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Default Market Offer Prices 2022-23 Draft determination

Powershop Australia Pty Ltd (**Powershop**) thanks the Australian Energy Regulator (**AER**) for the opportunity to provide comments in response to the AER's Default Market Offer Prices 2022-23 Draft determination paper (the **Paper**).

Background on Powershop

Powershop is an innovative retailer committed to providing lower prices for customers and recognises the benefits to customers in transitioning to a more distributed and renewable-based energy system. Powershop has introduced numerous new, innovative, and customer-centric initiatives into the market.

Statement

While Powershop does not support price regulation, Powershop acknowledges that the policy intent behind the Default Market Offer (**DMO**) was clear from the outset. Powershop has concerns with the Paper and the bottom-up methodology and believes that it puts the original policy intent at risk. The Paper and the AER's attempt to reset the DMO, utilising a bottom-up approach with disparities in the broad assumptions outlined below, in Powershop's view puts the DMO at risk of putting undue pressure on sustainable competition.

The Paper essentially moves the DMO from a successful price cap, beneficial to customers and industry alike, to an uncertain and unproven 'efficient price retailer' concept such as the Victorian Default Offer (**VDO**), which in Powershop's view, is not aligned to the policy intent of the DMO.

Powershop does not believe the potential changes meet the objectives of the DMO, consequently impacting customers and industry negatively as we continue through energy transition. We urge the AER to reconsider and pause these changes (for the 2023-24 DMO) until there the proposed assumptions can be appropriately tested, and all relevant costs are accounted for in the bottom-up approach.

Indexation versus Cost Build-Up Approach

Powershop supported in its submission to the AER Options Paper in November 2021, a review into the methodology underpinning the DMO to ensure it had had achieved its objectives and indicated that, because of this success, very little change was necessary. Our support was on the basis that the new methodology, unlike the VDO, would ensure that the final determination more accurately reflected the costs to retailers, especially with the changing wholesale costs.

The change must also continue to uphold the policy intent of ensuring there is a reasonable margin and headroom applied for retailers to continue to invest in more innovative products and services, creating greater competition for customers.[1]

Powershop also refers to the AER's final decision for the 2021-22 setting of the DMO. The Paper confirmed "*Our continued use of the indexation approach has resulted in 2021-22 (DMO 3) prices that are lower for customers in all regions compared to last year*."[2] This confirms the success of the indexation approach after 3 annual DMOs, including its ability to achieve the key objectives of the DMO, with no submissions from stakeholders concerned that the model should be replaced. Without question it has been the AER's model of choice.

Powershop does not support a review or change in methodology that fails to confirm, with supporting evidence, that the bottom-up method would be more successful than what indexation achieves towards the DMO objectives. The review should seek to implement a model that improves the current model, rather than moving to an imperfect model that is inconsistent with the policy intent.

Powershop is of the view that using ACCC data, which is not collected specifically for assessing the costs for the DMO and has a different purpose, is flawed. On this basis, the AER should acknowledge these flaws when using the data to set a default price. What the ACCC data does not capture are key components such as depreciation (e.g. assets, IT software and system upgrades), regulatory costs and is not intended to be used for forecasting.

Regulatory costs
Apart from the Paper recognising costs incurred for smart meter installations, there is no allowance for regulatory costs retailers have incurred under the proposed model. If the proposed approach is to be applied, then consistency should be sought. Similar to the VDO and its allowance for regulatory costs, the proposed model should include costs for regulatory implementations. For example, this includes but is not limited to, the Better Bills Guideline implementation and Consumer Data Rights ongoing implementation costs. By not including costs such as this, the DMO does not reflect all of the costs that retailers are likely to face in the relevant period.

Wholesale costs
Powershop would like to highlight the rapidly increasing wholesale prices (even since the initial draft in February 2022), as an important consideration. Whilst the Paper has acknowledged the broader increase in wholesale costs, the most recent increase in March has been driven by international commodity price rises in coal and gas. These are related to high prices paid over the northern hemisphere winter and most recently flow on effects from the current geopolitical issues in Eastern Europe.

Powershop believes it is important to highlight this because the DMO in application uses an assumption that retailers have equally hedged into prices over time and does not factor such events. When the market experiences a huge, sudden increase in price, this creates a scenario where retailers could be in a position where, acquiring or retaining customers for the coming financial year has a negative value against selling existing hedges. In the case of a growing retailer, it could result in unprofitability when seeking new customers.

Powershop note that wholesale costs form part of the customer bill, but with such a big increase with current prices, this potentially doubles the Trade-Weighted-Price of the last 24/36 months. With current prices so high, Powershop suspects that this would negatively impact gross margin compared to just selling at current prices.

The AER believes this is not an issue, with the central philosophy applied being that across the market a loss for one retailer is a gain for another retailer who has sold the hedges. The flaw in having a fixed number assumes all retailers have perfectly predicted their customer numbers (including growth) and hedged accordingly. This causes issues when there is an expected price change later in 2022.

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[1] Powershop Australia, Default Market Offer prices Options Paper on the methodology to be adopted for the 2022-23 determination (and subsequent years), November 2021, Page 1
[2] Australian Energy Regulator, Final Determination Default Market Offer Prices 2021-22, April 2021, Page 7

The potential opposite effect applies if prices come down. The situation where retailer A buys hedges for the year ahead and prices fall means that other retailers can target your customers with lower prices, which means retailer A has too many hedge contracts. The Paper and the models that ACIL has applied to this point have struggled to reconcile over the last 2-3 years the big swings in prices experienced (down in the 2021 financial year and up in the 2023 financial year).

Forecasting risk
The DMO assumes retailers can forecast their exact customer numbers (24 months out) to begin progressively hedging, to avoid this exposure. Based on data and analysis, Powershop believes this is unrealistic and only discourages retailers to grow. Instead, trying to hedge 'new customers' only opens a retailer up to wholesale price risks and in the case of the 2023 financial year makes growing economically unattractive.

The DMO needs to address the current very high prices and how they may affect churn/retailers that are not seeking new customers as well as the high volatility of hedging contracts (both up and down), as a real risk retailers need to factor in and be duly compensated for.

Based on the above issues, Powershop does not see the evidence to support the Paper's decision to shift the forecast estimation method from the 95th percentile to the 75th percentile, particularly when their appointed consultant ACIL Allen have also supported the 95th percentile approach. 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.

Powershop notes the Paper responded to our submission to the AER's position paper that it believes ACIL's analysis does factor in price peaks. If the AER is to apply their cost stack method for a more accurate representation of the costs incurred by retailers, then based on the above, their response to our concerns of price peaks requires stronger consideration as they did not outline how their model does address peaks. Powershop would appreciate further consultation on this issue with ACIL and the AER before a final determination is made.

Finally, Powershop supports the Australian Energy Council's (**AEC**) position on the peer review of the wholesale methodology. Powershop does not support the potential appointment of Frontier Economics as their methods to calculating the wholesale costs in Victoria differ significantly, even more so to that of the request from the AER of moving from a 95th percentile to the 75th percentile. The Frontier Economics wholesale cost methodology is irrelevant to the DMO as applying their methods to this review simply fail the objectives of the DMO. Powershop supports retaining the ACIL Allen model, retaining the 95th percentile range as advised above.

Powershop also support the AEC's view that any peer review must be public and transparent to ensure that any price setting that the AER undertakes, recognises the value the AER places on this review as well as ensuring that all costs a retailer incurs have been duly considered.

Retailer Operating Costs (ROC) and Allowance Cap
Powershop appreciates that the Paper has acknowledged the costs associated with the rollout of smart meters across the NEM. However, we do not support the proposed approach as it will not capture a retailer's true costs incurred.

The proposed retailer allowance caps lack evidence or any thorough analysis in their application. Without a consistent, prescribed method, Powershop is concerned the allowance caps will only be set based at the behest of the AER, influenced by external, political factors. The lack of ability to calculate the correct caps initially for the cost build-up approach is why Powershop believes the indexation approach should remain for the DMO4 until the AER works with industry to confirm if the change in method captures retail costs and allowances correctly. This must also include the ability for retailers to be provided the appropriate headroom to help achieve the objective of continued competition and innovation.

Why DMO4 could fail its objectives
The initial policy intent of the DMO was to prevent retailers charging unjustifiably high standing offer prices, allow retailers to recover their efficient costs of providing services with a reasonable retail margin and to ensure incentives for competition, innovation and investment by retailers whilst retaining incentives for consumers to engage in the market. While we consider that the DMO met these objectives over the last 3 years, this methodology puts the policy intent at risk. If costs are not correctly accounted for, we could see retailers being unable to recover their efficient costs with a reasonable retail margin, and a dampening of competition in the market.

Powershop is concerned that DMO4 sets a risky precedent and expectation that it is no longer a default option, but a false pretence that it is a competitive option that disengaged customers believe would be good for them (not knowing it is still far more expensive than any market offer).

Another key objective not adequately achieved under DMO4 through the intent of a default offer being that of an efficiently priced offer, reduces the ability for retailers to assist their engaged customers through greater competition and innovation through products and services. Any upcoming opportunities that could be made available to customers by the industry would be significantly reduced because of the lack of funds available to invest in this innovation required to adapt to the current energy transition.

Without evidence or logic supporting the changes proposed to the DMO model as above, Powershop does not believe the AER has provided enough clarity on many of the assumptions highlighted throughout the paper. This lack of clarity on the proposed changes leads industry to consider the worst-case scenarios of the bottom-up approach. Powershop proposes to defer these significant decisions until at least the 2023-24 DMO until there is appropriate evidence to support these changes.

If you have any questions in relation to this submission, please do not hesitate to contact me.

Yours sincerely

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