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17 March 2022

Ms Stephanie Jolly
General Manager, Market Performance
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Submitted electronically: DMO@aer.gov.au

Dear Ms Jolly,

Re: Default Market Offer - draft determination for 2022/23

Red Energy and Lumo Energy (Red and Lumo) welcome the opportunity to respond to the Australian Energy Regulator's (AER's) draft determination for the Default Market Offer (DMO) to apply from 1 July 2022.

Red and Lumo have consistently supported the DMO as a safety net for standing offer consumers and as a reference price that helps electricity consumers participate in the competitive market with confidence. At the same time, the DMO is also intended to promote competition and innovation as the mechanism for achieving good consumer outcomes. Our support of the DMO is contingent on the AER striking the appropriate balance between these policy objectives.

We have also consistently argued that market offers provide a better combination of price and service standards and that very few, if any, consumers should be on the DMO. Consumers in aggregate will derive the greatest benefit from a competitive market that rewards innovation and efficiency gains, rather than a regulated DMO that starts to resemble an estimation of reasonable or efficient operating costs.

Therefore, we have strong concerns that the AER's draft determination suggests it is placing greater emphasis on the DMO policy objective to protect consumers from excessively high standing offer prices. The AER has not struck the right balance between the policy objectives. In our view, this undermines competition by creating uncertainty about the returns to retail operations. This will likely have an unintended consequence with some retailers reconsidering their competitive strategies and may scale back their activities in some DMO network areas or avoid specific consumer segments.

Furthermore, we note the shift in methodology for the calculation of retail operating costs and the AER calculating an allowable and acceptable margin that is consistent across all DMO network areas. In our view, this creates the impression that the DMO is similar to the Victorian Default Offer, namely, an estimation of efficient retail costs. Unlike the Victorian Default Offer, the DMO is a price cap and is a safety net for those who can not engage in the market. Some consumer advocates incorrectly view the DMO as a viable product for many consumers, but this has never been its sole or primary policy objective. When combined with the proposal by the Department of Industry, Science, Energy and Resources (DISER) for retailers to refer to the DMO as a 'price set by government', we expect many consumers will select the DMO even though a market offer will provide a better combination of price and service quality.

As mentioned in our submission to DMO4 and previously, the potential repositioning of the DMO is also contrary to numerous regulatory measures that seek to encourage market participation. These range from prescribing the DMO as a reference price with associated advertising requirements, prescribed notifications (in advance of a price change or expiry of a benefit), the Retail Pricing Information Guideline, forthcoming changes to Energy Made Easy, the recent switching rules, and the extension of the Consumer Data Right to the energy sector.

The draft determination continues the trend of previous determinations in rendering the DMO into a form of *de facto* price control. That is not consistent with its policy objective, and will ultimately harm consumers through lower competition and investment, and ultimately increased prices.

Use of ACCC dataset for calculation of retail costs

We do not support the AER's decision to shift to a cost plus methodology for the retail component for DMO4. The AER's decision is based on the availability of retailers' responses to data requests by the Australian Competition and Consumer Commission (ACCC). As the AER acknowledges, this is a proxy estimate based on data that is collected for market monitoring, rather than explicitly for the determination of regulated retail prices. It doesn't rely on common definitions or cost allocation methodologies across retailers and is also a backward looking estimate, whereas the DMO is a regulated maximum price for the coming 12 months. Furthermore, the ACCC does not request information from the smallest retailers, so the AER is relying on aggregated, adjusted and incomplete information. This means it cannot fully and accurately assess how DMO decisions will affect retail operations across the industry.

The AER claims that using the ACCC dataset is preferable to alternatives such as the reported results of listed retailers or benchmarks from historic regulatory decisions. This may be the case but we are not convinced it will produce better outcomes than the indexation approach that it used for the first three DMOs, particularly as each of the AER, ACCC and DISER have concluded that the DMO has met its policy objectives. The AER should consider developing a more consistent, comprehensive and fit for purpose data request in conjunction with the ACCC if it believes a cost plus model will better achieve DMO objectives.

The AER will be aware of the ACCC's specific issues but we note the latter's various comments about the dataset in its most recent report to the Treasurer on prices, profits and margins in the supply of electricity in the National Electricity Market in November 2021.[1] It refers to challenges in identifying precise costs for retailers operating across numerous regions (including non DMO regions) and retailers who service residential and small business consumers. Below are two examples from the report, but there are numerous other qualifying comments in the November 2021 report.

> *'For retailers operating in multiple regions, many costs related to servicing customers are not region specific but spread over the whole customer base. The*

[1] Australian Competition and Consumer Commission (2021), *Inquiry into the National Electricity Market, November 2021 Report*

allocation decisions made to apportion costs between regions can materially affect the reporting of retail margin at the region level. Retail margin (EBITDA) is therefore a more reliable metric at a whole of business level. For some retailers this means NEM-wide, but some operate only in certain regions.' (page 32)

'Some retailers did not record certain categories of costs on a region-by-region basis or by customer type, and therefore applied allocation methodologies to estimate costs for the categories. For example, some of the difficulty in compiling a small business customer dataset using retailers' own information stems from some retailers not recording costs separately for residential and small business customers. Instead, these retailers record information for a combined group, commonly referred to as 'mass market'. In such cases retailers were asked to apply an allocation methodology between residential and small business customers when reporting data to the ACCC.' (page 47)

In light of these comments, we do not share the AER's confidence in its reliability and suitability, or as a basis for drawing precise conclusions about returns to retail operations across DMO network areas. Rather, they should be viewed as upper bound estimates of realised retail margin at best, particularly for smaller retailers. The impact of any margin erosion or a failure to adequately account for all elements of retail operating costs will fall most heavily on smaller retailers and detrimentally impact retail competition.

We note the ACCC draws attention to differences in operating costs between the Tier 1 retailers and smaller retailers. As a general point, the corporate structure of each retailer drives their cost base and the structure of the Tier 1s, who tend to have a greater reliance on shared services across their broader operations, can be vastly different from a Tier 2 or 3 retailer. For example, retailers differ in how they allocate costs when they operate across regions and/or supply multiple consumer segments, including commercial and industrial, SME and residential, as the ACCC acknowledges. The allocation of corporate overheads is one example but another results from the recent shift to global settlements and the reallocation of the cost of Unaccounted for Energy by AEMO. Larger retailers and those who serve multiple consumer segments will likely use different methods to allocate this cost.

The AER must consider the differential impact on all retailers from its proposal to change its methodology, noting the policy objectives of the DMO and the very real potential to harm smaller retailers.

The imprecision of these estimates of cost and realised margin is also relevant for the AER's objective to equalise margin across all DMO networks. We acknowledge the policy rationale for seeking to achieve this but we do not believe there is sufficient certainty on which to base a DMO determination. The decision to significantly reduce the retail component in the three NSW networks will likely undermine competition.

In our view, the AER has two viable options for DMO4. Our preferred option is to defer the change in methodology until DMO5, to allow it and the ACCC to develop a more suitable dataset that meets their respective needs. We appreciate the AER's acknowledgement of the administrative burden on responding to data requests but in this instance, the benefits of responding to a more tailored request will outweigh the cost.

Alternatively, the AER should adopt a more conservative approach in the final determination for DMO 4 that acknowledges its limitations. On this last point, the AER's draft decision to allow a higher margin for SME customers (15% in contrast to 10% for residential consumers) is appropriate, given the challenges that the ACCC identified about estimates of the cost of supplying electricity to this segment.

Otherwise, we see significant risks for competition and in particular for the likely impact on smaller retailers, noting the DMO also functions as a price cap and a reference for the majority of market offers.

Retail operating costs

It is even more important for the AER to account for all elements of retail operating costs if it proceeds with the change of methodology. There is less scope to absorb errors, miscalculations and omissions than under the indexation approach without undermining competition, particularly with the DMO functioning as a price cap and reference price.

Therefore, we welcome the AER's decision to include specific allowances for bad and doubtful debts, and for the cost of smart meters as these are material items for retailers. We will follow up this submission with more recent estimates of the cost of smart meters to allow the AER to capture this in its final determination.

In terms of bad debt provisioning, the impact of the pandemic will linger well into 2022/23 so we support its inclusion in the DMO and the AER's approach to estimating this component. This is a cost of undertaking retail operations and debt remains at elevated levels. Many consumers have increased their debt levels due to their specific circumstances but also following the regulatory response to the pandemic, which impacted retailers ability to manage their exposure to bad debt. Noting that the longer this debt is held, the less likely retailers are to recover it in full.

We also note the importance of capturing actual network costs in the final determination. This has not always been possible in the past, due in part to the failure of the electricity networks to submit and publish their pricing proposals within prescribed timeframes. DISER is proposing to change the date for the final determination to address this but there is no guarantee this will occur in time for DMO4. As such, the AER may need to include an additional allowance to account for the risk that actual costs differ from those incorporated in the final DMO. Alternatively, it must adjust future DMOs to account for any difference, although we note the AER was reluctant to do this for previous DMOs and margins were eroded as a result.

The ACCC dataset will also fail to capture additional retail expenditure to implement significant regulatory initiatives, such as the Consumer Data Right. The AER should consider including such costs as an additional item, noting the CDR rules have been finalised and all retailers are starting to implement the necessary system and procedural changes. To this point, the AER has set the DMO at a level that recovers costs in the year in which retailers incur them and avoided ex post adjustments as far as possible and we recommend it continue with this approach, rather than waiting for them to be captured in future ACCC datasets.

Wholesale costs

Red and Lumo welcome the AER's decision to include the cost of AEMO directions in the wholesale component of the DMO. We agree with the AER's conclusion that this is a material cost that retailers cannot avoid through more effective risk management and efficiency gains and as such, should be recovered through the DMO.

However, the AER's decision to change its assumptions about retailers' forecasting accuracy raises longer term concerns about the transparency, predictability and stability of the AER's approach to cost estimation. We understand this decision was one of judgement, instead of being based on rigorous analysis, observed behaviour and outcomes, or even in consultation with market participants.

We also note the AER's intention to undertake a peer review of its methodology for the calculation of wholesale and environmental costs. We strongly recommend the AER avoid making further changes to this methodology following this peer review and ahead of its final determination for DMO4.

While it is entirely reasonable for the AER to review its methodologies, retailers must be given sufficient notice of any significant changes to the calculation of any component of the DMO and the opportunity to participate in the review process. Any change in methodology has the potential to penalise some retailers relative to others depending on their business model, whether their hedging strategies are more aligned with the current methodology, or where they have adjusted their strategy in line with the AER's established approach.

About Red and Lumo

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

Red and Lumo thank the AER for the opportunity to respond to its draft determination. Should you wish to discuss aspects or have any further enquiries regarding this submission, please call Geoff Hargreaves, Regulatory Manager on 0438 671 750.

Yours sincerely

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