Etrog Consulting

RESPONSE TO AER DRAFT DETERMINATION

Prepared for:

Queensland Council of Social Service (QCOSS)

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Default Market Offer 2020-21

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

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Introduction

This report has been prepared by Etrog Consulting Pty Ltd for the Queensland Council of Social Service (QCOSS). It responds to a draft determination on the Default Market Offer (DMO) for 2020-21, which was published by the AER on 10 February 2020.[1]

QCOSS is the state-wide peak body in Queensland representing the interests of individuals experiencing or at risk of experiencing poverty and disadvantage, and organisations working in the social and community services sector. QCOSS therefore focuses on the interests of residential customers, and examines the impacts of regulatory processes and decisions on those experiencing or at risk of experiencing poverty and disadvantage in particular.

Etrog Consulting previously provided a submission to the AER's position paper on the DMO for 2020-21.[2] This response to the AER's draft determination builds on our previous submission, and subsequent discussions with the AER, QCOSS, and other interested consumer organisations.

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.

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.

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1 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/retail-guidelines-reviews/retail-electricity-prices-review-determination-of-default-market-offer-prices-2020-21

2 See *Default Market Offer Price (2020-21)*, response to AER position paper, Etrog Consulting, 17 October 2019

In April 2019, the AER published its first DMO price determination, which set the DMO price for 1 July 2019 to 30 June 2020.[3] The AER refers to this as the DMO 1 determination. The AER is now in the process of determining DMO prices for 2020-21. The AER refers to this as the DMO 2 determination.

Policy objectives of the DMO

It is the view of Etrog Consulting that the policy objectives of DMO 1 may not have all been met in the manner in which the AER claims that they have been met.

The AER's own evidence that the DMO 1 price was well above efficient costs proves that DMO 1 does not meet the policy objective of preventing unjustifiably high standing offer prices.

The DMO should allow retailers to recover their efficient costs, as set out in the ACCC's REPI recommendation 30, and confirmed as still being applicable in the AER's August 2019 inquiry report. The DMO should not allow retailers to recover well above their efficient costs. Allowing retailers to recover well above their efficient costs would undermine the intent of DMO to protect customers who are on standing offers from paying unjustifiably high prices.

The AER must focus DMO 2 on assisting customers on the DMO, who for whatever reason are not moving to market offers, by ensuring that those customers do not have to pay prices that are significantly higher than market offers.

Given the path being followed by the AER not to set the DMO for 2020-21 at efficient costs in accord with 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 expect that DMO 2 will also fail to meet its objectives.

Our preferred methodology for calculating the DMO

The AER can and should identify efficient costs for all cost components, and base DMO 2 on efficient costs, in order to meet its policy objectives.

The AER should build a new cost stack for Network, Wholesale, Environmental and Retail costs and margins to establish DMO 2. This will establish efficient costs, as envisaged for the DMO based on recommendation 30 from the ACCC.

We encourage the AER to ensure that its final determination on the DMO for 2020-21 in regard to the Energex area (in which QCOSS is directly interested) incorporates the AER's final network charges for 2020-21, so that estimates do not have to be used.

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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

We see no justification for retail costs and margins to increase by CPI each year. All businesses should increase productivity. Productivity is critical for the long-term competitiveness and profitability of any business.[4] 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.[5] The need for increased productivity is clearly stronger in the competitive retailing sector than in the regulated network sector.

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 AER should not approve positive step changes until it has a process for applying productivity improvements to retailers' costs, and a process for identifying and analysing possible negative step changes in retailers' costs.

We suggest that for its final determination the AER should check its annual usage estimates across all network businesses.

Lack of consumer focus in the DMO process

There appears at the moment to be a lack of ownership of the full process of implementation of the DMO to ensure that customers benefit. The AER goes through a mechanical process where the AER convinces itself that customers benefit from the DMO. However, that is insufficient to meet customer-facing objectives.

It would be of value if the AER can show support for recommendation 38 in the ACCC's REPI final report regarding a grant scheme for consumer and community organisations to provide targeted support to assist vulnerable consumers to improve energy literacy. This could occur, for example, when the AER interacts with the various government departments who could fund such a scheme.

The AER's draft determination is opaque to consumers. It sets out a technical mechanism for retailers to implement the DMO. It is industry facing, not consumer facing. While industry facing instructions are important, consumer facing explanations are also required and are absent. It would be very difficult to explain to consumers how the DMO is calculated. We suggest that the AER should be focused not just on the mechanics of calculating the DMO, but also on how to make it understandable to customers.

Thoughts for the future

The current policy objectives are retailer focused, and we do not believe they are being met. We suggest that policy objectives from a consumer perspective are required in future.

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

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

Given the non-cost reflectivity of the “residual costs” in the DMO, and the opaqueness that results, we question whether the DMO is meeting policy objectives related to customers’ pricing expectations.

We accept that the DMO serves a purpose of providing a “marketing benchmark” at whatever level it is set, but we question whether this is sufficient to meet the policy objectives of pricing.

A holistic approach to policy reforms in relation to retail pricing of electricity is required, so that all consumers benefit, and none miss out.

The scope of customers that are covered by the various policy interventions should be reviewed, along with the customer-facing resources that may be required by community organisation to assist consumers, and vulnerable consumers in particular, to take advantage of the reforms that are happening.

We question whether the DMO is sufficiently sophisticated to keep up with network tariff reform, where more complex tariffs are becoming the norm on the basis that they will be more “cost reflective”.

For example, with the proposed introduction of demand tariffs, possibly as default tariffs for some customers, the current lack of DMO coverage for customers on demand tariffs has potential to become a significant lacuna in coming years if the DMO and reference prices are to be calculated in future years, beyond DMO 2.

1. INTRODUCTION

This report has been prepared by Etrog Consulting Pty Ltd for the Queensland Council of Social Service (QCOSS). It responds to a draft determination on the Default Market Offer (DMO) for 2020-21, which was published by the AER on 10 February 2020.[6]

The AER has requested that submissions to its draft determination should be received by 9 March 2020. This report has been developed in consultation with QCOSS with the understanding that QCOSS is intending to submit this report to the AER as a Companion Report to its own submission to the AER.

QCOSS is the state-wide peak body in Queensland representing the interests of individuals experiencing or at risk of experiencing poverty and disadvantage, and organisations working in the social and community services sector. QCOSS therefore focuses on the interests of residential customers, and examines the impacts of regulatory processes and decisions on those experiencing or at risk of experiencing poverty and disadvantage in particular.

Etrog Consulting previously provided a submission to the AER's position paper on the DMO for 2020-21.[7] This response to the AER's draft determination builds on our previous submission, and subsequent discussions with the AER, QCOSS, and other interested consumer organisations.

Etrog Consulting thanks the AER for taking time to explain to us aspects of its draft determination. We commend the AER for holding a webinar on 2 March 2020, in which QCOSS, Etrog Consulting and other consumer organisations participated. This was far preferable to the previous stakeholder forum that the AER held in Sydney on 26 November 2019, which did not allow for telephone or video conference facilities. According to the AER website, 35 stakeholders attended the in-person forum in Sydney, whereas around twice that number participated in the webinar. As well as the increased participation, advantages of the webinar over the in-person forum included lower costs for the AER and participants, and less time commitment in busy schedules (saving travel time and costs). All these also would have contributed to the higher level of participation.

The remainder of this report is structured as follows:

- Section 2 provides background to the AER's draft determination and this response.
- Section 3 discusses the policy objectives for the DMO, whether they have been achieved in DMO 1, and whether they will be achieved in DMO 2.
- Section 4 sets out our preferred methodology for calculating the DMO.
- Section 5 sets out our concern regarding lack of consumer focus in the DMO process.
- Section 6 discusses our thoughts for the future of the DMO.

6 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/retail-guidelines-reviews/retail-electricity-prices-review-determination-of-default-market-offer-prices-2020-21

7 See *Default Market Offer Price (2020-21)*, response to AER position paper, Etrog Consulting, 17 October 2019

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.

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.

In April 2019, the AER published its first DMO price determination, which set the DMO price for 1 July 2019 to 30 June 2020.[8] The AER refers to this as the DMO 1 determination. The AER is now in the process of determining DMO prices for 2020-21. The AER refers to this as the DMO 2 determination.

8 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

3. POLICY OBJECTIVES OF THE DMO

This report section discusses the policy objectives for the DMO, whether they have been achieved in DMO 1, and whether they will be achieved in DMO 2.

The AER sets out that the policy objectives of the DMO are to:

- Prevent retailers charging unjustifiably high standing offer prices;
- Allow retailers to recover their efficient costs of providing services, including a reasonable retail margin; and
- Not reduce incentives for competition, innovation and market participation by customers and retailers.

3.1. THE AER CLAIMED THAT DMO 1 MET THE POLICY OBJECTIVES OF THE DMO

In its position paper for 2020-21, the AER claimed that it was satisfied that the DMO 1 price balanced the policy objectives:[9]

- *Preventing unjustifiably high standing offer prices* – The AER claimed that the DMO 1 price achieved this outcome by being lower than nearly all retailers' standing offers, including those of the relevant local area retailer (LAR) in each distribution zone (that is, the retailer with the vast majority of standing offer customers).
- *Allowing retailers to recover their efficient costs* – The AER claimed that this outcome was achieved as the DMO 1 price was well above the median market offer (the AER's proxy for a retailer's assumed efficient costs) in each distribution zone, which the AER considered was a reasonable indication of retailer's efficient costs.
- *Not reducing incentives for innovation, investment, competition and market participation by customers and retailers* – The AER claimed that this outcome was achieved as the DMO 1 price was significantly higher than most market offers in each distribution zone, meaning customers on a DMO would have a strong incentive to shop around and switch.

3.2. ETROG CONSULTING COMMENTARY ON THE ACHIEVEMENT OR OTHERWISE OF POLICY OBJECTIVES IN DMO 1

It is the view of Etrog Consulting that the policy objectives of DMO 1 may not have all been met in the manner in which the AER claims that they have been met. Our response to the AER's position paper considered each of the policy objectives in turn.

3.2.1. Preventing unjustifiably high standing offer prices

As stated above, the AER claimed that the DMO 1 price achieved this outcome by being lower than nearly all retailers' standing offers, including those of the relevant local area retailer (LAR) in each distribution zone (that is, the retailer with the vast majority of standing offer customers).

9 See the AER's position paper on DMO 2, section 1.3, pages 11-12

Etrog Consulting contends that it is not convinced based on this evidence that the DMO 1 determination achieved the objective of *preventing unjustifiably high standing offer prices*. There are several reasons for this contention:

1. The achievement of lower standing offer prices in 2019-20 as against previous years is not an indicator that standing offer prices are not still unjustifiably high.
2. The AER has not defined what is an "unjustifiably high standing offer price", as against a "justifiably high standing offer price". Without such consideration, it is not possible to conclude whether the standing offer prices are or are not unjustifiably high.
3. The AER has stated, as quoted above: "*The DMO 1 price was well above the median market offer (the AER's proxy for a retailer's assumed efficient costs) in each distribution zone, which the AER considered was a reasonable indication of retailer's efficient costs*."

   We see no justification for the price of an essential service such as the supply of electricity to be well above efficient costs, and neither has the AER provided any such justification. Prices well above efficient costs are almost by definition unjustifiably high. There is thus an inherent contradiction in the Position Paper.

   The ACCC's Retail Electricity Pricing Inquiry (REPI) final report 'Restoring electricity affordability and Australia's competitive advantage' on which the DMO is based reported the following among other findings:[10]

   - The high tariffs associated with such standing offers are sometimes referred to as a 'loyalty tax' that is imposed on consumers who remain on, or end up on, a standing offer.
   - Average revenue for standing offer consumers was significantly higher than average revenue for market offer consumers.
   - The high price of standing offer bills outweighed the benefit of having access to a default offer with additional essential consumer protections.
   - The standing offer was no longer working as it was intended and was causing financial harm to consumers.

   The AER's finding that the DMO 1 price was well above efficient costs demonstrated that these findings of market failure by the ACCC remained unsolved with the implementation of DMO 1.

> The AER's own evidence that the DMO 1 price was well above efficient costs proves that DMO 1 does not meet the policy objective of preventing unjustifiably high standing offer prices.

10 See section 12 of the REPI report.

3.2.2. Allowing retailers to recover their efficient costs

As stated above, the AER claims that this outcome was achieved as the DMO 1 price was well above the median market offer (the AER's proxy for a retailer's assumed efficient costs) in each distribution zone, which the AER considered was a reasonable indication of retailer's efficient costs.

What this proves is that retailers have recovered well above efficient costs, rather than that they have recovered their efficient costs (and no more). This goes to the heart of the purpose of implementing the DMO.

Recommendation 30 of the ACCC's Retail Electricity Pricing Inquiry (REPI) final report 'Restoring electricity affordability and Australia's competitive advantage' on which the DMO is based 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.*

However, a later (December 2018) letter signed by Rod Sims as ACCC Chair then changed that, saying:

> *The ACCC does not consider that the AER should determine the efficient cost of supply in each jurisdiction or distribution zone, or that the AER should set the DMO at an 'efficient' level.*

This caused confusion in the calculation of DMO 1, which was reflected in several submissions to the AER's consultation process on the implementation of DMO 1.[11]

The ACCC's August 2019 report *Inquiry into the National Electricity Market* affirms[12] the original wording of recommendation 30, without any emendation. This should enable the AER to implement DMO 2 in accordance with recommendation 30, and not as re-interpreted in the implementation of DMO 1.

Customers on standing offers are largely customers who have never taken up a market offer in the years since retail competition was extended to all customers. These customers are showing considerable inertia and resistant to change. They have not been swayed by the marketing that entices them to switch to a market contract to save money. They may be price inelastic, or they may be in hardship and have some barrier to switching such as medical issues or lack of proficiency or lack of confidence in decision making that prohibits them from participating in the competitive market. Setting standing offer prices higher than the efficient cost of supply gives the incumbent retailer a pseudo-monopoly rent to benefit from these customers' inertia.

11 This was reflected in submissions to the draft determination of DMO 1 from Etrog Consulting, PIAC, and others.

12 See page 127

> The DMO should allow retailers to recover their efficient costs, as set out in the ACCC's REPI recommendation 30, and confirmed as still being applicable in the AER's August 2019 inquiry report. The DMO should not allow retailers to recover well above their efficient costs. Allowing retailers to recover well above their efficient costs would undermine the intent of DMO to protect customers who are on standing offers from paying unjustifiably high prices.

3.2.3. Not reducing incentives for innovation, investment, competition and market participation by customers and retailers

As stated above, the AER claims that the DMO 1 price achieved this outcome because the DMO 1 price was significantly higher than most market offers in each distribution zone, meaning customers on a DMO would have a strong incentive to shop around and switch.

We concur that the DMO has not reduced incentives for innovation, investment, competition and market participation by customers and retailers. Our evidence is the market activity, advertising and marketing, market entry, energy retailer comparison sites and actual engagement of customers with electricity retailers, all of which continue apace.

This market activity is largely centred on and involves customers already on market offers who are engaged in the market. Those are the customers who are continuing to shop around and switch retailer. However, those were not the customers that the DMO was intended to help. The DMO was intended to assist customers not engaged. DMO prices that are significantly higher than most market offers in each distribution zone do not assist customers on the DMO.

> The AER must focus DMO 2 on assisting customers on the DMO, who for whatever reason are not moving to market offers, by ensuring that those customers do not have to pay prices that are significantly higher than market offers.

3.3. The AER's Response in its Draft Determination to our Submission to the AER's Position Paper in Regard to Policy Objectives

In its draft determination, the AER recognised that we had:

- Noted that any price above efficient costs is 'unjustifiably high' by definition; and
- Supported the objective that a DMO allow the recovery of efficient retail costs including reasonable retail margins, and that prices above these are by definition 'unjustifiable'. On this basis, we considered that the DMO 1 price has not met the objective of preventing unjustifiably high prices.[13]

We have carefully read the draft determination and do not find that the AER has actually refuted either of these positions in regard to policy objectives, and thus has not justified its assertions that DMO 1 met its objectives.

13 See the AER's draft determination on DMO 2, section 3.3, pages 28-29

Instead, the AER has responded by quoting from a letter signed by Rod Sims as ACCC Chair, which was a submission to the DMO 1 process.

3.4. OUR CURRENT POSITION IN REGARD TO THE POLICY OBJECTIVES OF THE DMO

As we pointed out in our submission to the DMO 2 position paper, and as restated in section 3.3.2 above, letters from the ACCC Chair to the DMO 1 process caused confusion in the calculation of DMO 1, which was reflected in several submissions to the AER's consultation process on the implementation of DMO 1.[14]

Importantly, and also as restated in section 3.3.2 above, we further pointed out in our submission to the AER's DMO 2 position paper that the ACCC's August 2019 report *Inquiry into the National Electricity Market* affirms[15] the original wording of recommendation 30, without any emendation.

> The ACCC's most recent publication reaffirms recommendation 30: *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.* This publication is more recent than the letters from the ACCC Chair on which the AER is now relying.
>
> The ACCC's most recent publication that affirms recommendation 30 should enable the AER to implement DMO 2 in accordance with recommendation 30, and not as re-interpreted in the implementation of DMO 1.
>
> We find that the AER has not justified its assertions that DMO 1 met its objectives.
>
> Given the path being followed by the AER not to set the DMO for 2020-21 at efficient costs in accord with recommendation 30 from the ACCC, we expect that DMO 2 will also fail to meet its objectives.

14 This was reflected in submissions to the draft determination of DMO 1 from Etrog Consulting, PIAC, and others.

15 See page 127

4. OUR PREFERRED METHODOLOGY FOR CALCULATING THE DMO

4.1. IDENTIFY EFFICIENT COSTS FOR ALL COST COMPONENTS

Our preferred methodology for DMO 2 remains that which we set out in our submission to the DMO 2 position paper, for the reasons set out there.

> The AER can and should identify efficient costs for all cost components, and base DMO 2 on efficient costs, in order to meet its policy objectives.
>
> The AER should build a new cost stack for Network, Wholesale, Environmental and Retail costs and margins to establish DMO 2. 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.

Some of the issues with the AER's proposed methodology became clear when the AER answered questions towards the end of the webcast on 2 March 2020. Question 6 posed to the AER asked why the original REPI recommendation to base the DMO on efficient costs had been dropped. As part of its reply, the AER stated that the observed median market level served as reasonable proxy for efficient costs. The next question asked whether the AER was asking retailers to absorb additional costs associated with customers on Time of Use (TOU) tariffs. The AER responded that the DMO was "sufficiently high above retailer's costs" to accommodate any small extra cost associated with customers on TOU tariffs. This illustrates our difficulty with viewing the AER's methodology as a proxy for efficient costs.

A further issue with the AER's proposed approach is lack of transparency, and the somewhat arbitrary nature of the way that the "residual costs" from DMO 1 are carried forward into DMO 2. This can be seen in the discussion on page 42 of the draft determination in regard to differences between actual and forecast Ausgrid and SAPN network tariffs in 2019-20. Given the AER's methodology of using residual costs, it would be very difficult to explain to consumers how the DMO is calculated. As stated on page 42 of the draft determination: "We agree with Ausgrid that the difference between the original and revised calculations of network costs (due to the over-recovery) now becomes part of residual costs of the base cost stack." This further adds to the lack of transparency, and the difficulties that would arise if trying to explain the calculation of the DMO to customers, which are discussed further in section 5.2 below.

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

4.2.1. Our submission to the AER's position paper for DMO 2 on increasing retail costs and margins by CPI each year

We see no justification for retail costs and margins to increase by CPI each year, especially as the AER is also recognising step changes due to changed business requirements. All businesses should increase productivity. Productivity is critical for the long-term competitiveness and profitability of any business.[16] 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.[17] The need for increased productivity is clearly stronger in the competitive retailing sector than in the regulated network sector.

The AER's Position Paper stated: "*The DMO is also not aiming to drive efficiencies in the retail operating costs*." While that may be true when looking at the DMO in a vacuum, 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.

4.2.2. The AER's response in its draft determination

The AER recognised our viewpoint:

> *QCOSS disagrees with the use of CPI as an index forecasting retail costs from DMO 1 as they believe a different calculation than that used in DMO 1 should be used. QCOSS suggests businesses in a competitive market would increase their productivity which should reduce costs over time and suggests a lower rate of change than CPI should be applied.*[18]

However, we do not find anywhere in the draft determination where the AER actually addressed our important point that businesses should increase their productivity over time. The AER takes into account increased productivity in its network business determinations, but not in its DMO process, and has not addressed this anomaly.

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

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

18 See the AER's draft determination on DMO 2, section 3.4.4, page 45

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

We noted in our submission to the position paper on DMO 2 that QCOSS had stated in its December 2018 submission to the AER's Position Paper for DMO 1:

> *QCOSS' view is that customer acquisition and retention costs (CARC) should not be included in the DMO price. The DMO price is a cap on what is essentially the standing offer and is regarded as a safety net then CARC should not be included as there is no need to actively recruit and retain customer 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 who do not shop around do not get the benefit of the activities relating to these costs.*

We also are aware that the ACCC recommendation 30 explicitly stated that CARC should be included in the DMO calculation. That does not diminish the validity of QCOSS' argument, which deserves further consideration.

However, the AER has not apparently given any consideration at all this point in its draft determination. The term CARC meaning 'Customer acquisition and retention costs' appears in the list of 'Shortened forms' at the front of the DMO 2 draft determination, but appears to have merited no actual consideration at all in the draft determination.

4.4. Step changes

The AER's position paper for DMO 2 identified possible positive step changes relating to five-minute settlement, the Retailer Reliability Obligation and Consumer Data Right (CDR), and the AER's draft determination has left open the possibility that the final determination might accommodate step changes.[19] This position was also restated in the webinar on 2 March 2020.

We would have difficulty with a positive step change of this nature, for two reasons. One is that a positive step change needs to be considered in the context of overall productivity improvements that we would expect to see, as discussed in section 4.2 above. Allowing for positive step changes without allowing for productivity improvements seems to be unbalanced.

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

The AER's draft determination sets out that its criteria for our 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 DMO determination period;
- The change(s) will lead to a material overall change in the retail costs of an efficient and prudent retailer; and

19 See the AER's draft determination on DMO 2, section 3.4.4, pages 46-47

- The change in retail costs is not compensated in our forecast of other cost elements.[20]

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

The AER should not approve positive step changes until it has a process for applying productivity improvements to retailers' costs, and a process for identifying and analysing possible negative step changes in retailers' costs.

4.5. Opportunity to improve the clarity of how the handling of Time of Use (TOU) tariffs is explained

The handling of TOU tariffs for comparisons against the reference price in DMO 2 is in our opinion not well explained in the draft determination. We are grateful to the AER for taking the time to explain it to us.

Essentially, we find that the key data source that determines the algorithm for how TOU tariffs are handled for comparisons against the reference price in DMO 2 is the set of tables in Appendix F of the AER's draft determination that show energy usage in kWh for each hour of the day for each TOU network tariff and network business.[21]

A "worked example" in Appendix D brings the numbers from Appendix F but does not cross-reference Appendix F as the source, making it difficult to work out where those numbers in the worked example in Appendix D came from.

We suggest that for the final determination the AER should clarify further how the TOU tariffs are handled, with worked examples that contain enough information so that readers could be empowered to recreate the calculations themselves.

Further discussion of the way in which the DMO is presented from a consumer viewpoint can be found in section 5.2 below.

4.6. Annual usage estimates

For the Energex area, the AER proposes that:

- An average residential customer without controlled load consumes 4,600 kWh pa.
- An average residential customer with controlled load consumes 4,400 kWh pa on load that is not controlled, plus 1,900 kWh pa controlled load, for a total annual usage of 6,300 kWh pa.[22]

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20 See the AER's draft determination on DMO 2, section 3.4.4, page 46

21 See the AER's draft determination, pages 100-104

22 See the AER's draft determination, section 4, table 11, page 49

The sources of these numbers are said to be Network distribution businesses' 2019-20 annual pricing proposals, with controlled load assumptions based on the AER's 2017 Energy Consumption Benchmarks.

We checked the published documents in the Energex 2019-20 annual pricing proposal,[23] and did not find annual usage numbers. Perhaps they are in the Energex Tariff Approval Model 2019-20 which is listed as being confidential and not published, and therefore not accessible.

We checked the AER's 2017 Energy Consumption Benchmarks.[24] We found there in Table 3.6 that ACIL Allen had estimated the annual electricity consumption of a residential customer in the Energex area to be 4,706 kWh pa. Table 3.7 did not break down the Queensland figures by Energex vs Ergon Energy but showed that in Queensland overall:

- An average residential customer uses a total of 4,597 kWh pa
- An average residential customer without controlled load uses 4,648 kWh pa
- An average residential customer with controlled load uses 4,564 kWh pa

We also looked at Energy Queensland's submissions to the AER's network pricing determination for 2020-25 but did not find there any published data on average residential customer usage of electricity.

Our conclusion based on the data available to us in the sources that the AER says it used is that in total an average consumer with controlled load uses about the same amount of energy is total as an average consumer without controlled load. We therefore find it difficult to accept the AER's suggestion that in total an average Energex residential consumer without controlled load uses 4,600 kWh pa, while an average Energex residential consumer with controlled load uses an order of magnitude higher amount of 6,300 kWh pa.

We suggest that for its final determination the AER should check its annual usage estimates across all network businesses.

4.7. Network Prices

We note that the Energex final determination that will include network prices for 2020-21 is due "in April 2020", while the final determination on the DMO for 2020-21 is due to be published "30 April 2020"

We encourage the AER to ensure that its final determination on the DMO for 2020-21 in regard to the Energex area (in which QCOSS is directly interested) incorporates the AER's final network charges for 2020-21, so that estimates do not have to be used.

23 Available at https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/pricing-proposals-tariffs/energex-annual-pricing-2019-20

24 Available at https://www.aer.gov.au/retail-markets/retail-guidelines-reviews/electricity-and-gas-bill-benchmarks-for-residential-customers-2017

5. LACK OF CONSUMER FOCUS IN THE DMO PROCESS

As discussed in section 3 above, the AER sets out that the policy objectives of the DMO are to:

- Prevent retailers charging unjustifiably high standing offer prices;
- Allow retailers to recover their efficient costs of providing services, including a reasonable retail margin; and
- Not reduce incentives for competition, innovation and market participation by customers and retailers.

While these objectives are presented as they apply to retailers, the real purpose of the DMO is to protect customers. The focus of the DMO is on helping consumers, on the basis that up to now some consumers were not getting the outcomes they ought to expect from the market. This is what lay behind the ACCC's report, and the various federal government policy interventions that have followed.

Taking that into account, we would expect a consumer focus in the DMO process, but this seems to be lacking, as discussed in this report section, in regard to the AER's response to consumer-side input to the position paper, and consumer engagement processes more generally.

5.1. THE AER'S RESPONSE TO CONSUMER-SIDE INPUT TO ITS POSITION PAPER

We have highlighted above three areas where we felt that the AER did not respond in its draft determination to our previous submission on the AER's position paper. Specifically:

- We noted in section 3.3 above that we have carefully read the draft determination and do not find that the AER has actually refuted our positions in regard to policy objectives, and thus has not justified its assertions that DMO 1 met its objectives.
- We noted in section 4.2.2 above that we did not find anywhere in the draft determination where the AER actually addressed our important point that businesses should increase their productivity over time. The AER takes into account increased productivity in its network business determinations, but not in its DMO process, and has not addressed this anomaly.
- We noted in section 4.3 above that we had previously stated that QCOSS' position regarding customer acquisition and retention costs (CARC) deserved further consideration. However, the AER has not apparently given any consideration at all this point in its draft determination.

The draft determination makes it clear that there is a divide on important aspects of the process between retailers' submissions and consumer-side submissions.[25]

25 See the AER's draft determination, page 28

Appendix A to the draft determination lists the submissions and shows that there were 13 submissions in total. Of those, eight represented retailer interests, one was from a network business, and four were from consumer-side submissions. Thus, retailers made the majority of submissions, but that majority did not reflect the full spectrum of views on the position paper. References therefore to what "most submissions" said was really just references to what retailers said and therefore was a phrase that we would suggest should not be used because it was not reflective of the range of submissions.

Yet the draft determination states: "We note most submissions regard the DMO 1 price as having achieved our policy objectives."[26] This somehow vindicates the AER. What this really should have said was that retailers' submissions regard the DMO 1 price as having achieved the AER's policy objectives. Consumer-side submissions, notably QCOSS and PIAC, did not. They should not be left to feel marginalised in the AER's decision-making because they come outside the majority of (retailer) submissions.

We noted similar comments of the form: "Most stakeholders supported this approach", and "The majority of submissions supported residual costs increasing by CPI" in the webinar on 2 March 2020. Again these kinds of comments are in danger of making consumer-side stakeholders feel marginalised because the consumer-side does not have the resources to make as many submissions to the AER as compared to industry participants.

Rather than appearing to base its analysis on the views of "most submissions", the AER needs to demonstrate that it is analysing all submissions, and taking balanced views across the spectrum of stakeholders.

Further, QCOSS also raised the following matters in its cover letter submission to the AER's position paper:

- The DMO should be extended to cover all consumers rather than just those on standing offers.
- Community organisations should be resourced to provide support to ensure that the DMO and reference bill reforms will deliver tangible outcomes to those in most need.

The AER dismissed these: "These issues would require changes to the Regulations and are therefore out of scope of the role of the AER in determining the DMO price."

QCOSS of course knows that these matters are "out of scope" of what the AER considers its role to be, but that does not mean they should be dismissed by the AER without further discussion. Rather, they can be considered in future policy development. There appears at the moment to be a lack of ownership of the full process of implementation of the DMO to ensure that customers benefit. The AER goes through a mechanical process where the AER convinces itself that customers benefit from the DMO. However, that is insufficient to meet customer-facing objectives.

26 See the AER's draft determination, page 43

Of relevance here is recommendation 38 in the ACCC's REPI final report:

> *In addition to existing funding, the Australian Government and the relevant state or territory government should fund (to a value of $5 per household in each NEM region, or $43 million NEM-wide, per annum) a grant scheme for consumer and community organisations to provide targeted support to assist vulnerable consumers to improve energy literacy. This grant scheme should be modelled on the approach taken by the Queensland Council of Social Services in administering the Switched on Communities program. This targeted support will assist vulnerable consumers to participate in the retail electricity market and choose an offer that suits their circumstances.*

It would be of value if the AER can show support for recommendation 38 in the ACCC's REPI final report regarding a grant scheme for consumer and community organisations to provide targeted support to assist vulnerable consumers to improve energy literacy. This could occur, for example, when the AER interacts with the various government departments who could fund such a scheme.

5.2. CONSUMER ENGAGEMENT PROCESSES

There have been innovations in consumer engagements over the last few years. These can be seen in the network businesses' approaches to consumer engagement, where network businesses have been consulting and collaborating with actual customers in deliberative forums, a People's Panel and other such forums to ensure that the businesses' regulatory proposals really are in the long-term interests of consumers.

However, the AER's own processes seem to lag in implementing such innovations, and need to catch up.

We are seeing the AER's implementation of the DMO generally as an industry rather than consumer focused process. It would fail if it were analysed the way network business' consumer engagement activities are analysed these days. To our knowledge, the AER has not run focus groups with consumers, nor deliberative forums, or similar engagements. Those and other activities are things we have now come to expect from network businesses, and we question when the AER is going to move in that direction.

The AER's draft determination is opaque to consumers. It sets out a technical mechanism for retailers to implement the DMO. It is industry facing, not consumer facing. While industry facing instructions are important, consumer facing explanations are also required and are absent. It would be very difficult to explain to consumers how the DMO is calculated. We suggest that the AER should be focused not just on the mechanics of calculating the DMO, but also on how to make it understandable to customers.

6. THOUGHTS FOR THE FUTURE

In this section we give some thought to how the policy objectives of the DMO may be addressed more effectively in the future, from a consumer perspective.

We write this section in the hope that it will not be dismissed by the AER as being “out of scope”, but rather will be taken forward by the AER, in conjunction with the ACCC and the federal government, to achieve better outcomes in the long-term interests of consumers in future.

6.1. POLICY OBJECTIVES

As discussed above, the current policy objectives are retailer focused, and we do not believe they are being met. We suggest that policy objectives from a consumer perspective are required in future.

Given the non-cost reflectivity of the “residual costs” in the DMO, and the opaqueness that results, we question whether the DMO is meeting policy objectives related to customers’ pricing expectations.

We accept that the DMO serves a purpose of providing a “marketing benchmark” at whatever level it is set, but we question whether this is sufficient to meet the policy objectives of pricing.

6.2. A HOLISTIC APPROACH

Various policy interventions have been introduced, but each is apparently considered in its own silo. For example, new regulations on conditional discounts and fees will come into effect from 1 July 2020.[27]

Consideration should be given to how this affects the DMO. More generally a holistic approach to policy reforms in relation to retail pricing of electricity is required, so that all consumers benefit, and none miss out.

The new regulations on conditional discounts and fees will come into effect from 1 July 2020 will only affect contracts signed from that date. Consideration needs to be given to whether customers on existing contracts are missing out on market reform.

As noted in section 5.1 above, the scope of customers that are covered by the various policy interventions should be reviewed, along with the customer-facing resources that may be required by community organisation to assist consumers, and vulnerable consumers in particular, to take advantage of the reforms that are happening.

6.3. ENERGY TARIFF REFORM

We question whether the DMO is sufficiently sophisticated to keep up with network tariff reform, where more complex tariffs are becoming the norm on the basis that they will be more “cost reflective”.

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27 See for example https://www.aemc.gov.au/news-centre/media-releases/new-rules-will-protect-consumers-large-energy-bill-penalties for more information

For example, with the proposed introduction of demand tariffs, possibly as default tariffs for some customers, the current lack of DMO coverage for customers on demand tariffs has potential to become a significant lacuna in coming years if the DMO and reference prices are to be calculated in future years, beyond DMO 2.

6.4. CUSTOMER USAGE PROFILES

While an improvement in the application of a daily profile to TOU tariffs is welcomed, it is still simplistic. The assumption that a typical consumer uses a given amount of energy in kWh in any particular hour as shown in Appendix F to the draft determination does not take into account that the actual form of TOU tariff offered by the customer's retailer will affect the customer's usage profile. A customer with say a peak rate applying 3pm to 9pm should have a different load shape as compared for example to a customer with peak rate applying 7am to 10pm. The differential in price between peak and off-peak rates (and shoulder rates where applicable) will also affect consumer behaviour. Larger differentials should create larger behaviour changes, based on elasticity of demand considerations.

Whether or not a customer has solar PV (and possibly storage) will also affect usage behaviour. Within the solar PV customer segment, we would also expect differences in load shapes between customers getting high legacy feed-in tariff for exports (where those still apply), as against customers with newer installations who are getting a lower feed-in tariff for exports.

Some of these issues are also relevant to the single load profile applied for customers on flat rate tariffs.

These issues may merit further attention if the DMO and reference prices are to be calculated in future years, beyond DMO 2.