



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

PO Box 632
Collins St West VIC 8007
T 1300 115 866
F 1300 136 891
W lumoenery.com.au



21 October 2019

Mr Mark Feather
General Manager - Policy and Performance
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Submitted electronically: DMO@aer.gov.au

Dear Mr Feather,

Re: Position Paper - Default Market Offer 2020/21

Red Energy and Lumo Energy (Red and Lumo) are pleased to make this submission to the Australian Energy Regulator's (the AER's) Position Paper on the determination of the Default Market Offer (DMO) for 2020/21.

Red and Lumo strongly support a competitive retail market for all energy customers. We consider that strong, competitive markets deliver the best outcomes for customers as they can choose products and services that meet their energy needs. The DMO sets a price cap and has been implemented as a replacement for the existing safety net, standing offers. DMO 2 should continue to ensure that all retailers continue to be able to compete effectively to deliver better value and choice to consumers.

Given the expertise by the Australian Competition and Consumer Commission (ACCC) generally and acquired through the Retail Energy Pricing Inquiry (REPI), we consider that the ACCC should be directly charged with determining the DMO, with input from the AER. Recognising that as it currently stands the AER has been tasked with administering this function, we believe the AER has achieved a reasonable balance in satisfying the policy objectives of the DMO in the first year. We note it is still too early to determine its precise impact, particularly when it is also necessary to account for the impact of the advertising requirements on retailers. This substantially changed the way that retailers were able to present their offers and we have seen - and continue to see - changes to the number and type of offers available to energy consumers.

It remains to be seen whether under the DMO Regulations, the advertising requirement to present the various sets of information in order to compare offers helps consumers to participate in competitive energy markets.¹ This must remain an important focus for the AER and ACCC over the next 12 months.

The potential for error exists in any framework for the regulation of retail prices and can impact a retailer's ability to recover the efficient costs of providing customers with what is considered an essential service. Whilst our preference is that the ACCC assumes responsibility of the DMO, under the current approach we recommend that the AER adopt a conservative approach to the setting of the DMO price cap considering potential impacts to the fundamentals of a competitive market and flow on impacts to limiting customer choice.

¹ Subdivision B of *Competition and Consumer (Industry Code— Electricity Retail) Regulations 2019*

Understanding that the DMO code is a regulatory instrument we support option 1 as outlined in the AER's position paper, as the lowest risk option for setting DMO 2. We also suggest the AER revisit its assumptions about retailers' operating costs. This point is explored in more detail below.

Forecasting changes in the cost of supply

The position paper explains that the AER has engaged ACIL Allen to estimate the change in wholesale and environmental costs using a market based approach. ACIL Allen's report includes a comprehensive description of its approach to estimating costs and we appreciate the AER's transparency by making the report publicly available for consideration.

The AER acknowledges that its forecasts of the change in significant cost items will not be the same as those that some retailers will actually face. Therefore, we recommend it take a conservative approach accounting for the range of business models prevalent in the retail market and independent hedging strategies of retailers. This would maintain two of the core policy objectives of the DMO - 'to allow retailers to recover their efficient costs of providing services' and 'to maintain incentives for competition, innovation and market participation by customers and retailers'.²

The market based approach proposed by ACIL Allen and the AER is reasonable and consistent with previous and current determinations from other jurisdictions (with the Victorian Default Offer as a recent example). Noting that retailers operate within a volatile wholesale market, ACIL Allen should ensure its analysis and conclusions reflect the best and most recent information available about the current and expected state of the markets. This will ensure that DMO 2 is set as accurately as possible.

Energy markets are experiencing heightened volatility largely as a result of the increased penetration of solar PV, the withdrawal of dispatchable baseload generation and low storage levels impacting hydro generation. This volatility is reflected in higher prices for swap and cap contracts available in the futures market over the past 12 months and is expected to continue through to the timing of the AER's draft and final determinations. Any modelling that draws on market data should reflect retailers' hedging strategies to manage their exposure to wholesale costs over a reasonable period of time, while also capturing pricing data as close to the final determination date as possible.

ACIL Allen's modelling will also need to include realistic assumptions about a prudent retailer's hedging strategy, namely, appropriate weightings for the different types of products available and some reasonable level of exposure to spot prices. We would welcome the opportunity to work with ACIL Allen and the AER as they develop their assumptions and gather the inputs to their modelling.

In light of this, we note that historic Network System Load Profiles (NSLP) and Controlled Load Profiles are "historic". These are not necessarily the best indicators of future load profiles and ACIL Allen should give greater weight to more recent profiles that reflect the current state of the market.

² Australian Energy Regulator (2019), *Position Paper - Default Market Offer 2020-21*, pp. 9-10

Similarly, assumptions about load profile may reflect the profiles of certain retailers' customer base but not others. Some retailers may, as an example, have more volatile profiles as they have a relatively high proportion of solar customers. Another example is the statement that an appropriate benchmark for a broadly reflective retailer's hedging strategy is a 'risk averse retailer with an established load'.³ However, this necessarily involves assumptions about the size and composition of a retailer's customer base and is a potential barrier to new entry.

Finally, we do not share the AER's view that there is 'limited value' in separating the NSLP into residential and small business customer profiles.⁴ There is a substantial difference in the volume of consumption between these categories of consumer, which the AER acknowledges in its prescribed model annual usages (20,000 kWh for small business compared with around 4,600 kWh per annum for residential across the 5 networks). We think that further analysis is required by the AER to identify the extent of significant difference in load profile between these two broad categories and how it impacts retailers' exposure to volatility of that load.

Retail costs

The AER's proposed approach to adjusting retail operating costs and customer acquisition and retention costs (CARC) is reasonable. We also support the AER's decision to include a step-change framework to account for exogenous factors that influence retailers' operating costs, such as significant regulatory initiatives. This is an important element of the DMO determination process that gives retailers some reassurance they will be able to recover reasonable costs.

We also support the AER's assessment criteria and proposed approach for identifying and quantifying the impact of such changes, including a commitment to consult with retailers.

The AER concluded in its determination of DMO 1 that it expected the costs of 5 minute settlement would be '*primarily associated with market generators and the replacement of meters. In the event that these costs are passed on, the retailer will incur the costs through increased wholesale and/or network costs. Given these costs are already included in our cost forecast, we do not propose to further adjust our forecast retail costs. However we will need to consider the implications of this reform from when it comes into effect on 1 July 2021 in future determinations.*'⁵ It did not include any specific allowance of adjustment for 5 minute settlement in DMO 1.

We do recommend that the AER revisit its conclusions about the costs apportioned for the transition to 5 minute settlement. In particular, the contribution to retailer operating costs in 2020/21. As the AER notes, this will impose significant costs on industry as retailer systems are updated (including settlement; risk management; trading; billing; reporting; data collection and storage), processes to reflect the five minute settlement intervals will need to be developed and implemented and retailers will need to manage risks including potentially renegotiating longer term hedging contracts.

³ Ibid. page 25

⁴ Ibid. page 28

⁵ Australian Energy Regulator (2019), *Final Determination – Default Market Offer Prices 2019-20*, page 56

We do not agree with the statement that 5 minute settlement system development costs have already been incorporated in forward retail prices, as retailers would not have had reliable estimates of the full impact of preparing for 5 minute settlement either at the time of the final rule determination or when the AER made its first DMO determination. Furthermore, retailers would not incur costs in a linear manner leading up to commencement on 1 July 2021, especially as the Australian Energy Market Operator still has not finalised the technical specifications for implementation. Following this being completed, retailers will be better placed to provide the AER with more rigorous estimates of the timing and the magnitude of the cost of implementing 5 minute settlement. Red and Lumo can provide the AER with this information on a confidential basis.

Moreover, retailers would not seek to recover costs incurred from implementing regulatory changes into systems (such as 5 minute settlement) from their customers prior to the commencement of that regulatory initiative. This means they would not have factored these costs into their retail prices at the time the AER identified the range for DMO 1, namely, the median of market and standing offers respectively in October 2018.

We support the AER’s statement that it will monitor the proposed application of the Consumer Data Right to the energy sector and its likely contribution to retailers’ operating costs. The AER will be aware of Treasury’s recent consultation on priority datasets; this will determine which datasets are designated, and who will be the designated data holders. At the same time, the ACCC will need to develop energy-specific rules that will require retailers to create processes for the verification of data recipients and for the safe and secure transfer and retention of energy data. Similar to 5 minute settlement, these costs are still unknown and have not been factored into October 2018 offers.

Time of Use Tariffs

We recommend the AER reconsider its position and undertake further analysis before it proceeds with its suggestion that the price determination for residential customers on flat rate tariffs (with and without controlled load) is a reasonable per person price to apply to Time of Use (TOU) customers. We observe a significant difference between the network components of a single rate and a TOU customer at the DMO prescribed level of consumption, particularly in the Ausgrid distribution network.

Red and Lumo provide the table below as an indication to the AER of the matter raised above. It clearly highlights that a TOU customer at different consumption levels are subject to very different underlying network pricing. We believe this warrants the AER to reconsider its position.

Network	Tariff	Network costs @ DMO consumption (ex-GST)	Difference in network TOU – single rate
Ausgrid	Single rate	\$483	
	Time of use	\$630	\$147
Endeavour	Single rate	\$567	
	Time of use	\$654	\$87
Essential	Single rate	\$805	
	Time of use	\$821	\$16

The AER concludes that the likely impact at this time is quite minor due to the relatively small number of consumers on a TOU standing offers. However, this is a function of the networks' tariff structures and their assignment policies, neither of which have been set for 2020/21. We expect this will quickly become a significant risk for all retailers since any consumer can select a standing offer and the networks tend to assign all new connections and those who upgrade their meters (to a smart meter, for example) to a TOU tariff.

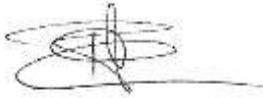
The AERs proposed approach may have unintended consequences, namely mandating retailers use a profile that might mislead consumers on the type of offers and savings available which are not applicable if they have a peaky usage profile and are assigned to a TOU tariff.

About Red and Lumo

Red and Lumo are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria, South Australia, New South Wales and Queensland, and electricity in the ACT to over 1 million customers.

Should the AER wish to discuss or have any enquiries regarding this submission, please contact Geoff Hargreaves, Regulatory Manager on 0438 671 750.

Yours sincerely

A handwritten signature in black ink, appearing to be "Ramy Soussou". The signature is fluid and cursive, with a long horizontal stroke at the end.

Ramy Soussou
General Manager Regulatory Affairs & Stakeholder Relations
Red Energy Pty Ltd
Lumo Energy (Australia) Pty Ltd