future DMO prices, ECA does not have a strong view on which the AER chooses to adopt. As discussed below, we see a number of potential positive and negative consequences to each, however we do see additional benefits to supporting a bottom-up approach. These relate to:

- A reluctance to perpetuate the information asymmetry problem (e.g. step-change claims)
- A reluctance to enshrine the 2018 levels of retail costs and margins.
- The inequity emerging between network regions as prices diverge.

⁸ <https://energyconsumersaustralia.com.au/wp-content/uploads/ACCC-Electricity-Supply-and-Pricing-Inquiry-Submission.pdf>



Ultimately, the correct approach is the one which delivers the best price for consumers and attempts to resolve the issues identified previously in this submission.

Option One - estimating retail costs and a DMO allowance

Option One clearly resolves the identified issue of information asymmetry by annually calculating the retailer price and an additional DMO allowance. We therefore support the approach on this basis.

We see further benefits to this option as it will ensure any increased productivity in retailer costs will be passed on to consumers. However, the source of this data must be robust, reliable and accurate. We support the use of the ACCC's Electricity Monitoring Inquiry reports as a robust source of data but raise questions about what will replace it when the inquiry concludes in 2025. With no mechanism currently in place to allow the AER to demand accurate costs from retailers, there is a risk that reductions in retail costs will not be reported in a bottom-up approach.

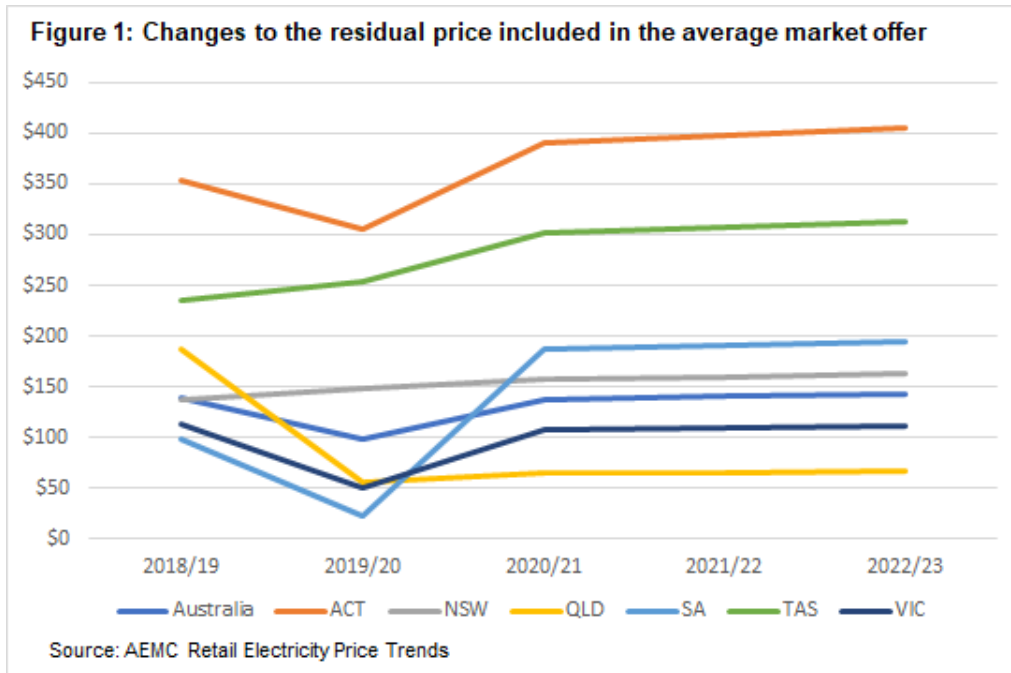
When calculating retail costs, we support an approach based off the most efficient retailer's costs, not an average or median. A price set above this level would see large incumbents earning excess returns from their lower costs while providing little incentive for less efficient retailers to become equally efficient. While this may force some retailers to exit the market, it would ultimately be in consumers' long-term interests as they are left with only the most efficient offers.

The AER has noted that one issue with a bottom-up approach is the potential for increased price volatility. We share this concern for this approach. As mentioned previously, we believe consumers should have access to a relatively stable price for energy. This year, COVID-19 poses an even greater risk to this. In Victoria, where a cost-stack method is used to set the VDO, consumer advocates have raised concerns of growth to the cost-stack. Victorian Council of Social Service (VCOSS) notes their particular concern around retailers claiming increased costs due to the temporary bad debt allowance⁹. The AER's determination should consider the potential for events such as COVID-19 to impact prices and the need to protect consumers from large changes.

Analysis of the VDO's cost-stack method suggests there is no clear indication that a bottom-up approach leads to increased retail margins. The below chart suggests the opposite may be true as Victoria's residual, the cost most impacted by the differing methodologies, is the lowest of all states apart from Queensland¹⁰. This gives us an indication that a bottom-up approach has historically measured retail costs lower than the indexation approach, resulting in lower offers for consumers.

⁹ <https://vcoss.org.au/policylibrary/2021/06/escs-victorian-default-offer-2022-approach-consultation-paper/>

¹⁰ Residential electricity price trends 2020 data | AEMC



As identified by the AER in its Options Paper, Option One also offers a solution to the wide variety in retail margins we see under the current approach. The AER’s analysis shows that retail margins can vary anywhere from just over 5% to over 37% depending on customer type and network region¹¹. We support setting a consistent DMO allowance which, while increasing the cost in some regions, would ensure that retail margins across all regions and customer types would remain consistent.

In Victoria, we have seen the VDO’s bottom-up approach continue to allow the entrance of new electricity brands with the entrance of two new retailers in the months following its introduction¹². This indicates that it is possible to determine a retail margin that is both consistent for all consumers while remaining high enough to allow for continued innovation and consumer choice in the market.

Option Two - continue indexation of the DMO residual

In previous submissions we have commended the pragmatism of the current approach and noted that overly complex processes can delay benefits and cheaper prices for consumers. We have also detailed in this submission how the DMO has already achieved positive outcomes for consumers and retained competition and choice in the market. The indexation approach is also less likely to result in price volatility as it is based off a singular figure calculated for the DMO 1 and is not as subject to changes in the market. Considering this, there is reason to argue that major changes to the indexation approach are not necessary.

¹¹ https://www.aer.gov.au/system/files/AER%20-%20Default%20Market%20Offer%20-%20Price%20determination%202022-23%20Options%20Paper%20-%2025%20October%202021_0.pdf

¹² <https://2020.aemc.gov.au/competition-review/jurisdiction/victoria#retail-market-structure>



However, there are a number of issues with the indexation approach in need of consideration. The initial residual calculated for DMO 1 is increasingly out of date and risks not reflecting current conditions. Further, the lack of incentives for retailers to report price reductions and the difficulty in validating reported price increases is a core issue that must be amended. One approach would be to apply a common productivity factor, similar to what the AER does when forecasting opex for distribution businesses as part of the reset process. However, we note that doing so would likely require extensive consultation which would go beyond what is necessary for the DMO. This method also does not address the variety in retail margins.

Option 3 - adjust residual to reflect changes in retail costs using ACCC data

The benefits of Option 2 also apply to Option 3 however we consider Option 3 as the better option of the two. It provides some improvement to the issue of information asymmetry while also addressing our issue that the retail margin in 2018 is increasingly out of date.

Using the ACCC data to calculate the difference between DMO 1 and DMO 4 will provide a more transparent annual adjustment as well as offering a more up-to-date figure. However potential increased retail costs due to COVID-19 are of particular concern to this approach. If the AER chooses not to calculate retail costs annually there is a possibility that increased retail costs this year will be carried out through the entire duration of the methodology. Without knowing the impact of COVID-19 on retail costs it is difficult to know how this methodology will affect consumer bills.

Other Considerations

- We support a five-year duration to the chosen approach on the basis it would provide a longer period of stability. We do raise concerns, however, around the sourcing of retail cost data at the conclusion of the ACCC's Inquiry. Any data must be robust and accurate, passing on any price reductions to consumers.
- We also support the AER moving away from using the 95th percentile to calculate wholesale costs. We believe it makes sense to use the 50th percentile as any under or over performance of assumed DMO costs should be balanced by an effective hedging strategy.

Conclusion

Once again, we thank the AER for the opportunity to comment on their review into the DMO. We believe the DMO is an important mechanism for protecting consumers from unaffordable energy prices and ensuring competition remains at an adequate level to provide consumer choice. Any change to the methodology used to set it should take these priorities into account. On balance, we believe a bottom-up approach is most likely to achieve the objectives we have set out in this submission.

If you have any questions about our comments in this submission, or require further detail, please contact Alice Gordon by email, alice.g@energyconsumersaustralia.com.au.

Yours sincerely,

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