

Energy Locals Pty Ltd
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Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear AER

RE: Feedback on issues paper for the Default Market Offer price determination 2023-24

Please find below our submission to the questions raised in the issues paper for the Default Market Offer price determination for 2023-24.

I confirm that the information contained in this submission is not confidential and may be made publicly available to facilitate an informed and transparent consultative process.

Yours sincerely



Adrian Merrick
Chief Executive Officer
Energy Locals Pty Ltd

SCHEDULE 1 RESPONSE TO QUESTIONS RAISED IN THE ISSUES PAPER FOR THE DEFAULT MARKET OFFER PRICE DETERMINATION 2023 - 24

Question: Do you consider maintaining the existing methodology in the current wholesale environment is appropriate? If not, which improvements or other methodologies should we consider adopting?

Response: We agree that the existing methodology is broadly appropriate. We support a heavier weighting of the price towards the most recent period, which we believe is more reflective of the way retailers are hedging in practice.

Hedging three years in advance is closer to speculating than hedging due to the rapidly evolving nature of both the supply and demand side. The transition to renewable energy as well as the solar and battery uptake makes it extremely difficult to predict load and usage patterns three years out as this horizon allows for substantial change in generation and fuel mix on the supply side. This translates into substantial risk premiums and costs if a retailer wishes to hedge three years in advance especially if they are using load following hedges which transfer nearly all market risks to the seller.

Given the extremely competitive nature of the retail market it is imperative that that the wholesale position is economical. Starting to hedge three years in advance creates greater room for error. We believe that three year hedging strategies are mainly limited to vertical integrated utilities where there is purely a transfer of value between generation and retail books. Given the customer numbers of traditional retailers are far more predictable, a three year hedging horizon will hand further market power to these organisations and add another restriction to the ability of newer retailers to compete.

Consideration should be given to using the average of the daily closing price in lieu of the trade weighted volumes to allow for the current lack of liquidity on the exchange. Liquidity decreased significantly post the market volatility at times when volume would normally be high as the start of the contract period approaches. This coincided with the step change in the wholesale price.

Using contract prices and traded volumes from the ASX does not fully reflect the actual source of hedges, as small retailers face difficulties accessing the ASX and depend on OTC trades, which generally have higher costs. Clearing houses have been charging multiples of the ASX margins due to volatility in the market. We believe that these costs should be included in the DMO calculation.

Retailers also face higher cost of capital to finance increased prudentials and margin calls. These costs are becoming more significant in an environment of rising interest rates. Furthermore, given that these costs can spike during times of wholesale disruption, retailers are forced to maintain financing facilities, which also increase operating costs.

Question: Does the use of net system load profiles in determining our hedging model reasonably reflect retailer risk management strategies? How could our load profile assumptions be improved?

Response: Smart meters continue to be rolled out, often because consumers are adding solar to their premises. As such, it is becoming increasingly important to include this data when determining the load shape.

We believe a single load profile for each state best reflects the way customer usage is actually hedged.

Question: Do you support the inclusion of confidential contract information into the book build process? How could we make this process as robust and reliable as possible.

Response: As the AER has pointed out, the ASX has been fairly illiquid in recent times and inaccessible to small retailers. We agree that this applies to South Australia in particular, but is also the case in other jurisdictions. We can also confirm that we are facing difficulties in accessing clearing house services.

However, we do not support the use of confidential contract information as it would include a large volume of internal transfers within vertically integrated participants, which we believe are not reflective of actual retailer hedge costs. These purely represent a transfer of earnings between departments of an organisation. A vertically integrated retailer can use this transfer price mechanism to move profit between business units to suit the narrative it wishes to portray to the market.

We would also be concerned that taking the focal point off the ASX as a point of reference for the DMO would further exacerbate the decline in the volume on the ASX. We believe it is imperative that the market has a deep, liquid and transparent futures market as this would help drive down costs.

Question: Do you support the inclusion of additional contracting products in the modelling process, such as options?

Response: Including options in the modelling process would add unnecessary complexity to the process, which would undermine transparency and prevent retailers from being able to predict the DMO with confidence. It is not our opinion that the use of options is prevalent in retailer hedging strategies. Furthermore, we feel that the majority of the options volume on the ASX is undertaken by trading houses managing their speculation books.

As such, we do not support the inclusion of products such as options in the modelling process.

Question: Do you support the current book build process used in the wholesale methodology component?

Response We agree that the existing methodology is broadly appropriate. We would support a heavier weighting of the price towards the most recent period. Longer periods create greater uncertainty which transfers into costs. This uncertainty is also reflected in the market trend of liquidity declining in years two and three, which is also evident in the contracting strategies of Commercial and Industrial customers.

Consideration should be given to using the average of the daily closing price in lieu of the trade weighted volumes to allow for the lack of liquidity on the exchange due to issues with participants accessing clearers. These have occurred post the market volatility which has driven down volume at times when volume would normally be high, as hedging tends to increase as retailers approach the start of the contract period. This has coincided with the step change in the wholesale price.

Longer hedge periods also expose retailers to significant cash requirements to service any mark-to-market cash calls.

Question: Are there any additional costs stakeholders believe should be considered in the wholesale energy cost that have not previously been included?

Response The current methodology includes the additional costs from the prior year, which means that retailers will always be 12 months in arrears. The AER should consider making an estimate for the current year and then truing it up based on the actual occurrences.

There should be an allowance for the cost of unaccounted for energy, which was introduced to the market this year to all retailers. In addition, the margin requirements should include the additional multiple of the ASX prescribed margins being charged by clearers.

Question: Should we consider any changes to our retail costs approach?

Response We believe that the approach to establishing the retail costs is appropriate.

We recommend that the allowance for bad and doubtful debts should be adjusted to reflect the increased size of the average invoices and the expected economic climate over the coming 12 months.

The current methodology focuses on data available in the financial statements of large retailers, who are arguably less exposed to bad debts, as they have a large customer base which is more stable than that of a smaller retailer, where in many cases all customers have switched within the last few years. We know that switching leads to further customer churn, and churn is a key leading indicator of bad debt.

We also note the additional requirements that retailers need to meet in order to manage customer debt in a compliant manner.

Question: Should the retail allowance be changed and, if so, in what way?

Response We do acknowledge that higher overall cost stacks lead to higher retail allowances, given that they are based on percentage allowances. We do believe that this is justified in the current environment given the significant risks to retailers.

The AER also continues to increase its demands on retailers to support customers who are experiencing hardship or face natural disasters, etc. Whilst we agree that this support is necessary, we ask that the costs relating to this additional support be reflected in the retail allowance.

Question: What issues should the AER consider for customers in embedded networks in the DMO

Response We support the extension of the reference price provisions to embedded networks. This will provide transparency to embedded network customers and improve their ability to compare prices.

We strongly advise against introducing the DMO as a price cap for embedded network customers.

Implementing a price cap without capping input prices will undoubtedly lead to business failures and disruptions to the services promised to customers. A similar scheme in the United Kingdom, where prices utilities can charge were capped, while still exposing them to uncapped input prices, has led to the failure of 28 energy suppliers since June 2021, costing consumers £2.8bnⁱ. It would expose embedded network operators to the full impact of market failures, similar to the one that happened between June and August 2022 and potentially crippling companies who are unable to increase costs to customers because of the government's energy price cap. This risk would reduce competition, leaving only large integrated retailers able to supply the market, essentially harming consumers by increasing prices in the long term.

In addition, embedded networks offer their customers additional benefits, such as on-site renewable energy generation, battery storage, and electric vehicle chargers at zero up front cost to customers. These costs are usually recovered from customers over the life of the assets but are not factored into the DMO methodology. Restrictions such as the one suggested by the AER will reduce the use of these new energy technologies in these buildings, or alternatively will drive up the cost of ownership or rental if they are included.

ⁱ <https://www.theguardian.com/money/2022/jun/22/failing-energy-suppliers-cost-uk-consumers-2-billion-pounds-watchdog>