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11 November 2021

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

Via email to DMO@aer.gov.au

Dear Ms Jolly,

Re: Default Market Offer Price 2022-23– Options paper

Simply Energy welcomes the opportunity to provide feedback on the options paper for the Default Market Offer 2022-23 (DMO 4).

Simply Energy is a leading energy retailer with approximately 750,000 customer accounts across Victoria, New South Wales, South Australia, Queensland and Western Australia. As a leading retailer focused on continual growth and development, Simply Energy supports the development of effective regulation to facilitate competition and positive consumer outcomes in the market.

While Simply Energy understands the policy intent behind the introduction of the DMO and considers that the DMO has met the policy intent to date, Simply Energy does not support price regulation in competitive markets.

The Australian Energy Regulator (AER) has also indicated that the DMO price has met its policy intent to-date and has not provided evidence that the current methodology is deficient. Before presenting options that would significantly change the methodology, the AER should have first demonstrated there was an issue with the current methodology and its ability to meet the DMO's objectives. If there were clear issues with the current methodology, Simply Energy may have been supportive of the AER revisiting how the DMO price is calculated. At this stage, Simply Energy considers the current DMO methodology is largely fit-for-purpose, with some improvements possible through iterations to the existing approach.

Simply Energy's submission provides feedback on each of the AER's stakeholder questions.

Retail costs, profit margin and DMO allowance

Of the three options presented in the retail costs section of the options paper, Simply Energy would support either Option 2 or Option 3 as these would provide regulatory certainty and consistency with the methodology to date. Simply Energy considers the AER's current approach to estimating retail costs could be improved through iterating the current methodology to ensure the DMO price moves more closely in-line with cost changes faced by energy retailers.

Simply Energy would not support a move to a bottom-up cost methodology, as proposed in Option 1. While a bottom-up cost methodology may be appropriate for developing an offer that will be available in the market (such as the Victorian Default Offer), it is unnecessary for the purposes of setting a price cap. Option 1 would also be a significant change to the current methodology, which Simply Energy does not consider is justified when the current methodology has been largely successful at meeting the objectives.

Option 1 – Estimating retail costs and a DMO allowance

Question 1: What is the most appropriate approach to estimating retail operating costs under a cost-based approach?

Question 2: What information should we have regard to in estimating retail costs?

While Simply Energy does not support Option 1, we consider that the Australian Competition and Consumer Commission's (ACCC) published retail cost information would be the most reliable and transparent source of retail operating cost data.

Assuming that the 'DMO allowance' component would be sufficiently large to address the risk that the ACCC's data underestimates the retail costs of smaller retailers, we consider there would be limited benefit in requiring retailers to provide additional cost data beyond what is provided in the ACCC's dataset. However, it would be reasonable for the AER to consider data voluntarily provided by retailers that demonstrates forecast cost changes in the upcoming period that are not captured by the ACCC's historical dataset.

Question 3: What are the impacts on retailers facing a time lag for recovery of retail costs?

Simply Energy agrees that the time lag is unlikely to be a significant issue, as retail costs should have a relatively consistent rate of change over time. However, Simply Energy considers that the AER should retain a mechanism to respond to any exogenous shocks (i.e, either the step change framework or a re-opening mechanism), so that these costs can flow through to the price cap at the time they occur rather than in the following years. For example, unexpected economic shocks can lead to higher unemployment levels and reduce customers' ability to pay their energy bills, which would result in higher bad debt costs for retailers.

Simply Energy considers that the AER should apply an annual Consumer Price Index (CPI) adjustment to the ACCC's retail cost data, which would align with the AER's proposed approach to using the ACCC's retail cost data in Option 3. This would ensure that the retail cost estimate would hold its value in real terms for the coming year. Based on the AER's response to a question on this issue at the public forum on 10 November, it appears that an annual CPI adjustment was intended, even though it is not obvious in Figure 4.1 of the options paper.

Question 4: Is the DMO protecting customers from unjustifiably high prices? If so, why?

Question 5: What factors are relevant in considering whether a price is excessive?

Simply Energy considers that the DMO has helped consumers to better understand and compare electricity offers amongst retailers. To date, the DMO has been set a level that has enabled retailers to provide market offers that are below the price cap and to compete for new customers.

As part of its post-implementation review of the *Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019* (DMO Code), the Department of Industry, Science, Energy and Resources (DISER) commissioned survey research from Newgate on consumer awareness, understanding and perceptions of the DMO and the reference price. Newgate found that almost half of survey participants agreed with the statement 'the amount of money I could save is not worth the time and effort' when asked about barriers for engaging in the market.[1] During the implementation of the DMO reform, several stakeholders suggested that the introduction of the DMO would consolidate the range of available offers close to the DMO price and would make it

[1] Department of Industry, Science, Energy and Resources 2021, *Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019*: Post-implementation review, 10 September, p. 11.

more challenging for engaged consumers to access the same very low-priced offers that they could access prior to 1 July 2019. Newgate's finding may indicate that the DMO is set at a level that does not provide consumers with access to substantial enough savings to encourage them to shop around and/or move away from standing offers in large numbers.

Question 6: What other factors should we consider when assessing the DMO allowance required to incentivise customers to engage in the market?

The AER should consider Newgate's research into whether customers perceive there is value in engaging in the market. This type of research may provide behavioural insights into how high the price cap should be set to ensure that customers will engage with the retail market and enter into market contracts.

Simply Energy has previously proposed that the 'DMO allowance' should ensure that the DMO price is maintained at a consistent level above competitive retail electricity offers to the extent possible. This would mean that consumers signing-up today can trust their discount is comparable to those available in the market when they choose to next engage with the market.

For example, a consumer may sign-up to an offer that is 20 per cent below the DMO in 2021. If the DMO does not move in line with actual retail cost changes, the offers available when the consumer next engages in the market may only be around 15 per cent below the DMO (even though these offers may actually cost less per month than the consumer's current contract). From the consumer's perspective, the available offers may initially appear to be less competitive than their current contract, which may reduce their incentive to engage in the market and switch retailers.

If the DMO does not move in line with cost changes, it may reduce the usefulness of the reference price and deter consumers from switching to offers that would lower their electricity bills. As such, all things being equal, the DMO should strive to provide consumers with a transparent and consistent benchmark that does not suppress retail cost-recovery.

Question 7: Should the margin above efficient costs in the DMO price be consistent across all DMO regions and customer types?

Question 8: What is an appropriate DMO margin to achieve the policy goals?

As noted above, Simply Energy considers that the DMO price should be maintained at a consistent level above competitive retail electricity offers over time. For example, this may mean that the DMO price is maintained at 20 per cent above the median market offer in all distribution regions. This appears to align with the AER's suggestion that the retail margin be consistent across all DMO regions and customer types.

The actual figure that represents a 'reasonable margin' will depend on how the AER estimates the other cost components of the DMO. It may be appropriate for the 'margin' allowance to be lower if the AER takes conservative estimates for all cost components (and vice versa if the AER adopts less conservative estimates). Because it is challenging to state a single figure for a 'reasonable margin', Simply Energy would be concerned if the AER placed too much weight on previous decisions from Australian regulators. For example, the Essential Services Commission of Victoria (ESC) has adopted a margin allowance in the context of its role to set an efficient electricity price that can be accessed by Victorian electricity customers. Because of the different objectives between the AER and the ESC, it would not be reasonable for the AER to adopt a retail margin percentage that is consistent with the ESC's methodology.

Option 2 – continue indexation of the DMO residual

Question 9: Should we continue indexing the current residual?

Question 10: What are the benefits and disadvantages of this approach?

Simply Energy would support the AER continuing to index the current residual going forward. As the DMO price has appeared to meet its objectives to date, it is reasonable to maintain consistency with the current approach.

To improve the indexation approach, Simply Energy proposes that the AER consider supplementing its CPI indexation with additional measures that estimate other drivers of retail cost changes. This would reduce the need to rely on the step change framework to capture unexpected cost changes that are not compensated elsewhere in the DMO methodology. For example, the AER could estimate changes in bad debt expenses in line with credible forecasts such as movements in the unemployment rate.

Because the AER's cost forecasts will not reflect the actual outcomes in the market, the DMO price may become too high or too low relative to median market offers over time. To maintain the DMO price at a consistent level above competitive retail electricity offers over time, it may be appropriate for the AER to occasionally rebase the DMO cost stack to retain the DMO's relationship to market offer prices.

In relation to the AER's identified issues with the indexation approach, Simply Energy does not agree that the absence of a productivity factor is an issue. The DMO is intended to be a backstop price with a generous level of headroom above the reasonable cost of supplying customers, which would give space for a healthy competitive market to be the normal mode of supplying customers. In that context, customers should be encouraged to engage in the retail energy market and access the benefits of productivity improvements through a market retail contract. As noted above, the AER could also occasionally rebase the DMO cost stack if the DMO price became too high or too low.

Question 11: How could the step change framework be improved?

The step change framework could be improved by introducing a transparent trigger for when the framework would apply. The current approach does not provide stakeholders with sufficient clarity around the circumstances when the AER would make an adjustment to the DMO price. Ideally the framework would be triggered if a cost change was forecast to meet a percentage or absolute threshold.

A key challenge with the step change framework is that it is difficult for the AER to assess the significance of forecast cost changes in a transparent manner, due to the commercially sensitive nature of individual retailer's cost data. While not ideal, we would understand if the AER largely relied on publicly available data on forecast cost changes when applying the step change framework.

Option 3 – adjust the residual to reflect changes in retail costs using ACCC data

Question 12: Should we perform an adjustment to reflect movement in retail costs and, if so, should this be performed on an annual basis?

Simply Energy considers there is merit in this proposal. We are supportive of the annual indexation approach reflecting changes in all drivers of retail cost changes (not just changes in CPI).

Simply Energy would support the retention of the step change framework if the AER adopted Option 3. As outlined in our response to Question 3, a mechanism to respond to any exogenous shocks (i.e, either the step change framework or a re-opening mechanism) would ensure that these costs can be accounted for in the price cap at the time they occur rather than in the following years.

Duration of the methodology

Question 13: How long should we retain the methodology we adopt in this review?

Simply Energy agrees with the AER that a five-year duration for the updated DMO methodology would provide regulatory certainty and consistency. We would also support a minimal review of the methodology after three years, to ensure the DMO allowance is meeting the key objectives. However, this may not be necessary if the AER retains a mechanism to adjust the DMO price in response to exogenous shocks.

Wholesale costs

Question 14: Is our existing wholesale cost forecasting methodology, in terms of its approach and considerations (modelling of demand and supply, spot price, hedging etc.) complete, appropriate and representative of costs to supply energy?

Simply Energy supports the AER continuing to apply its existing wholesale cost forecasting methodology. The most appropriate methodology is one that takes into account futures market data and relies on transparent and publicly available market information.

Question 15: Should our existing assumed hedging strategy be adjusted to allow for a higher level of spot market exposure? And if so, what is the appropriate level of exposure?

There does not appear to be a strong reason for the AER to adopt less risk averse settings when forecasting wholesale costs. Simply Energy considers that the risk to retailers from the AER setting a wholesale cost allowance that is too low is more significant than the potential downside to customers from an allowance that is set at a slightly more conservative level. The objectives of the DMO also align with adopting conservative settings rather than attempting to replicate the most efficient hedging strategy and level of spot market exposure.

Simply Energy is also concerned that by adopting less risk averse settings that the AER may be encouraging retailers to take on additional spot market exposure. The current European gas crisis provides an interesting case study for Australian regulators, particularly in relation to the UK energy sector's issues with its price cap and licensing framework. Relevantly to the AER's question, Ofgem's Chief Executive has suggested that the failure of several UK energy suppliers was because they could not cope with the sharp and sustained shock in wholesale gas prices (which is partly due to these suppliers not being sufficiently hedged against these cost increases).[2] As part of its goal to improve the financial resilience of the retail energy sector going forward, Ofgem will be increasing its scrutiny of suppliers' risk management and hedging strategies.[3] The current situation in the UK suggests that the AER should be encouraging retailers to be risk averse and limit their spot market exposure, rather than implicitly encouraging retailers to take on additional risk by setting the DMO price based on a less risk averse approach.

Simply Energy considers that the issues with the UK price cap and regulatory framework demonstrate the importance of setting the DMO conservatively so that the market can weather these types of exogenous shocks.

[2] Davies, R 2021, Ofgem says it needs to build a 'more resilient' UK energy market, The Guardian, 8 October 2021, accessed at; https://www.theguardian.com/business/2021/oct/07/ofgem-says-it-needs-to-build-a-more-resilient-uk-energy-market

[3] Ofgem 2021, Rising wholesale energy prices and implications for the regulatory framework - letter, 29 October, accessed at; https://www.ofgem.gov.uk/publications/rising-wholesale-energy-prices-and-implications-regulatory-framework

Question 16: Does our assumption of a retailer building their hedge book from the time of the first trade recorded by ASX Energy, remain appropriate, or is a shorter period justified? What is an appropriate period and why?

Simply Energy is comfortable with the current approach, as we support a conservative estimate that has limited volatility on an annual basis. In a situation where a significant exogenous shock occurs that is not appropriately captured by the current approach, Simply Energy would expect that the step change framework or a re-opening mechanism could be used.

Question 17: Does the 95th percentile hedged WEC estimate remain appropriate, in context of the hedging strategy? What alternative percentile could be applied and what would the justification be?

As noted previously, the AER should adopt conservative estimates for the DMO price rather than attempting to replicate the most efficient costs. For that reason, Simply Energy supports Option 1, which would continue to apply the current approach that uses the upper range of modelled prices.

In relation to Option 2, Simply Energy does not agree with the AER that it is reasonable for the DMO wholesale cost component to involve some price risk for retailers. The AER should not be encouraging risky behaviour from energy retailers and should instead ensure that the price cap methodology enables retailers that choose to adopt a conservative risk management and hedging strategy to earn a reasonable margin.

Environmental costs

Question 18: Do you agree with the appropriateness of our environmental cost forecasting methodology for DMO 4?

In relation to the costs of compliance with jurisdictional energy efficiency schemes, Simply Energy notes that the South Australian Retailer Energy Efficiency Scheme (REES) concluded at the end of 2020 and was replaced by the Retailer Energy Productivity Scheme (REPS).

As part of its forecasting methodology, the AER should update its cost estimates to include the costs of complying with the REPS. The REPS has different activity specifications relative to the REES and this will result in retailers incurring different costs than those incurred under the REES. The Essential Services Commission of South Australia will be annually reporting on the costs of each type of activity delivered under the REPS[4], which may provide the AER with a useful source for its cost estimate.

Network costs

Question 19: Should the calculation of network costs for residential customers continue to be based on flat rate tariffs only? If yes, as what level of TOU tariff penetration should this approach be reassessed?

Question 20: If TOU network tariffs are included in our assessment, should we use a simple weighting of customers on each tariff type across all jurisdictions, or a separate weighting for each network area?

Question 21: Is the DMO daily load profile (provided to retailers to calculate annual market offer costs for TOU offers) sufficient for calculating annual TOU network costs?

[4] ESCOSA 2021, Retailer Energy Productivity Scheme: Reporting Requirements – Final Decision, September, accessed at; https://www.escosa.sa.gov.au/ArticleDocuments/21751/20210907-REPS-ReportingRequirement-FinalDecision.pdf.aspx?Embed=Y

Question 22: Should we assess metering costs separately from network costs?

As will be discussed under Question 24, Simply Energy considers that advanced metering costs should be included in the DMO price. However, we do not have a preference as to whether this is estimated separately from network costs or included in the network cost allowance.

While including time-of-use (ToU) network costs in the DMO price may result in a slightly more accurate estimation of retailers' costs, Simply Energy considers that it is more important that the final DMO price is set at a conservative level with a generous level of headroom above the reasonable cost of supplying customers. For that reason, Simply Energy does not have a preference as to whether the AER includes ToU network tariffs in its assessment and whether these tariffs are included based on a simple cost methodology or a weighted average cost methodology.

Question 23: Do you agree with our preferred position to not true up network costs in calculating the DMO price?

The AER should not be requiring retailers to bear significant risk of misforecasted network costs, as these are outside of our control. If the DMO price is set conservatively and allows for a reasonable margin, Simply Energy considers these risks would be minimal and agrees that there would be little benefit in implementing a true-up mechanism for network costs. However, there may be a case to implement a true-up mechanism if the DMO price is not set conservatively and exposes retailers to a higher risk of not recovering their efficient costs and earning a reasonable margin.

The importance of a true-up mechanism will also depend on the overall DMO cost methodology moving forward. There is a stronger case for the AER to true-up network costs if it moves to a bottom-up cost methodology, because these are actual costs that retailers are incurring each year.

Ideally, the AER would be able to use actual network tariffs when setting the DMO price each year, which would avoid any need for a true-up mechanism. Simply Energy has requested DISER to address this issue in its DMO Code review and implement an equitable long-term solution. Specifically, we consider that the AER should be provided with additional time to make its annual DMO determination while also bringing forward the timing of the annual network pricing proposal process (for example, by amending the National Electricity Rules to require network businesses to submit final prices by an earlier date). This would ensure that the matching up of these two pricing decisions is not fully at the expense of retailers and their already tight timeframes to implement standing offer price changes.

Advanced meter costs

Question 24: Should the DMO 4 methodology include an allowance for advanced meter costs? And if so, is the proposed approach above viable to calculate and account for its cost?

Simply Energy is in favour of the DMO methodology including an allowance for advanced meter costs going forward. These are real costs incurred by retailers, which will only increase as the uptake of advanced meters becomes more significant in the coming years. As part of the AER's information gathering request for DMO 4, we have provided the AER with our annual per customer costs for residential and small business customers with a type 4 (or type 4A) meter in each distribution region.

The current Australian Energy Market Commission (AEMC) review into the regulatory framework for metering services has identified that the current arrangements are not supporting the timely rollout of smart meters.[5] A key element of the AEMC's review is identifying options to accelerate the smart meter rollout to reach penetration levels that enable the benefits of smart meters to be

[5] AEMC 2021, Review of the regulatory framework for metering services: directions paper, p. i, accessed at; https://www.aemc.gov.au/sites/default/files/2021-09/EMO0040%20Metering%20Review%20Directions%20paper%20FINAL.pdf

realised. The AEMC has identified that one issue with the rollout has been a lack of, or split, incentives. If the AER were to include an allowance for advanced meter costs in the DMO price, this may go some way to improving retailers' cost recovery for smart meter installations.

The AEMC is considering several options to accelerate the smart meter rollout, including setting targets for retailers to replace a certain percentage of their customers' meters with smart meters each year.[6] If this option (or similar options that impose obligations on retailers) are implemented, Simply Energy would expect the AER to reflect the costs of complying with those obligations in the DMO price.

Model annual usage and time-of-use determination

Question 25: Do you support our use of DNSP data, cross-checked with other sources, to determine residential annual usage?

Simply Energy supports the AER's proposal and agrees that it is appropriate to revisit the annual usage figures in this review.

Question 26: Do you support applying a single figure of 10,000 kWh for small business usage across all DMO regions?

Question 27: Do you support applying individual ACCC reported median usage figures in NSW, SA and south-east Queensland? If so, please outline the advantages of this approach.

Because small business consumption varies much more significantly than residential consumption, there is likely no single figure that will be largely representative. It is not clear that this issue would be solved by Option 2, which uses median usage figures for each jurisdiction. For that reason, Simply Energy supports the simplicity of using a consistent annual usage figure for all jurisdictions.

Question 28: Do you support averaging across 3 years of data to calculate annual usage?

Simply Energy agrees with the AER's reasoning for this option, as the coronavirus pandemic and associated government restrictions have clearly impacted residential electricity usage. We also consider there is uncertainty around how residential electricity usage will change in the short-term as Australia moves to the next phase of the coronavirus pandemic.

Question 29: Would you prefer we reflect TOU usage in annual usage estimates, or calculate annual usage based on flat rate usage, given most customers are flat rate customers?

At this stage, Simply Energy prefers the simplicity of the annual usage estimates being based on flat-rate usage. There may be several reasons for differences in annual usage between flat-rate and ToU customers. For example, customers often install a smart meter at the same time as their solar PV system. This may result in lower annual usage for ToU customers, as they are more likely to supplement grid usage with their own solar generation.

Question 30: Do you support updating the usage profiles by averaging across 3 years of usage data?

Simply Energy supports the AER's proposal and agrees that it is appropriate to revisit the annual usage figures in this review.

[6] Ibid, p. ii

Question 31: Do you support maintaining the profiles based on a mix of TOU and flat rate offers?

Simply Energy supports the AER's proposal and agrees that the benefits of an additional information request for retailers on ToU usage data would have marginal benefit and create additional regulatory burden.

If in the future the AER found there would be significant benefits from updating the daily usage profiles to account for seasonal and weekend usage, there may be a case to ask retailers to provide ToU usage data.

Concluding remarks

Simply Energy looks forward to continuing to work actively with the AER to ensure that the DMO methodology is fit-for-purpose during the upcoming years and that the DMO 4 price accurately reflects forecast changes in the cost of supplying electricity retail customers.

Simply Energy welcomes further discussion in relation to this submission. To arrange a discussion or if you have any questions please contact Matthew Giampiccolo, Senior Regulatory Adviser, at matthew.giampiccolo@simplyenergy.com.au.

Yours sincerely

James Barton
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