30 November 2022

Gavin Fox
A/General Manager, Market Performance
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Lodged by email: DMO@aer.gov.au

Dear Gavin,

RE: Default market offer prices 2023-24 Issues paper

Powershop is an innovative retailer committed to providing low prices for customers and which recognises the benefits to customers in transitioning to a more distributed and renewable-based energy system. Powershop has introduced several significant, innovative and customer-centric initiatives into the retail energy market, including the first mobile app that allows customers to monitor their usage, a peer-to-peer solar trading trial and a successful customer-led demand response program.

Statement

Powershop thanks the Australian Energy Regulator (the "**AER**") for the opportunity to present our views on the Default Market Offer (the "**DMO**") for 2023-24. Powershop acknowledges that the events of the past 12 months have presented the AER and the wider industry with challenges that did not exist during the development of the DMO policy objectives. More than ever before, in price regulation and price setting, the energy sector is having to deal with the challenges of a market in transition and constant flux, as a result of numerous internal and external factors.

Powershop consider that it is important to understand the impact that the DMO has on both customers and retailers as industry manages the challenges of the energy transition and recent wholesale market volatility, and that it is imperative the AER upholds the foundational principles and objectives of the DMO, particularly in the setting of the retail allowance.

Powershop shares the AERs concerns of customers experiencing vulnerability and higher retail prices leading to an escalation of consumer debt overall. Powershop also agree that the retail sector is under significant pressure in an increasingly volatile environment.

Powershop does not believe customer vulnerability should be considered a key driving force to set DMO prices given the original policy intent. Powershop encourage the AER to consider a more suitable approach to addressing concerns surrounding vulnerability. Firstly, Powershop supports the objectives the AER has outlined in the recently released "Towards energy equity – a strategy for an inclusive energy market". Powershop considers that this work is vitally important to understanding both the challenges that vulnerable customers are experiencing and meaningful, measurable actions that can be taken by the AER and the sector more broadly.

Secondly, Powershop considers that in this challenging environment, it is important for the AER to uphold the foundational principles and objectives of the DMO. This extends to the passing through of unforeseen costs and the maintenance of the retail allowance in light of a market with increasing volatility and risk. Reverting away from these objectives for an isolated decision can potentially create even further financial risks and unforeseen costs that would be worn by retailers and ultimately customers.

The United Kingdom

In handing down its final DMO4 prices, the AER stated that;

"Setting the DMO is not about setting the lowest price. We are required to set a price that will allow retailers to recover their costs, earn a reasonable margin and support retailers to compete and offer better deals and products in a competitive retail environment. If a large number of retailers are unable to recover their costs and are forced to exit the market – as we have seen recently in the United Kingdom – that will add more cost to consumers"[1].

Powershop agrees with this statement, especially the attention to the situation in the UK. The onus is on industry and the AER to continue to monitor the situation in the UK. While Australia is a different market with different challenges, there are some parallels to be drawn between the two jurisdictions.

Similar to the recent events in the National Electricity Market, during 2021-2022, the wholesale price retailers paid for gas and electricity in the UK increased to unprecedented levels. However, in the UK this led to the failure of 29 energy suppliers. Those failed retailers, except for Bulb Energy (1.6 million customers) were managed through the equivalent Retailer of Last Resort (RoLR) scheme. "Ofgem's current best estimate of the cost of the 28 suppliers that have exited the market is £2.7 billion, which equates to around £94 per customer"[2]. The cost of failure is being borne by consumers.

The UK government also announced all households would receive £400 of support with their energy bills. In Australia, we have had 6 retailers enter the RoLR scheme during 2022. While the scale of failures is not equivalent, the principles around the role of price regulation is important to understand. The UK government stepping in to assist with increasing prices through a lump sum payment demonstrates that while the default price is still largely cost reflective, consumers require assistance by other means to manage the increase in price.

Maintaining the policy objectives of the DMO

Powershop note that the AER has observed 'the median market offer is now marginally below the DMO price'[3] which reflects that the current DMO is already deviating from its stated intentions of allowing for reflective market costs. It is our view the AER should focus on true accurate costs pass through rather than reworking the retail margin to artificially reduce the DMO and depart from its original objectives of providing a safety net.

At times of significant market volatility, we believe it is critical that the AER provides regulatory certainty in the approach to assess the suitability of the DMO with the overall objectives of the

[1] https://www.aer.gov.au/news-release/aer-sets-energy-price-cap-to-protect-consumers
[2] https://www.aer.gov.au/news-release/aer-sets-energy-price-cap-to-protect-consumers
[3] https://www.aer.gov.au/news-release/aer-sets-energy-price-cap-to-protect-consumers page 9

policy remaining constant, so that the true underlying changes in the market can be assessed and appropriately applied.

Pursuing a change of the objectives of the DMO to meet the challenges of the short-term environment will have a negative impact on the long-term sustainability of the competitive market. The AER now faces a true test of ensuring it applies the original principles and objectives of the DMO.

With significant costs to be incurred by retailers up to 1 July 2023, the AER places retailers at risk and under further financial strain. The objectives of the DMO require that retailers receive full compensation for costs incurred, a reasonable margin and allowance for customer acquisition and retention costs in their final prices.

In fact, the key policy intent of the DMO was to mitigate the impact of unjustifiably high standing offer prices for those customers that remain disengaged, which was indeed met with the DMO1. In this respect the DMO was designed to not disincentivise participation, distort innovative product offerings or negatively impact investment by retailers.

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?

Powershop did not support the previous DMO4 change of the forecasting estimation method to a risk position to the 75th percentile, away from the 95th percentile. Powershop submitted in March 2022 “The AER are making assumptions with this change that could negatively impact the market in a time of flux. With the current uncertainty and fluctuations in the wholesale market, going back to a 75th percentile estimation only raises a greater risk of understating true wholesale costs of which the customer and retailers would have to bear.”[4].

Powershop also believes that 2022 has demonstrated that the range of potential outcomes has widened significantly. Consequently, there are considerable risks to retailers beyond the 75th percentile which must be considered in business continuity planning. Powershop suggests a reversion to a 95th percentile approach in acknowledgement of the expected volatility through the market transition period.

In addition, the calling of the T-1 Retailer Reliability Objective (**RRO**) in South Australia has drastically changed the typical "trade volumes" and costs in a particular period, with negative impacts on trade volumes and a reduction in liquidity. The impact on retailers means that the AER will need to consider the impact of the RRO in the development of the wholesale cost element of the DMO.

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

Powershop holds the expectation that the AER will continue to reference the ASX standard products which up until now has been satisfactory, especially when you take into consideration the additional complexity of the inclusion of additional contracting products in the modelling process. Powershop would like the AER to acknowledge that retailers hedge their market risks using a range of products, particularly where the standard trading products may not always be most the appropriate for particular retailers and their profiles, or low liquidity of which is very costly.

[4] Default Market Offer Prices2022-23 Draft determination, Powershop submission, March 2022, Page 3

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

Powershop believes the timing of the cut off period of 1 July does not consider the retailer trade period between April and 30 June, with volatility / negative market movements not considered by the DMO. Powershop believes that a volatility allowance could be incorporated into the DMO. The allowance can be corrected either up or down in the following DMO.

Another key factor that also impacts different retailers is that many of them may not have access to all derivatives/instruments. We strongly encourage the AER to consider that the approach to wholesale contracting may differ greatly between smaller and vertically integrated or larger retailers.

In its projection of efficient wholesale costs, the AER must contemplate the likely approach smaller and new entrant retailers will prudently take in seeking to minimise residual volumetric risk. In constructing a hedging portfolio, the more likely path for smaller retailers may be to mitigate market risk through full load flex products, such as load following hedges, if available to the retailer. These are likely to come at a premium to the forward price but are essential for the efficient risk management for such retailers.

Unless alternative hedging strategies are considered, the DMO is at risk of being set at a level that will only allow the incumbent dominant retailers to operate economically in the market. There are costs with managing portfolios which move up and down, particularly evident where retailers are undergoing struggles to effectively maintain volatile positions.

Finally, Powershop also wish to highlight (Figure 1 below) that market volatility has significantly increased and consequentially, the risks needing to be mitigated by retailers. Within the graphs, a random day was selected from each month in September 2022, June 2022, March 2022 and December 2021 and plotted those days against the spot price. This is shown on the right side.

We then mapped for those same days of those same months for the 12 months preceding (i.e. September 2021, June 2021, March 2021, and December 2020), providing a comparison year on year. The difference in granularity between the graphs is linked to the release of 5 minute settlement.

Even in the limited timeframe, 12 months ago high price excursions were rarer. While high prices still existed, they were not a feature of the normal market and the intra-day volatility was also lower. Now we can see significantly increased intra-day volatility, which needs to be managed by retailers on behalf of customers.

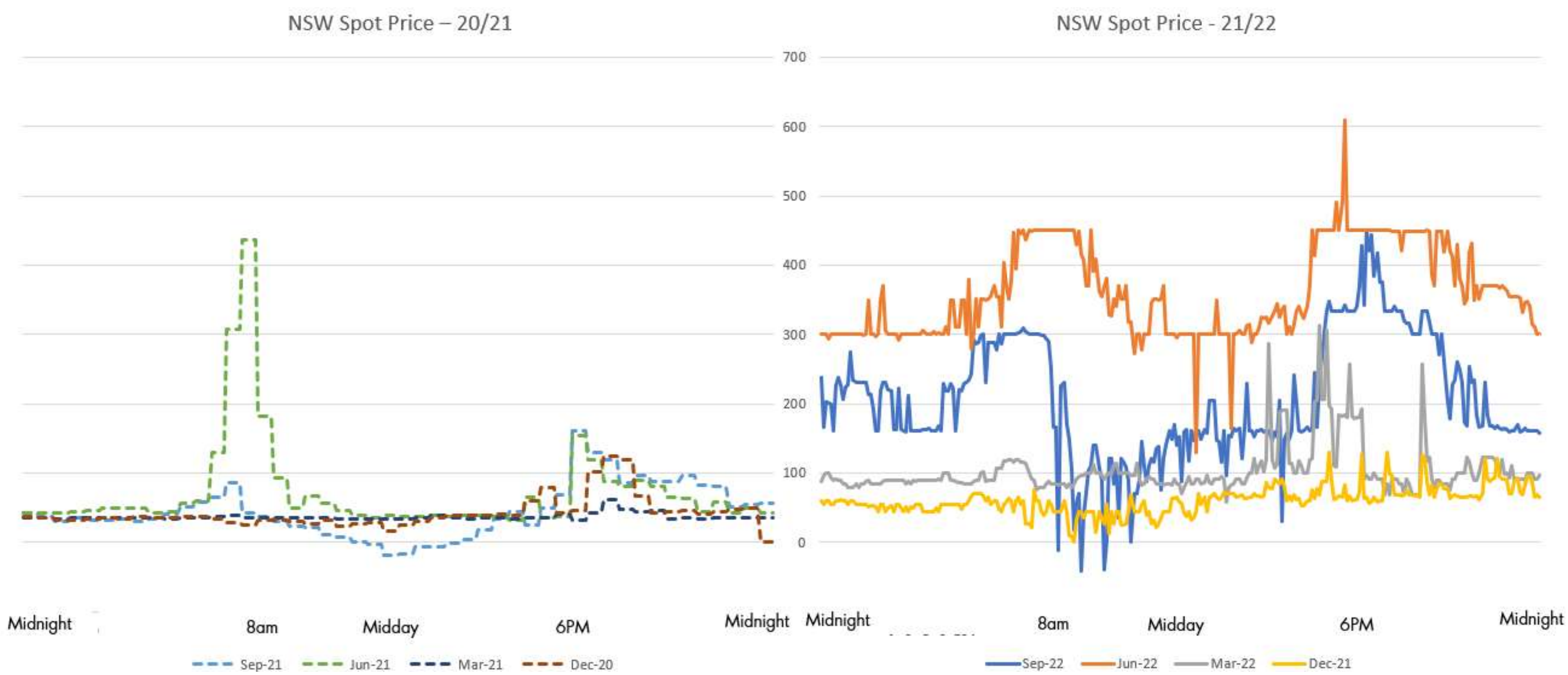

Fig 1. A comparison, year on year of the spot price for the same randomly picked day in each month, showing a marked increase in volatility. The difference in granularity between the graphs is attributable to the change from 30 minute settlements to 5 minute settlements.

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

Powershop considers that a maintenance of the 10% and 15% retail allowance glide path is the most prudent approach in a market with increasing risk and volatility for retailers. The AER will continue to face challenges in a fluctuating market when it comes to setting the retail allowance, supporting the continuation of the glide path set by the AER.

In addition to the above view, calculating the cost stack and changes to the DMO year on year has been a challenging task and is likely to continue to be during the energy transition. With increased intervention and market challenges that retailers are facing, including costs relating to market suspension and RERT costs, maintaining a retail allowance sufficient to weather these risks is appropriate.

It must also be a factor that the DMO does not currently have a legislative mechanism allowing for a revised DMO outside of the normal regulatory period. In Victoria, under the Victorian Default Offer (the **"VDO"**) legislative requirements, it is possible to recalculate the VDO where an event occurs or a circumstance arises outside of the control of retailers within the regulatory period, that was unforeseen or sufficiently uncertain as to not have been taken into account at the making of a price determination.

With the lack of this flexibility in relation to the DMO, risk is borne by retailers where the DMO is not able to adapt quickly to include unforeseen costs or events (such as the aforementioned market suspension and associated compensation).

We acknowledge that cost-of-living pressures are a concern for customers, retailers and regulators. However, we see the importance of a holistic approach to affordability issues rather than using the DMO to drive prices to unrealistic and artificially low levels, which will place further constraints on retailers and have long term consequences to the competitive market and ultimately consumers.

Powershop would encourage the AER to continue to work with industry on other initiatives that can have significant influence. This includes the continued push for greater access to concessions and other programs to assist with targeted relief. Powershop is cognisant of the Game Changers program that the AER is progressing with the industry. The holistic approach taken from this program we believe will be more impactful for customers, particularly recognising that retailer energy bills pass through the entire supply chain costs and place retailers as the sole bearers of supply chain credit risks.

Conclusion

Powershop understands that the AER is cognisant of the impacts this decision will have on consumers and retailers, and Powershop believes the issues of the retail allowance and wholesale cost methodology should be carefully considered. Powershop strongly believes that the DMO is not the mechanism to address cost of living pressures and should continue to fulfil the policy objectives set from the beginning. Powershop supports consistency of approach regarding the retail allowance, understanding the environment in which retailers are operating. In addition, Powershop supports continued work on addressing vulnerability and cost of living pressures outside of DMO price regulation.

Powershop would welcome further engagement with the AER on the points highlighted through this submission. If you would like to discuss, please contact James Ell at james.ell@powershop.com.au.

Yours sincerely,

Libby Hawker
GM Regulatory Affairs and Compliance