



**EnergyAustralia**

LIGHT THE WAY

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

EnergyAustralia Pty Ltd  
ABN 99 086 014 968

Level 19  
Two Melbourne Quarter  
697 Collins Street  
Docklands Victoria 3008

Phone +61 3 8628 1000  
Facsimile +61 3 8628 1050

enq@energyaustralia.com.au  
energyaustralia.com.au

**Lodged electronically:** [DMO@aer.gov.au](mailto:DMO@aer.gov.au)

Dear Ms Jolly,

**Default Market Offer - Options paper on the DMO pricing methodology – PUBLIC VERSION**

EnergyAustralia is one of Australia's largest energy companies with around 2.4 million electricity and gas accounts in NSW, Victoria, Queensland, South Australia, and the Australian Capital Territory. EnergyAustralia owns, contracts, and operates a diversified energy generation portfolio that includes coal, gas, battery storage, demand response, solar, and wind assets. Combined, these assets comprise 4,500MW of generation capacity.

We welcome the opportunity to provide this submission to the AER's Options paper on the Default Market Offer (DMO) pricing methodology (Options Paper).

We commend the AER's holistic approach to the review and openness to significantly changing the pricing methodology. Overall, however, we have questions around whether there is a need to change the DMO pricing methodology at this time, as the current methodology is effectively delivering the DMO's policy objectives. That is, it is delivering a DMO price which benefits customers by allowing competition and innovation and is incentivising customer engagement, while still protecting customers from disproportionately high Standing Offer prices.

Promoting these DMO objectives is particularly important in the current clean energy transition to increasing renewable energy generation in the National Electricity Market. The DMO plays a broader role than only ensuring Retailers recover their efficient costs for Standing Offer customers. In the clean energy transition, Retailers will be expected to innovate and compete on providing new electricity products and the DMO should be set high enough to allow this. The DMO as the Reference Price also helps to encourage strong customer engagement which underpins healthy competition.

In the absence of strong evidence to suggest that the current pricing methodology is not meeting the DMO objectives, we suggest that the AER retain the current methodology, with some improvements to the step change framework to make it more practical to use (Option 2). Overall, pursuing an alternative approach to the DMO pricing methodology is unlikely to deliver better outcomes for customers through increased accuracy, and this objective can only be reached to some degree. Achieving accuracy in forecast prices is difficult for Retailers and is more difficult when parties such as regulators undertake it under more rigid constraints and with a reduced range of

inputs. Instead, the AER should aim to identify where the DMO is set too high relative to retail prices or estimated retail margins across different Retailers.

We also note that any significant changes in pricing methodology could result in large step changes in prices (both increases and decreases depending on the distributor zone) and sudden changes to the levels of comparison discounts of Market Offers against the DMO Reference Price. These changes will not be underpinned by movements in Retailer costs, could result in bill shock to customers, and will cause customer confusion. Prices set by Retailers or regulators should aim to foresee and smooth price shocks for customers to the extent possible.

We observe several issues for the AER regarding Options 1 and 3. In summary:

- Option 1 as a cost stack approach may at first glance be an attractive option, but considering the details, it provides a false sense of precision. Its accuracy as a pricing methodology depends on the accuracy of estimating the residual cost components and current data sources are not workable.
  - Determining retail operating costs will be problematic. The AER discusses using ACCC data on retail operating costs which will be reported in November 2021. While this ACCC data is suitable for market monitoring purposes, we question whether it is sufficiently robust or detailed enough to estimate efficient costs across a variety of Retailers in the market.
  - The alternative of requesting Retailer's individual operating cost data and assessing those costs will take into account the variety of Retailers, but will be resource intensive for the AER and Retailers and will lack transparency. The alternative also has challenges in setting up the framework to ensure the same cost treatment by Retailers and verifying submitted data in time for DMO 4.

Both the ACCC data and requesting individual Retailer data sets will involve various decision points, balancing disparate views from Retailers and other stakeholders, and will be resource intensive for all involved. This arbitrariness is further exacerbated in that the cost stack approach will require the calculation of the Additional Allowance which is intrinsically very imprecise because it is difficult to quantify the objectives of the Additional Allowance into a price component. We are not aware of any strong precedents which would assist the AER.

Ultimately, a cost stack approach will still have a level of arbitrariness and imprecision and therefore is unlikely to ensure better customer outcomes, relative to a continuation of the status quo.

- Option 3 seems attractive as a "middle" option. However, the key issue with Option 3 also relates to the how representative the ACCC data is. The AER proposes to use the ACCC data to update the change between retail operating costs in 2019 and 2021 by applying the difference (in proportional terms) to the DMO's Retailer operating costs in 2019 and 2021. This difference is one amount and may not be sufficiently representative of all efficient Retailers in the market.

In light of the above, Option 2 is the strongest option. We acknowledge however that the energy market is in a state of flux. The changes are being driven by market design and network tariff reform (e.g. demand charges and export tariffs), increasing Distributed Energy Resources (DER) uptake and technological developments, which will likely change how Retailers operate and set electricity prices. Furthermore, the Consumer Data Right will deliver better usage data to third parties and

enable more accurate comparisons of plans for a customer, compared to Reference Pricing (which is based on average customer usage data). We suggest that the DMO pricing methodology be reviewed in three years' time to ensure it remains suitable and to ensure any underlying assumptions remain appropriate.

If you have any questions in relation to this submission, please contact me (Selena.liu@energyaustralia.com.au or 03 9060 0761).

Yours sincerely,

Selena Liu  
Regulatory Affairs Lead

## EnergyAustralia's submission

This submission discusses the AER's proposed Options 1-3 for the DMO pricing methodology, and then discusses other specific issues raised in the AER's options paper regarding wholesale electricity costs, network costs, annual usage amounts, and embedded network customers.

### 1. Option 1 – cost stack approach to pricing methodology

As set out in our cover letter, we see several challenges for the AER to adopt Option 1.

The main difference with Option 1 (cost stack approach) compared to Option 2 and 3 (some form of continuing the indexation approach) is the determination of residual cost. Under Option 1 the AER will estimate the components – retail operating costs, retail margin and Additional Allowance. The challenges in determining each of these components is discussed in turn below.

#### Retail operating costs

At first glance, the appeal of Option 1 is that it could allow for better updates for retail operating costs from year to year. However, we consider that reliable data that can be readily used by the AER to inform these costs is not currently available.

The AER's preliminary view is that the ACCC analysis of retail costs for 2020-21 in its November 2021 report will be a robust and reasonable estimate of retail operating costs. We expect this data to largely reflect the data from the ACCC's 2019 report and have based our comments on that report.

The ACCC's data reflects the largest 18 Retailers. There is therefore a risk that the data will not represent the costs of all "efficient" Retailers, including many small but viable Retailers. This is particularly the case where the costs are weighted in favour of the largest Retailers which benefit from some economies of scale.

We also note that Retailers may have reported data inconsistently (different costs in different categories) and the ACCC may have excluded certain Retail Operating costs when calculating their averaged figures. The ESC's experience in determining the retail costs for the VDO in 2019 is also notable. In the ESC's draft decision, they proposed to use ACCC reporting in the Retail Electricity Pricing Inquiry Report which reported on the Victorian average for retail operating costs, with a 5 per cent buffer. However, the ESC then identified that the ACCC's reported costs excluded shared costs. The ESC decided to adopt a previous ICRC decision on retail operating cost as an alternative approach with an additional allowance of \$10 to account for specific costs for Victoria.<sup>1</sup>

Regulatory benchmarks such as the ICRC's retail operating costs for ActewAGL have other challenges because they may not be appropriate for Retailers the DMO applies to. For example, the level of economies of scale that ActewAGL has in the ACT market may be a material point of difference. We also understand the approach taken by ICRC does not include costs of customer acquisition (CARC) in its retail operating costs or any other allowance, whereas the DMO would seek to reflect CARC to support retail competition.

The AER also discusses an option of collecting data on retail operating costs from Retailers, which could potentially be more accurate than using the ACCC data but raises other practical issues. The AER would need to develop guidelines to ensure consistent cost treatment and cost allocation by Retailers, and even then, information asymmetry would arise and there would be difficulties in verifying compliance with the guidelines. The time intensive nature of this option applying across many Retailers would also make it difficult to implement by 1 July 2022.

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<sup>1</sup> [Victorian Default Offer to apply from 1 July 2019 \(esc.vic.gov.au\)](https://www.esc.vic.gov.au/vic/default-offer-to-apply-from-1-july-2019), p 65

## Additional Allowance

The Additional Allowance needs to promote two broader DMO objectives:

- Enable competition (allow pricing below the DMO) and allow retail investment in innovation.
- Maintain an overall level of the DMO price which incentivises customer engagement.

We discuss these two objectives below, and then discuss how a cost stack methodology could approach them.

### *First DMO objective: Enabling competition and innovation*

The ACCC has previously stated that the “DMO was not intended to be the lowest priced or near lowest priced offer, and should not be set so low as to constrain competition and innovation, or disincentivise customer participation in the market”. Regarding competition, the ACCC notes that “The DMO is not designed to replace competition entirely in placing downward pressure on prices in the market, but is designed to address the disproportionate profitability of Standing Offer customers”.

To enable competition, the DMO needs to be set at a level which enables Retailers to price below the DMO price. For new Retailers, the DMO price should not create barriers to entry, and should be set at a level which is high enough to cover higher retail costs and higher risk (spread across a smaller customer base) that new entrants initially face. The current DMO successfully achieves these outcomes, with several new entrants to the retail market since the DMO was introduced.

With regard to innovation, the Additional Allowance is key to enabling investment in innovation. Retailers make investments in non-price elements of their electricity service and the associated costs of these investments should be recoverable from Standing Offer customers).

**[Confidential:**

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### *Second DMO objective: Incentivising customer engagement*

The DMO as the Reference Price also plays a critical role as the benchmark against which all Market Offers are compared. Higher percentage savings off the Reference Price (DMO) are correlated with higher customer engagement and higher customer churn.

**[Confidential:]**

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The DMO's role in incentivising customer engagement also has a feedback loop with competition. As more customers engage, retail competition intensifies leading to better price and non-price outcomes. Better outcomes for customers are achieved by customers engaging in the market, rather than remaining on the regulated price (DMO).

#### *Regulatory precedents*

An allowance for the first objective (competition and innovation) has been previously considered by other Australian regulators<sup>2</sup> but often only as CARC.<sup>3</sup> The AEMC has previously explored in its *Advice on best practice retail price methodology* potentially using the retail margin of a new entrant (minus the margin for an incumbent) to reflect higher risks of new entrants, and that this could be the basis of an additional "competition margin".<sup>4</sup>

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<sup>2</sup> [Microsoft Word - Best Practice Retail Price Regulation - Final Report - EMO0027 - 26 September 2013 - EMBARGOED \(aemc.gov.au\)](#), pages 74, 75

<sup>3</sup> See AEMC discussion, [Microsoft Word - Best Practice Retail Price Regulation - Final Report - EMO0027 - 26 September 2013 - EMBARGOED \(aemc.gov.au\)](#), page 78

<sup>4</sup> [Microsoft Word - Best Practice Retail Price Regulation - Final Report - EMO0027 - 26 September 2013 - EMBARGOED \(aemc.gov.au\)](#), p 78

Both these approaches only partially meet the first objective as they do not reflect the innovation objective specifically (although we note that competition in itself drives innovation). Further, both these approaches do not specifically link to the second objective (customer engagement).

As a strong precedent for the Additional Allowance is lacking, we would suggest that the AER err on the side of caution and not specifically determine the Additional Allowance. Splitting this component out from other components gives a false sense of precision and is not likely to lead to a more accurate outcome.

The AER has referred to a potential “top down” approach to determining the Additional Allowance. For example, DMO 3 would be used as the starting point – all other cost components, including wholesale electricity, network, environmental costs, and retail operating costs could be calculated and subtracted from DMO 3, providing an indicative margin and Additional Allowance for DMO 3. This could be converted to a percentage of the other cost components and applied as a percentage DMO allowance to DMO 4 and future DMO determinations. The benefits are that it ensures the additional DMO allowance remains closely aligned with the previous DMOs, provides transparency on the amount of DMO allowance, and is simple and easily explained. However, the potential pitfalls are that its accuracy heavily relies on the estimation of retail operating costs (which will be subtracted to provide the margin and Additional Allowance) – and as discussed above determining Retailer operating costs is problematic.

#### Median Market Offer is not a good proxy for Retailers’ efficient operating costs

The AER has sometimes compared the median Market Offer against the DMO price, using the median Market Offer as a “proxy for Retailers’ efficient costs”. While it is a potentially useful data point, it should be used alongside comparisons to Retailers’ actual cost data submitted to the ACCC and billing data which shows the annual prices paid by customers. This is a peripheral issue to the DMO pricing methodology, but it is significant to highlight because it shows that the AER should not assume that the difference between Market Offers available in market and the current DMO price, indicates the level of retail margin and/or Additional Allowance.

To illustrate, it is not correct to conclude that the difference between the DMO 3 and the median residential Market Offer of 10-16% means that there is a 10-16% Additional Allowance above retail margin (see percentages presented in Table 4.3 of the AER’s options paper). This is because a proportion of customers would not be on Market Offers available in market, but would be on other offers.

#### Other comments

If the AER were to pursue a cost stack approach, we would suggest that it would be worth calculating different DMO prices for each network tariff type and each distributor, rather than calculating a DMO for a flat rate tariff only across the state. This would allow the AER to pass through differences in network costs on these two dimensions.

## 2. Option 3 – DMO allowance with changes to calculation of retail operating costs

We understand the intent behind Option 3, to provide for a transparent annual adjustment to the residual via linking the changes in the DMO to the changes in the ACCC’s reported retail operating costs from 2019 to 2021. However, like our views on Option 1, the changes in the ACCC’s reported retail operating costs may not reasonably reflect all viable Retailers, including many small Retailers. Changes to retail operating costs and productivity gains (reduction in retail costs) are difficult to generalise across Retailers from year to year. Retailers make productivity enhancements at different times.



### 3. Option 2 – indexation approach with improvements to step change framework (preferred)

In view of the issues with Option 1 and 3, Option 2 appears to be the best option. The indexation approach has successfully delivered on the DMO objectives; and has demonstrably balanced other competing considerations regarding resource intensiveness and burden, accuracy, and transparency. We would however suggest that the step change framework be improved as suggested by the AER in its Options paper.

The step change framework will become increasingly important to reflect exogenous cost changes, particularly as Retailers are required to implement more regulatory reform. To date, no additional costs have been incorporated in the DMO via the step change framework which may indicate issues in its practical application. In contrast, the ESC has acknowledged both five-minute settlement and an increased bad debt allowance recently for COVID 19. The ESC has also not adopted other cost adjustments based on immateriality. We consider that the issue may be associated with the AER not being confident to use submitted cost data from Retailers, and the ambiguity over what costs are material to qualify as a step change.

The AER has previously pointed to “headroom” as being sufficient to absorb various regulatory costs. However, this view is not sustainable when the AER has not established the actual value of headroom based on analysis of Retailer costs, and considering the cumulative costs across multiple regulatory changes (which together might have amounted to being material).

New regulatory change in the next five years includes:

- Reforms being recommended by the Energy Security Board which relate to market design for the wholesale electricity market and system security services; and reforms to support DER integration into the NEM. These changes will impose significant cost on AEMO in updating market systems (which would be incorporated via AEMO fees) but they will also impose significant cost directly on Retailers which should also be recoverable.

The ESB’s final report estimates that its recommended reforms will cost AEMO between \$250-\$330 million alone to implement system changes at its end.<sup>5</sup> We would expect significant costs for Retailers as well in corresponding changes to their market systems and processes. Some reforms are immediate and will be implemented in the next five years. E.g. the integrating energy storage reform, which AEMO estimates will cost between \$19m and \$28.7m.

- The Consumer Data Right, a large and complex reform with significant technology build and process changes.
- Significant reform to better integrate embedded network customers into the market so that they are visible in market systems.
- Separate to Retail operating costs, the New Demand Peak Reduction Scheme in NSW which is a certificate trading scheme that promotes demand management activities. This will likely also become an ongoing environmental cost, similar to the NSW Energy Savings Scheme.

We support two of the AER’s suggested improvements to the step change framework. These improvements relate to better defining qualifying material cost changes and standardisation of information provided by Retailers for the same step change via a guideline. The AER refers to potentially requiring independently assured information about step changes in costs. We take independent assurance as meaning some form of external assessment which could be costly for Retailers and may deter claiming costs in the first place.

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<sup>5</sup> [1629944958-post-2025-market-design-final-advice-to-energy-ministers-part-a.pdf \(aemc.gov.au\)](#), p 53

#### 4. Wholesale electricity costs

In general, we support maintaining the status quo approach to wholesale electricity costs, but we flag issues for the future and discuss the AER's proposals below.

##### Wholesale electricity costs will need to eventually reflect any new market design reform

The AER's hedging strategy applied in the current DMO pricing methodology assumes a Retailer will seek to manage wholesale price risk by entering futures contracts traded on the ASX or over the counter contracts. In general, this reasonably reflects prudent Retailer practices currently and for the short term, and ACIL's use of ASX futures energy prices is appropriate.

We expect significant regulatory reform to wholesale market design would potentially change how Retailers are expected to manage wholesale price risk. In the future, a hedging approach based on ASX futures contracts may be less relevant. For instance, where the large majority of load is managed via entering into long term Power Purchase Agreements with certain generation sources.

This will be an issue which is more relevant in the mid-term once reforms and policy decisions by governments are clearer. However, it is a strong reason to set a cycle of review of the DMO pricing methodology every three years to enable the DMO to evolve in line with broader market reforms.

##### Ability to vary the DMO

While this is a matter for DISER, we note that the DMO Code should also include an ability to vary the DMO beyond the minor changes and validity grounds that currently exist in the DMO Code. The AER should be able to adjust the DMO should there be an unexpected or unforeseen event with shorter consultation time periods, in the same way that the ESC is able to. This would assist the AER in revising the DMO price in response to events similar to the UK crisis involving a string of recent Retailer failures.

Below we address the specific wholesale electricity cost issues raised by the AER in its Options Paper.

##### Hedging strategy of the representative Retailer

The AER seeks views on whether it should move away from the DMO's retail 'risk averse' settings (use of a 24–26-month hedge book build and assumed contract mix with minimum spot market exposure), to adopting less risk averse settings. We ask whether any Retailers have changed their hedging approach since 2019 which may provide a reason for the DMO approach to be reviewed.

Regarding hedge book build, the AER already adopts an average trade-weighted price for the contract prices, which would mean recent wholesale prices closer to the DMO regulatory period would have greater weighting than those farther away. We do not see changing the current 24–36-month hedge book build to a 12–18-month hedge book build as having a significant effect where wholesale prices are relatively stable (the need to have an adjustment mechanism should unforeseen events arise is a separate issue discussed above).

There are also benefits in maintaining a consistent approach across DMO regulatory periods and supporting a smoother price path for the DMO from one period to the next (which a longer hedge book facilitates). The AER should also be mindful that, whichever approach it adopts, it will apply in both a falling and rising wholesale electricity market. It may be attractive to have the DMO reduce faster to reflect a falling wholesale electricity market, but the reverse would apply in a rising market with potential bill shocks to customers.

In relation to the assumed contract mix where the AER suggests an alternative approach that would assume increased level of exposure to the spot market, we would like to understand what the exact level of exposure would be. Again, whatever approach the AER adopts needs to be appropriate for a falling and rising wholesale electricity market and adopt an appropriate level of prudence in Retailer practices. In the current environment, Retailers that have hedged to a lesser extent are benefiting from being able to pass through lower spot prices, but the benefit and risks are asymmetric. The risks are much greater in a rising and volatile market where a significantly unhedged Retailer could fail. The current UK crisis demonstrates the risks of an unhedged approach, 20 Retailers have failed and one of the main reasons is a strategy of being unhedged and high levels of spot market exposure.

Further we note that a more risk adverse approach can accommodate Retailers who choose to adopt a less risk adverse approach, but the reverse does not apply. We encourage the AER to approach this issue conservatively and maintain a prudent and risk adverse approach.

#### Margin for forecast error

In relation to the margin for forecast error that the AER should adopt, we see this as a question about wholesale market stability. It may be appropriate for the AER to adopt a lower margin of error if the market was fairly stable into the foreseeable future. However, we expect that the wholesale spot market may continue to change as the NEM moves towards integrating more centralized renewable energy and distributed energy resources. In this uncertain context, a conservative approach and retaining the status quo of 95% percentile of hedge priced outcomes would be sensible.

### 5. Network costs

Regarding the AER's discussion on network costs, we see consistency with the current approach is preferred and do not see a real need to change the network cost to reflect TOU network costs, where the indexation approach is continued (Options 2 or 3). The current approach based on flat network tariffs is reasonable for an indexation approach. We agree with the AER's proposal to pursue including the final network tariffs in the final DMO where possible.

### 6. Advanced meter costs

With advanced meter proliferation gradually increasing across the NEM to an eventual end state of full roll-out, it would be appropriate to now include advanced meter costs in the DMO price (net the avoided costs for accumulation meters paid to Distributors). The difference between advanced meter and accumulation meter costs is material **[Confidential:**

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### 7. Model annual usage

We understand the AER's rationale in proposing to decrease the model annual usage of small business customers in line with a value that better reflects more business users. However, as the AER is aware, the range of small business customer usage is very widely dispersed. Selecting one usage figure which is broadly representative is difficult to begin with. Considering our own small business customer profiles, the current figure of 20,000 kWh per annum remains a reasonable estimate, and so any benefits of reducing the usage amount appear marginal.

Any benefits from changing the business usage profile should also be weighed against the regulatory cost on Retailers. This regulatory cost would be in the form of Retailers updating their processes to

calculate Standing Offer tariffs and Market Offers against the new DMO price, to ensure compliance with the price cap and for Reference Pricing.

In addition, we note that **changing the business usage profile may inadvertently change the effective level of the DMO price cap.**

Compliance with the DMO price cap is calculated by a Retailer taking its electricity tariff of daily supply charge (multiplied by 365 days) and adding it to its usage tariff (multiplied by the AER's model annual usage). This provides the Retailer's unconditional price which must be lower than the DMO price cap which is expressed as an annual amount.

The balance between how much of the unconditional price is made up of the daily supply charge versus the usage charge component will change if the usage profile is decreased (usage component will constitute less of the unconditional price, compared to now where the usage component would make up more of the unconditional price).

This could potentially mean the change in usage profile may actually cause unconditional prices which now fall below the price cap to exceed the new price cap based on the new usage amount. This is because in proportional terms there is more daily supply charge for each kilowatt hour of usage charge which could increase the retail price overall. This change to the effective price cap is subtle, and while the Retailer could change the level of its daily supply charge, comparing on a like for like basis, the overall effect would be to lower the price cap. We doubt this would be the AER's intent and suggest that this effect would need to be mitigated, but it is difficult to see a workable solution. Continuing with the status quo (20,000 kWh per annum) would be the best approach to avoid this issue.

## 8. Usage - TOU determination

We support retaining the current approach for setting the annual usage amount to specifically reflect TOU customers. Given most customers are flat rate customers, the current approach to calculate annual usage based on flat rate usage is reasonable.

Separately, we also flag another small issue. We have identified that the current flat rate annual usage amount appears to include controlled loads. Given the profile is supposed to present a standard flat rate usage profile (with no controlled load), the controlled load usage should be excluded from the usage profile. Including it, would change the shape of the usage profile particularly in SA. We also understand that the current approach may be due to limitations in AEMO data but that the five-minute settlement change may now allow AEMO to undertake better metering data filtering. The AER may wish to discuss this with AEMO.

## 9. Embedded networks

As the AER would be aware, embedded network customers who are billed by an Exempt Seller rather than an Authorised Retailer, are indirectly protected by the DMO price cap. This is because Exempt Sellers are subject to the AER's Exempt Selling Guideline, which requires them not to charge a price higher than the Local Area Retailer's Standing Offer price (that is, the DMO price). The benefit of this indirect application means that an Exempt Seller could choose to mirror the Local Area Retailer's pricing which simplifies compliance with the DMO price cap and gives Exempt Sellers certainty that they are compliant.

We acknowledge there is a gap where an embedded network customer buys electricity from an Authorised Retailer, and that these customers would not have regulated price protections due only

to the fact that they buy electricity from an Authorised Retailer and not an Exempt Seller. This gap perpetuates differences in customer protections which do not have a sound policy basis.

We support changes to resolve this gap, by extending the same protection that applies to Exempt Sellers to Authorised Retailers selling to embedded network customers. i.e. require that the price not be higher than the Local Area Retailer's Standing Offer price (DMO price)). The benefit of this approach is that it is exactly the same obligation that applies to Exempt Sellers, and it is simpler to comply with for Authorised Retailers selling to embedded network customers which are often smaller operators.