red energy
PO Box 4136
East Richmond VIC 3121
T 131 806
F 1300 661 086
W redenergy.com.au

PO Box 4136
East Richmond VIC 3121
T 1300 115 866
F 1300 136 891
W lumoenergy.com.au

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Mr Gavin Fox
General Manager (acting), Market Performance
Australian Energy Regulator
GPO Box 3131,
Canberra ACT 2601

Submitted via email: DMO@aer.gov.au

Re: Issues Paper - Default Market Offer for 2023/24

Red Energy and Lumo Energy (Red and Lumo) are pleased to make this submission to the Australian Energy Regulator's (the AER's) issues paper for the Default Market Offer to apply from 1 July 2023 (DMO5).

Red and Lumo have been consistent advocates of the policy objective of the DMO. A benchmark is valuable to help customers compare offers. Importantly that should provide reasonable protection for disengaged customers, whilst not being set too low as to discourage competition amongst retailers and participation in the market by customers. The AER should remain steadfast in its consistent application of its methodology, as retailers now need certainty more than ever. We note that the AER attempted to tinker with the levers available to it in DMO4 (by specifying allowable margins and phasing them in across jurisdictions in different ways and by amending the methodology for calculating wholesale costs, for example). This has highlighted the implications for retailer viability and the unintended consequences for consumers associated with a lack of competition.

Red and Lumo urge the AER to focus on certainty and transparency in its approach, to avoid the next DMO determination having significant implications for the health of the competitive retail electricity market and the viability of many retailers, particularly smaller and more recent entrants. We note that this will be a difficult DMO for the AER, as it will make this determination in a highly volatile environment and arguably will require a more cautious approach. The consequences are not symmetrical as setting DMO5 too low will cause further retailer failures whereas setting DMO5 too high will see competition erode any perceived 'additional' headroom.

The market is reflecting a range of external factors that are impacting the cost of purchasing and delivering electricity to consumers, and as policymakers try to manage the NEM's orderly transition. This volatility is most apparent in wholesale market outcomes. It is important to keep the policy objectives of the DMO in mind within this context and acknowledge that the DMO should offer protection for disengaged consumers while offering sufficient headroom to encourage competition.

We strongly encourage the AER to avoid substantially altering the balance of policy objectives as a response to concerns about energy affordability. The AER is already doing great work in implementing its *Towards Energy Equity* strategy where ensuring inclusivity in the energy market, including entrenched and transitory vulnerability is being addressed. The existing regulatory framework is developed through specific, targeted and proportionate measures, such as the AER's Hardship Guideline to focus on supporting vulnerable customers. The AER should account for retailers' capacity to remain financially and socially responsible to support vulnerable consumers when setting the DMO.

It is not the policy objective of the DMO to address payment difficulties or vulnerability and a determination that significantly rebalances its policy objectives will have a detrimental impact on consumers over the longer term. Now more than ever, retailers need certainty about their ability to recover costs and adopt a hedging strategy that generally spans multiple years under price regulation. Greater emphasis on one policy objective relative to others, accounting for additional factors such as vulnerability, or changes to an established method for calculating cost components, will undermine that certainty.

The discretion available to the AER under the DMO Code allows it to make trade-offs between the various policy objectives and the process for making these assessments about the relative merits of different positions is unclear. Therefore, we have some concerns that the AER might be seeking to place greater emphasis on other policy objectives at the expense of allowing retailers to recover reasonable costs and promoting competition. Outcomes in the retail market, including the numerous retail failures in recent months and that some retailers have refused to accept new customers, suggest now is not the time to rebalance the DMO.

To this point, the AER has struck a reasonable balance. The number of consumers on standing offers has steadily declined in recent years and consumers have been better off by engaging in the competitive market to identify a more competitive offer, rather than passively signing up to the DMO. The promotion of competition is also implicit in various recent and forthcoming regulatory measures to promote engagement, such as the AER's Better Bills Guideline and the Consumer Data Right, both of which seek to encourage greater participation.

The issues paper contains numerous references to the impact of the expected increase in the DMO—and of changes to individual components of the cost stack—on vulnerable consumers and that this is a factor the AER should take into account. For example, the AER expresses concern about the consequences of a change in the dollar amount of the allowable retail margin, due to its calculation as a percentage of other cost components. The paper states this could lead to an 'improper balance' of the DMO objectives, and that a more appropriate response might be to allow a lower percentage to 'protect consumers from unreasonably high prices'.

There is a reasonable basis for concluding the level of the current DMO is contributing to a challenging environment for some retailers. The AER acknowledges that '*in current market conditions, it is possible that the DMO prices may be playing less of a 'safety net' role but instead more closely represent a typical offer in the market*.'[1] We agree with this statement and consider that this is directly attributable to the inadequacy of the headroom available in DMO4. While the AER dismisses the contribution of the current DMO to recent retailer failures (and instead attributes them to business models and hedging strategies), there is no counterfactual against which to test this hypothesis. The challenges for retailers could continue into DMO5 if the AER alters the balance of policy objectives.

Furthermore, the concept of an allowable margin and the AER's specific statements about the returns to retail operations in DMO jurisdictions should be interpreted with care. Our submissions to the AER's consultation for DMO4 noted some limitations of the Australian Competition and Consumer Commission's datasets that are used to reach these conclusions and it is likely that a significant number of retailers are earning lower returns than those outlined in the issues paper.

As a final point, effective competition does not *just* deliver efficient prices. It also encourages market participants to develop choice in different products and services. In the long term context of the energy market, this will include tools that increase consumers' ability to understand and manage their energy consumption. Suppressing the DMO to address short term concerns about vulnerability when more targeted and proportionate obligations exist will undermine this incentive to differentiate.

For these various reasons, we strongly recommend the AER adopt a consistent and conservative approach to setting DMO5.

Wholesale costs

The issues paper states that the current approach could potentially overestimate wholesale energy costs. However, this is inconsistent with the Frontier Economics report to the AER. The Frontier report instead suggested that they could only be over-estimated relative to the most efficient retailer. The AER is aware that the DMO is not intended to be an estimate of the cost incurred by an efficient retailer and in the current environment of volatile and elevated wholesale costs, the greatest risk is that regulated retail prices will not reflect the actual costs that many

[1] Australian Energy Regulator (2022), *Default market offer prices 2023-34: Issues paper*, page 10

retailers face. Frontier seems to acknowledge this risk under the current approach in its discussion of competition and innovation, despite concluding that there is no compelling reason to change.

Furthermore, Frontier states earlier in the report that '*true wholesale energy costs are complex, uncertain, and will vary by retailer. There is a range of alternative approaches to estimating retail wholesale energy costs for the purposes of the DMO.*'[2]

We agree with the AER's suggestion that there is merit in reassessing the market based approach to better assess how it contributes to the respective DMO objectives and in particular, whether it allows for the recovery of reasonable costs. As the AER notes, retailers adopt a broad range of approaches to managing their customers' load and limiting the inputs to its modelling to only include ASX trades (albeit verified against broker OTC data) will not always produce a reasonable estimate.

We acknowledge the AER's suggestion to potentially include option products in its modelling and agree they are an increasingly common hedging tool. It states that this will increase the complexity in the model but it would remain a transparent approach, given the availability of information from the ASX trade log, while better reflecting actual costs for many retailers. However, there is considerable detail to be worked through before the AER and other stakeholders can assess how a change of methodology might impact the DMO. For example, the AER will need to decide on which specific options it will include and whether it will apply a common approach across all jurisdictions, or whether it will only use options where there is an issue with contract market liquidity, i.e. South Australia. Furthermore, the AER would need to take account of the market price at expiry—rather than the initial strike price—which is the true reflection of the value of energy at that time.

Therefore, we see merit in the AER releasing further detail ahead of the draft determination of any analysis of the options market, the different approaches it has considered to account for options in its wholesale cost methodology, and how they have been assessed against the DMO policy options.

Generator compensation

The issues paper explains that the AER expects to be able to account for the costs of generator compensation as calculated by AEMO but not those calculated by the Australian Energy Market Commission (AEMC). The outcome of these calculations remains highly uncertain but retailers

[2] Frontier Economics (2022), *Review of retail wholesale energy cost estimation methodology: Final Report for the Australian Energy Regulator*, page 6

will potentially be exposed to a material cost that they cannot recover under the AER's proposed approach.

We encourage the AER to liaise with the AEMC to better understand the potential outcome and to allow it to make a more informed decision about the impact of excluding these costs. In the current environment, this cost may be significant and create challenges with liquidity, particularly for smaller retailers. Alternatively, the AER could include an amount in the final determination that reflects the best estimate available to it at that time and then adjust DMO6 within the next determination period if the difference between the estimate and actual amount is material (i.e. commensurate to a true-up mechanism). Another approach might be to include a higher retail allowance.

About Red and Lumo

We are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in New South Wales, Queensland, South Australia, Victoria and in the ACT to over 1.2 million customers.

We thank the AER for the opportunity to comment on its issues paper. Should you wish to discuss aspects of this submission or have any further enquiries, please contact Geoff Hargreaves or myself.

Yours sincerely

Stefanie Monaco
Manager - Regulatory Affairs
Red Energy Pty Ltd
Lumo Energy (Australia) Pty Ltd