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10 March 2022

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

Via email to DMO@aer.gov.au

Dear Ms Jolly,

Re: Default Market Offer Price 2022-23– Draft determination

Simply Energy welcomes the opportunity to provide feedback on the draft determination for the Default Market Offer 2022-23 (DMO 4).

Simply Energy is a leading energy retailer with approximately 730,000 customer accounts across Victoria, New South Wales, South Australia, Queensland and Western Australia. As a leading retailer focused on continual growth and development, Simply Energy supports the development of effective regulation to facilitate competition and positive consumer outcomes in the market.

While Simply Energy understands the policy intent behind the introduction of the DMO and considers that the DMO has met the policy intent to date, Simply Energy does not support price regulation in competitive markets.

Simply Energy's submission provides feedback on the AER's proposal to change its overarching approach to the DMO methodology.

There does not appear to be a strong case to change the overarching methodology

The DMO was introduced to be a 'backstop' with a generous level of headroom above the reasonable cost of supplying customers, which would give space for a healthy competitive market to be the normal mode of supplying customers. The DMO therefore provides fallback protection from excessively high prices for those consumers who are not engaged in the market. Unlike the Victorian Default Offer (VDO), the DMO is not intended to be a relatively low-priced alternative to a market offer.

Simply Energy considers that the DMO price and methodology have met its objectives to-date and there has not been sufficient evidence to suggest that the current methodology is deficient. Instead, the evidence suggests that the competitive Australian energy retail market is working effectively for consumers under its current settings. For example, the Australian Competition and Consumer Commission (ACCC) recently found that the cost of electricity for residential customers is at its lowest level in eight years. While this is primarily due to reductions in network and wholesale costs, retail operating costs and margins have declined significantly over the past two years.[1]

[1] ACCC 2021, Inquiry into the National Electricity Market – November 2021 Report, 22 November, pp. 6-7.

The ACCC found that retail margins in the past two years are at the lowest levels observed, and now account for around three per cent of a household's annual electricity costs.[2] The ACCC suggested that the recent reduction in retail margins was largely due to the introduction of the DMO and VDO.[3] The ACCC also identified that in 2020-21, the average retail margin was negative in South Australia and south-east Queensland, which meant that the average retailer was operating at a loss in those regions.[4]

Retaining the current methodology would maintain regulatory certainty and consistency with the methodology to date and ensure that the risk involved in supplying retail electricity is adequately accounted for. With retail margins at historical lows, we consider there is limited justification for the AER to seek to adopt less conservative settings in its DMO methodology.

The proposed retail cost methodology would benefit from more transparency

Simply Energy does not support the proposed move to a bottom-up cost methodology for the estimation of retail costs. While a bottom-up cost methodology may be appropriate for developing an offer that will be available in the market (such as the VDO), it is unnecessary for the purposes of setting a price cap. This is a significant change to the current methodology, which Simply Energy does not consider is justified when the current methodology has been largely successful at meeting the objectives.

While there is not a strong case to change methodologies at this time, we do consider the use of ACCC retail cost data plus a consistent retail allowance is the next best methodology and broadly aligns with the views we previously put forward in our submission to the consultation paper.

In the sections below, Simply Energy provides specific feedback on the proposed bottom-up cost methodology, the proposed retail allowance, the step-change framework, and the inclusion of advanced meter costs in the retail cost estimate.

Bottom-up cost methodology

Simply Energy proposes that, instead of moving to a bottom-up cost methodology, the AER use the ACCC's data as a cross-check on the residual amount to ensure it continues to be largely representative of retailers' operating costs with a reasonable amount of headroom.

However, if the AER is committed to moving to a bottom-up cost methodology, we continue to consider that the ACCC's published retail cost data would be the most reliable and transparent source of retail operating cost data. We do, however, acknowledge that the ACCC's data is unlikely to be fully representative of most retailers and may not incorporate all relevant costs. While these inaccuracies may reduce the usefulness of this data, we consider that this could be addressed by ensuring that the retail allowance specifically accounted for this risk.

Retail allowance

In our submission to the consultation paper, we argued that the retail allowance should be set to ensure that the DMO price is maintained at a consistent level above competitive retail electricity offers. We accept that the AER's proposed approach does appear to achieve this by applying a consistent percentage uplift above the cost stack. However, our key concern is whether the estimate of the retail allowance is appropriate and will meet the DMO's objectives. It is challenging to assess whether the retail allowance is appropriate due to how it has been estimated.

[2] ACCC 2021, Inquiry into the National Electricity Market – November 2021 Report, 22 November, p. 4 & 7.
[3] ACCC 2021, Inquiry into the National Electricity Market – November 2021 Report, 22 November, p. 7.
[4] ACCC 2021, Inquiry into the National Electricity Market – November 2021 Report, 22 November, p. 31.

In order to transparently estimate the retail allowance, the key questions that arise are; what are the components of the retail allowance and what are the reasonable values for those components? Simply Energy considers that a retail allowance should include:

- An estimate of the sustainable retail margin in the competitive electricity retail market;
- A component that represents the headroom of the DMO and provides incentives for innovation and consumer engagement in the market; and
- An uplift to cover the risk of forecast errors that are not included elsewhere in the cost stack (for example, risks that the ACCC cost data underestimates actual retail costs, and risks introduced through the wholesale cost and network cost methodologies).

If we assume that a sustainable residential retail offer includes a three per cent retail margin (which is already a historical low margin, as per the latest ACCC finding on actual margins[5]), this leaves a seven per cent buffer in the proposed retail allowance to account for the risk of forecast errors and to provide sufficient headroom to encourage consumers to engage in the market and move from standing offers to market offers. While the value of the headroom in the DMO is ultimately a judgment call for the AER, we question whether there is enough buffer in the proposed retail allowance to account for the risk of forecast errors and still provide sufficient headroom for the DMO to meet its objectives.

Instead of relying on implied retail allowances based on the DMO 3 prices, we encourage the AER to adopt a more objective and transparent methodology, where values are assigned to each component of the retail allowance. This would have the added benefit of being a methodology that can be replicated in future years.

Simply Energy also notes that there is scope for a higher small business retail allowance. At a minimum, Simply Energy considers the small business retail allowance should be calculated using a similar approach as was used to determine the residential retail allowance. There is no clear justification for the small business allowance to be set at the lower range of historic average outcomes.

Step-change framework

Although the proposed retail cost methodology would result in actual changes in retail costs being recovered in future DMO determinations, Simply Energy still supports the inclusion of a step-change framework or re-opening mechanism.

While a re-opener would be rarely used, it provides an option for the AER to amend the DMO price in the unlikely situation there is a significant and unexpected cost increase (either in retail costs or other cost components) that would result in the price cap being set below the reasonable costs of supplying standing offer customers. Although these costs would be recovered in future periods, if the cost change is so significant that the price cap becomes a binding constraint, the costs should instead be recovered in the period they are occurring.

If a re-opener is used, we expect that any uplift in the DMO price would be readjusted as needed in the following period.

Advanced meter costs

Simply Energy is pleased that the AER has proposed to include an allowance for advanced meter costs in the DMO price going forward. These are real costs incurred by retailers, which will only increase as the uptake of advanced meters becomes more significant in the coming years. As part of the AER's information gathering request for DMO 4, we provided the AER with our annual per

[5] ACCC 2021, Inquiry into the National Electricity Market – November 2021 Report, 22 November, p. 4.

customer costs for residential and small business customers with a type 4 (or type 4A) meter in each distribution region.

The current Australian Energy Market Commission (AEMC) review into the regulatory framework for metering services is considering several options to accelerate the smart meter rollout, including setting targets for retailers to replace a certain percentage of their customers' meters with smart meters each year.[6] If this option (or similar options that impose obligations on retailers) are implemented, Simply Energy would expect the AER to reflect the costs of complying with those obligations in the DMO price (either through the retail cost estimate or the retail allowance).

The proposed wholesale cost methodology will increase the risks faced by retailers

Simply Energy supports the AER's proposal to maintain its current approach to the hedging strategy and hedge book build period, as well as the proposal to include the costs of the Australian Energy Market Operator's energy directions. In this section, we will focus on our views on the proposed change to the margin for forecast error from the 95th percentile estimate to the 75th percentile estimate.

As the DMO provides fallback protection from excessively high prices and is not a relatively low-priced alternative to a market offer, it is reasonable that the DMO price is set high enough for retailers to be able to continue to recover their reasonable costs even when worst-case costs have eventuated.

There does not appear to be a strong reason for the AER to adopt less risk averse settings when setting the margin for forecast error. Simply Energy considers that the risk to retailers from the AER setting a wholesale cost allowance that is too low is more significant than the potential downside to customers from an allowance that is set at a slightly more conservative level. The objectives of the DMO also align with adopting conservative settings rather than attempting to replicate the most efficient hedging strategy and level of spot market exposure.

The expected volatility of the wholesale electricity market during the energy market transition suggests that the AER should not assume that its forecasts will be highly accurate. It would be prudent for the AER to remain conservative in its wholesale cost methodology. In terms of expected volatility, the next few years will involve the closure of some large fossil fuel power stations, the continued expansion of Distributed Energy Resources, and network tariff reform. There is also a risk that international issues (for example, the uncertainty relating to war in Europe) will flow through to Australia and create higher volatility in our electricity market.

As we noted in our submission to the consultation paper, we are concerned that if the AER takes a less conservative approach in the DMO that it may be implicitly signalling to retailers that they should be less risk averse in their approach to hedging against wholesale market exposure.

If the AER is committed to maintaining the 75th percentile estimate, Simply Energy urges the AER to adjust the retail allowance to account for the additional volatility risk that retailers would face from this decision.

The risk from relying on unapproved network tariffs should be considered in the DMO price

As we noted in our submission to the consultation paper, the AER should not be requiring retailers to bear significant risk of mis-forecasted network costs, as these are outside of our control. If the AER is unable to use approved network tariffs in DMO 4, we urge the AER to adjust the retail allowance to account for the risk faced by retailers through the reliance on unapproved network tariffs.

[6] AEMC 2021, Review of the regulatory framework for metering services: directions paper, p. ii

Ideally, the AER will be able to use actual network tariffs when setting DMO 4, which would avoid any need to adjust the retail allowance. Simply Energy has requested the Department of Industry, Science, Energy and Resources (DISER) to address this issue in its DMO Code review and implement an equitable long-term solution. However, based on DISER's recent directions paper, we are concerned that DMO final determinations will be made three weeks later than normal, which would significantly condense our internal timeframes to implement the price change for our standing offer customers on 1 July each year. This would heighten the risk of errors during the price change process, resulting in poor outcomes for our customers and a significant compliance risk. We urge the AER to work with the industry to ensure that any reduction in the time available for price changes is transitioned smoothly to reduce the risk of negative consumer outcomes.

Concluding remarks

Simply Energy looks forward to continuing to work actively with the AER to ensure that the DMO methodology is fit-for-purpose during the upcoming years and that the DMO 4 price accurately reflects forecast changes in the cost of supplying electricity retail customers.

Simply Energy welcomes further discussion in relation to this submission. To arrange a discussion or if you have any questions please contact Matthew Giampiccolo, Senior Regulatory Adviser, at matthew.giampiccolo@simplyenergy.com.au.

Yours sincerely

James Barton
General Manager, Regulation
Simply Energy