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19 November 2020

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

Submitted electronically: DMO@aer.gov.au

Dear Mr Feather,

Re: Position paper - Default Market Offer 2021/22

Red Energy and Lumo Energy (Red and Lumo) welcome the opportunity to make this submission to the Australian Energy Regulator's (the AER's) position paper for the Default Market Offer (DMO) to apply from 1 July 2021.

We broadly support the AER's decision to employ the same method to setting the third DMO. A consistent methodology reassures retailers that they will be able to recover reasonable costs over time, thereby supporting competition.

However, we believe the AER could achieve a more appropriate balance of the competing objectives of the DMO if it accounts for specific issues, namely the cost of servicing consumers on flexible tariffs, and by accounting for the incremental contribution of COVID-19 to retailers' bad and doubtful debt provisions. This would consolidate the progress made towards creating more competitive retail markets, which is apparent in key indicators such as the continuing decline in the proportion of consumers on standing offers.

The AER concludes that it has struck the right balance, referring to the difference between the DMO and median market offers across different networks and tariffs structures. In our view, this warrants further analysis. This headroom is tighter in some jurisdictions and specific networks and for some tariff types when all network and metering costs are taken into account. Furthermore, the AER acknowledges that the calculation of the median is influenced by the aggressive offers by very small retailers and it isn't clear that these will be sustainable over the longer term.

This is a significant issue for retailers even though the number of customers currently on both flat and Time of Use (TOU) standing offers is small. The DMO functions as a price cap and the headroom between it and the majority of flexible rate market offers is declining - and will continue to decline - as more consumers receive smart meters and are assigned to flexible network tariffs as a consequence. Furthermore, the DMO is a point of reference in advertising and communications (including price change letters) for all market offers.

Therefore, we encourage the AER to continue to analyse how network and metering costs differ under different tariff structures. We would welcome the opportunity to discuss this further and to provide confidential cost data and additional information to support the AER's analysis. We acknowledge the AER's reluctance to make ex post adjustments to the DMO - to reflect more recent information about network and metering costs, for example - as the subsequent year's DMO would not reflect costs during this period. This is a reasonable position but does highlight the importance of a conservative approach to setting each DMO. Otherwise, retailers may not market their most competitive offers to specific consumer segments or encourage existing customers to a smart meter. This undermines one of the key policy objectives of the DMO.

Adjustments to the retail component

The timing of this determination coincides with a period during which retailers are managing the impact of the COVID-19 pandemic by maintaining supply to their customers, increasing customer engagement with offers of financial support.

The expected impact of COVID-19 on retail operating costs - and more specifically, the impact on retailers' bad and doubtful debt provision - is a cost that we believe should be explicitly accounted for in the next DMO. As the position paper notes, the AER can do this through the retail cost step change framework. The incremental contribution to higher debt provisioning was unforeseen and this cost has been exacerbated by regulatory restrictions on normal industry credit management processes. It is sustained and material, and cannot be avoided through improved operational efficiencies; its impact was not factored into the AER's initial view of the retail component of the DMO.

Red and Lumo acknowledge their role in continuing to provide an essential service during the COVID-19 pandemic to customers who have suffered temporary financial stress. However, it is also essential that retailers are able to recover the costs incurred in maintaining that supply and in extending substantial credit to customers with no guarantee of repayment. Therefore, the AER's task is to understand both the magnitude of this cost and the period over which it is occurring, given the next DMO will apply from 1 July 2021. This cost is material and retailers will continue to bear it into the next DMO period.

This issue was addressed in detail in a presentation by our Chief Financial Officer, Martin Exelby, to the AER's recent stakeholder forum on the DMO (and we refer to that presentation as further input to the AER's consultation). Retailers' ability to manage their exposure to bad and doubtful debts has been reduced through policymakers and regulators' actions and public statements about how they should respond to COVID-19. While there has not been an explicit prohibition on disconnections for non-payment, retailers have changed their practices to support their customers and in response to the different iterations of the AER's Statements of Expectations. For example, we have removed mention of disconnections from customer communications and closed account aged debt has not been referred to third party collection agencies.

While Red and Lumo utilise disconnection for non-payment as a last resort, some customers have deprioritised energy payments with the consequence for non-payment and likelihood of disconnection substantially reduced. The effect of all of these actions has been to restrict retailers' ability to manage customer debt, encourage engagement and entry into payment arrangements if required. This shift in the traditional balance of power between consumers and retailers has resulted in increases in aged debt balances, higher collection risk and provisioning for bad debt.

The issue for the AER then becomes how to account for COVID-19's impact in a forward looking determination. Retailers have already made forward provisions for the potential impact (in terms of the likely change in bad and doubtful debt as a proportion of EBITDA compared to business as usual, for example) in line with relevant accounting standards and prudent business management. We refer to provision B5.5.2 in Australian Accounting Standard AASB 9:

> *Lifetime expected credit losses are generally expected to be recognised before a financial instrument becomes past due. Typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example, a modification or restructuring) are observed. Consequently when reasonable and supportable information that is more forward-looking than past due information is available without undue cost or effort, it must be used to assess changes in credit risk.*[1]

Therefore, the AER can draw on retailers' estimates of the potential COVID-19 impact on bad debts now and as 1 July 2021 approaches. These provisions are based on various assumptions about factors such as unemployment rates, measures to address the spread of COVID-19 (i.e. effects of lockdowns and their impact on economic activity), and the timing of the withdrawal of economic support and other stimulus measures.

At the present time, the published accounts and investor presentations for AGL[2] and Origin[3] reveal the movement year on year to end June 2020 in expected credit losses of between $20m and $40m respectively due to provisioning for the effects of COVID-19. Red and Lumo's increase in expected credit losses has also now been published within the Snowy Hydro accounts and shows an increase of $11.8m to $40.4 million for the year ended June 2020, including forward provisioning for the effects of COVID-19[4]. These are not immaterial increases

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[1] Compiled Australian Accounting Standards, AASB 9: Financial Instruments, page 71. Available: https://www.aasb.gov.au/Pronouncements/Current-standards.aspx

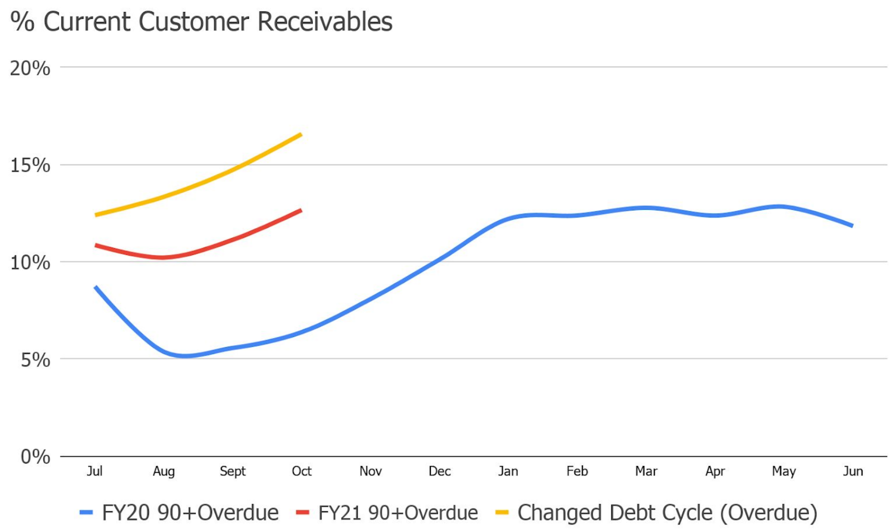
[2] AGL Energy Annual Report, Available: https://www.agl.com.au/-/media/aglmedia/documents/about-agl/investors/results-centre/2020/agl-fy20-full-year-results-presentation-180820.pdf

[3] Origin Energy Annual Report, Available: https://www.originenergy.com.au/content/dam/origin/about/investors-media/documents/origin_annual_report_fy2020.pdf

[4] Snowy Hydro Annual Report, Available: https://www.snowyhydro.com.au/wp-content/uploads/2020/09/Annual-report-1920.pdf

in retail costs and reflect independent audited assessments of expected bad debts for the next twelve months as at June 2020.

The following chart illustrates the change in the volume of our longer term customer debt over the last 12 months.



We note, however, that this coincided with record levels of household discretionary spending, as illustrated by independent economic analysis by Illion and AlphaBeta (part of Accenture).[5] Provisions for bad and doubtful debts at the end of June 2020 were made in an environment of exceptional Government stimulus spending, through the Jobkeeper and the enhanced Jobseeker arrangements. These will fall away, as will other emergency measures, such as freezes on loan repayments and rental payments. Retailers have not yet realised all of the increase in bad and doubtful debt resulting from COVID-19 and we anticipate these costs will continue to mount in 2021.

We recommend that the AER consult with a representative sample of retailers to better understand the magnitude and assumptions behind their expected adjustment, with a view to including a reasonable increased provision for bad debts in the next DMO. This would generate a forward estimate and proxy for future actual costs for the period commencing 1 July 2021. Red and Lumo would welcome the opportunity to be included in this exercise.

Productivity factor adjustment

The position paper refers to observations from some consumer groups that retailers as a collective are likely to have achieved significant efficiency gains in recent years and as a result, the AER is considering the merits of a productivity adjustment for the next DMO.

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[5] See: https://www.alphabeta.com/illiontracking

An adjustment of this kind is more appropriate in the context of a distribution network determination. It complements other aspects of an incentive regulation framework that encourage regulated monopolies to pursue efficiencies that consumers can then share. We also see practical problems in applying a productivity adjustment to an indexed regulated price that was not based on estimates of efficient costs. It is not clear how the AER could estimate efficiency gains in the context of an indexed determination.

This suggestion is at odds with the overarching policy objectives of the DMO, namely, to provide a fallback option for consumers who cannot or choose not to participate in a competitive market, while encouraging retailers to offer more compelling market offers. Consumers will always be better off when they can participate in competitive markets with confidence by accessing more competitive offers. We believe the AER should adopt a relative conservative approach to balancing the policy objectives, particularly in the context of the current pandemic.

Neither do we agree that reported estimates by the two largest retailers is compelling evidence that the industry as a whole has achieved substantial efficiency gains, particularly where retailers use different assumptions to calculate cost to serve (and retail operating costs more generally). If anything, the operational impact of COVID-19 - on work practices and established processes and procedures, for example - has added to retailers' costs or reversed any recent efficiency gains. Examples of this impact include:

- Management of arrangements for employees to work from home and the associated loss of some efficiencies.
- Additional resourcing required to support customers during the pandemic - this includes increased call volumes and handling times, changes to websites and other customer communications to advise customers of the support available to them
- Changes to established processes resulting from policymakers' and regulators' statements about how retailers should manage payment difficulties during the pandemic. This includes additional safeguards around reminder and disconnection processes to comply with the different iterations of the Statement of Expectations.

We expect most retailers could provide compelling evidence - both qualitative and quantitative - of how their response to the pandemic has added to their cost to serve.

Other matters

We support the AER's analysis of mechanisms for differentiating between the load profile of (aggregated) small business and residential consumers as this will provide more accurate estimates of wholesales costs for each consumer segment. However, the AER should be mindful of how the pandemic has impacted consumption patterns across all consumer groups.

Similarly, we support the AER's further analysis of usage profiles to develop more accurate measures (for the purposes of comparing TOU offers with the DMO). Our preference is for a relatively simple model, namely, the AER's Option 1 (a single day and with usage specified at 30 minute intervals). This would be the easiest option to implement, while 30 minute intervals are consistent with some of the more granular network tariff structures. Once again, however, the AER must be mindful of how the pandemic has disrupted consumption patterns over the past 12 months.

About Red and Lumo

We are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria, South Australia, New South Wales, Queensland and the ACT to over 1.1 million customers.

Red and Lumo thank the AER for the opportunity to comment on its position paper. As noted, we would welcome the ability to discuss the submission, including the impact of COVID-19. Please call Geoff Hargreaves, Regulatory Manager on 0438 671 750 to organise this discussion or to discuss aspects of this submission.

Yours sincerely

Ramy Soussou
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