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19 November 2021

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

Submitted electronically: DMO@aer.gov.au

Dear Ms Jolly,

Re: Default Market Offer - Options Paper on the methodology to be adopted for the 2022-23 determination

Red Energy and Lumo Energy (Red and Lumo) welcome the opportunity to respond to the Australian Energy Regulator's (AER's) Options Paper on the methodology to be adopted for the 2022-23 determination of the Default Market Offer (DMO).

Red and Lumo support the DMO as a safety net for standing offer consumers and as a reference price that complements other elements of the broader regulatory framework and helps electricity consumers participate in the competitive market with confidence. At the same time, the DMO is also intended to promote competition and innovation as the mechanism for achieving good consumer outcomes. Our support of the DMO is contingent on the AER striking the appropriate balance between these policy objectives.

The broader context for this review is important. We argued in our submission to the Department of Industry, Science, Energy and Resources' post implementation review of the *Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019* (the DMO Code) that it should commit to another review of the DMO Code within 2 years. In our view, the current configuration of the DMO will become less compatible with the likely direction of the competitive market and regulatory framework.

Our submission to the DMO Code review referred to forthcoming regulatory initiatives such as the Consumer Data Right, the Energy Security Board's recommendations to create flexible trading arrangements and a two-sided market, and the implementation of more cost reflective tariffs (including export charges) by distribution businesses. Each of these will fundamentally change the way that many consumers participate in the market, including the price signals they will see.

For example, the Energy Security Board predicts that many consumers will engage with multiple service providers and/or will be increasingly willing to respond to sharper price signals to (directly or indirectly) participate in wholesale markets or provide network support. The current form of the DMO as a reference is not compatible with this type of market and the retail products that will emerge as a result of these changes. There is a risk that the DMO would be either unhelpful for this growing consumer segment or misleading at worst. The AER will need to make increasingly arbitrary assumptions about the volume and timing of usage that will not reflect many consumers' actual experience.

With this context, we recommend the AER avoid substantial changes to its DMO methodology at this time, but instead focus on minor changes that would ensure a better balance of policy objectives.

Views on the impact of the Default Market Offer

The AER's approach to date has led to a diminution of headroom over time, which suggests it has placed a relatively greater weighting on the policy objective to reduce the standing offer price cap. If it persists, this will undermine the competitive market given the DMO functions as *both* a price cap and as a reference for the majority of market offers. There is a risk that the steady decline in recent years in the percentage of consumers who are on a standard retail contract will start to reverse, particularly in some jurisdictions.

Red and Lumo strongly hold the view that market offers provide a better combination of price and service standards and as a result, very few, if any, consumers should remain on the DMO. Consumers in aggregate will derive the greatest benefit from a competitive market that rewards innovation and efficiency gains, rather than a regulated DMO that starts to resemble an estimation of reasonable or efficient operating costs.

This view is also implicit in a broad range of policy initiatives and forthcoming regulatory measures, all of which are intended to encourage market participation. These range from prescribing the DMO as a reference price with associated advertising requirements, prescribed notifications (in advance of a price change or expiry of a benefit), the Retail Pricing Information Guideline, forthcoming changes to Energy Made Easy, the recent switching rules, and the extension of the Consumer Data Right to the energy sector.

The reduction in headroom commenced with DMO1, when the AER did not adjust the final determination (or indeed, any subsequent determinations) to account for material changes to network costs from those prevailing when the market pricing used to set the first DMO was collected, most notably in South Australia and south-east Queensland. The reduced headroom has been baked into the DMO and was further compounded in DMO2 and DMO3, when the AER did not explicitly account for the additional cost of smart meters (which includes ongoing capital costs in many instances) and to a lesser extent, between Time of Use (TOU) and flat network tariffs.

Therefore, we are pleased that the AER recognises the importance of these factors in the options paper and proposes to account for them in future DMOs. It also acknowledges the negative impact on competition and on specific policy initiatives, such as competitive metering and the use of more cost reflective network tariffs, of a failure to account for all reasonable costs and to then provide sufficient headroom in the DMO. Red and Lumo were happy to respond to the AER's recent data request relating to the cost of smart meters and would welcome the opportunity to discuss our response in more detail with the DMO team.

Specific comments

In light of our recommendation for a more fundamental review of the broader DMO framework, Red and Lumo encourage the AER to avoid significant changes to its current methodology, apart from accounting for the increasing costs of smart meters and reflecting actual network costs. This would provide consistency and certainty, while policymakers assess how best to align the DMO framework with the likely direction of the market.

The AER suggests the calculation of specific elements of retailer operating costs (Option 1) as a feasible alternative to the current indexation and step change framework. However, the AER acknowledges this is extremely challenging and will require determination of an appropriate margin and competition allowance. There is no single or correct answer to this question and there will be conflicting views among stakeholders, particularly as some consumer groups have a different view of what the appropriate weighting of DMO policy objectives should be. This was illustrated by the presentation of the Public Interest Advocacy Centre at the AER's recent DMO public forum.

The AER refers to analysis of the different margins that retailers earn across the DMO regions and the absence of a productivity adjustment as possible reasons for a shift of methodology. However, we do not see clear and compelling evidence of widespread productivity improvements across the broader retail sector. Furthermore, the reported results of ASX listed companies are not reliable sources of information about broader industry operations, despite being frequently cited as the basis for efficiency gains across the sector. In our view, the risks to competition of attempting to quantify these adjustments and then account for them in each DMO outweigh any potential benefits. Moreover, all consumers can readily access market offers, which are generally a better representation of efficient costs in an effectively competitive market.

The AER suggests that retailers' response to ACCC data requests would provide a viable input to this calculation. However, the AER rightly points out that this dataset is imperfect and backward looking. Furthermore, each response incorporates different methodologies and assumptions that reflect each retailers' specific corporate structure.

We also see some risk that a shift to a cost build up approach that has a specific focus on inputs such as assumed cost to serve, margin, competition allowance, depreciation, overheads, and bad and doubtful allowances, and adjustments for productivity will change the perception of the DMO. The DMO would be viewed by many as being similar to the Victorian Default Offer, which the Essential Services Commission deems to be a 'fair' price from an 'efficient' retailer. However, the AER is aware that the policy environment is substantially different, with the DMO set as a fallback price and for retail competition to continue to flourish.

Although we have concerns about the cost build up approach, indexation has led to a reduction in headroom over the course of the AER's three determinations. As a minimum, the AER should account for additional meter and network costs as it has suggested and we also welcome its suggestion to provide more clarity about the operation of the step change mechanism. Retailers provided details of the impact of COVID—in terms of the incremental contribution to bad and doubtful debt over historic levels—but the AER did not account for it in DMO3. Looking ahead, retailers will incur significant costs to implement the Consumer Data Right so further clarity about the step change mechanism will provide confidence to retailers that they can recover reasonable costs.

We also suggest that the AER could look at correcting the relative erosion of margins under the DMO in some regions (most evident in South Australia for example) through the indexation method, by adjusting DMO1 for the actual network cost movement that coincided with the introduction of the first DMO, and reindexing subsequent movements since according to actual network costs, not draft movements.

Finally, we encourage the AER to avoid significant changes to its methodology to calculate wholesale costs, noting its significance as a component of the cost stack; this will provide consistency and certainty to retailers. As the AER notes, shortening the book build period and/or assuming greater exposure to spot markets will lead to more volatile prices and in our experience, consumers tend to prefer a smooth price path. Moreover, a change to methodology at this point and after 3 years of the DMO will penalise some retailers relative to others, such as those whose hedging strategies are more aligned with the current methodology, or who have adjusted their strategy in line with the AER's model.

About Red and Lumo

We are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria, New South Wales, Queensland, South Australia and in the ACT to over 1.1 million customers.

Red and Lumo thank the AER for the opportunity to respond to its options paper. Should you wish to discuss aspects or have any further enquiries regarding this submission, please call Geoff Hargreaves, Regulatory Manager on 0438 671 750.

Yours sincerely

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Retail CFO
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