Adrian Merrick
Chief Executive Officer
Energy Locals

6 April 2023

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

AER Ref: 64687

Dear Ms Jolly,

Re: Default market offer prices 2023 – 24: Draft determination

Energy Locals Pty Ltd (ACN 606 408 879) welcomes the opportunity to provide a submission in response to the Australian Energy Regulator's (**AER**) draft determination for retail electricity default market offer (**DMO**) prices applying from 1 July 2023 to 30 June 2024.

General comments

Overall, Energy Locals agrees with the draft DMO determination and is grateful that the historic methodology has been applied consistently. Consistency of process is key to building trust and demonstrating transparency. It enables the market participants to plan with confidence.

We also welcome that the Draft DMO determination has clearly called out the major challenges facing retailers in the last 12 months, specifically:

- increased funding challenges due to rapid price increases and margin calls; and
- reduced hedging options due to clearing house withdrawals.

Regardless, Energy Locals acknowledges the pain and financial hardship that the unreasonably high wholesale prices are causing customers and believes that the market cannot continue in its current form. We will elaborate on this point later in this submission.

Wholesale cost allowance

Energy Locals believes that the allowances are a fair reflection of the hedging costs retailers have faced but note that many retailers will not have finished hedging for FY24 yet. We believe that the allowance should be updated for additional data covering the period between issuing the draft DMO and the final DMO.

We would like to draw attention to the reduced liquidity available to retailers following the withdrawal of clearers from the market. It is now more difficult and expensive for small retailers to access the ASX futures market. This is driving retailers to the over-the-counter market where hedges are traded at a margin to the ASX.

Energy Locals is of the opinion that the draft DMO determination does not fully reflect the cost of market participant funding obligations in its methodology. Retailers are forced to maintain sizeable cash buffers to cater for AEMO margin calls and prudential requirements, which have increased significantly over the past 12 months. In addition, the interest rate increases and higher perceived risk related to the sector is increasing capital costs for retailers.

We would also like to emphasise that the 2–3-year hedging horizon is putting small, fast-growing retailers at a disadvantage. Our company has approximately tripled its direct customer base between Dec 2020 and Dec 2022 and continues to grow. This makes it virtually impossible to reliably forecast the level of hedges needed over a longer period. In addition, a longer-dated hedge exposes the company to unviable prudential costs due to the increased mark-to-market exposure.

We believe that the 2–3-year time horizon limits opportunities for new retailers and hence stifles competition from innovative new entrants to the market.

Retail allowance

The draft DMO sets out the glidepath of the retail allowance to 10% for retail customers and 15% for small business customers.

The draft determination notes that this reflects an increase in *nominal* terms driven by the higher costs in other components of the cost stack.

We would like to emphasise again that this should appreciate the increased costs (e.g., bad debts and working capital costs) which are directly linked to the overall increase in a retailer's cost base. In addition, salaries and wages are a major part of a retailer's operating costs and current inflation levels and interest rates have a direct impact on that cost.

We also note that the AER is basing its bad debt allowances on data from the three large retailers that publish data publicly. We would like to point out that additional data is available from unlisted retailers who are required to lodge their financial statements with ASIC.

Retail Reliability Obligation (RRO)

Energy Locals is of the firm opinion that the RRO in its current form is flawed. It requires retailers to hedge a year in advance but does not require the purchaser of the hedge to hold it to maturity. We therefore question the efficacy of the obligation in its current form versus the problem it is trying to solve.

The current RRO means that vertically integrated businesses, who have the largest market share in South Australia, can simply 'sell' a paper contract between departments with no money changing hands, while small retailers need to buy on market. Due to the timeframes set out in the RRO, traders are aware of this requirement and can push the prices of the contract up, knowing that retailers have no choice but to purchase the contracts to comply with the rules. This has the impact of driving up prices for customers and favouring integrated retailers, without addressing the actual underlying problem.

DMO methodology

Energy Locals is comfortable with the overall methodology for deriving the DMO. It provides a foundation that enables retailers to plan effectively, giving them a predictable basis for forecasting prices.

However, we do support a tracking mechanism for systemic issues, which have the greatest contribution to poor outcomes for consumers.

Overall, Energy Locals believes that the DMO follows a sound methodology that monitors a flawed market. Currently, market outages of part of a generator's plant can actually increase the generator's profits by driving up market prices to the detriment of consumers. The generator is rewarded for delivering less energy at significantly higher prices, both of which are entirely the opposite of the outcomes that customers hope for.

International examples, such as the UK 'windfall tax', have shown that it's possible to redistribute excess profits given the fact that the short run marginal cost of generation does not always increase to the same extent as market prices. In the UK, this has been done without impacting the overall competitiveness of the market.

We also favour the investigation of mechanisms that can better orientate generators towards the outcomes that customers seek, which are reliable energy supply at affordable prices. The ETEF scheme, which was used in NSW in the early 2000s, created a pool that generators contributed to when market prices accelerated significantly faster than underlying costs, and to which retailers contributed when market prices sank significantly below the underlying costs in tariffs. This kept the wholesale market in balance while encouraging investment in the State. Such a mechanism would require adjustments to fit today's market, but we believe this would be possible – despite it's likely unpopularity with some traditional market participants.

Other ways to help customers

Smart meters – smart meters in DMO States can cost up to three times what consumers in Victoria pay. This cost is recouped from customers. We wonder whether price caps are required on these prices in the same way that the AER reviews the metering costs of network companies that serve Victorian customers.

Simplification of network tariffs – network tariffs are increasingly becoming more complex and impossible to understand by the end consumer. Redesigning the system to provide simple price signals will help to focus the market. We strongly support the opportunity to move hardship customers onto a simple and discounted network tariff. Such an initiative may form part of the AER's Game Changer work.

Focus on hardship customers – exempting hardship customers from small scale environmental certificates would make energy more affordable for those customers who most need it. The impact would be a minor increase in the payback period for solar PV but would not impact their overall competitiveness in a rising market.

Simplification of retail rules and regulations – would flow through to increased retail efficiency and underpin a reduction in the retail overheads.

We would be happy to discuss any aspect of this submission with the AER team should that be useful.

Yours sincerely

Adrian Merrick
Chief Executive Officer
Energy Locals