Level 33, Rialto South Tower
525 Collins Street
Melbourne, Victoria 3000
Fax +61 3 8807 1199
simplyenergy.com.au

30 November 2022

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

Dear Mr Fox,

Re: Default Market Offer 2023-24 – Issues paper

Simply Energy welcomes the opportunity to provide feedback on the issues paper on the Default Market Offer price for 2023-24 (DMO 5).

Simply Energy is a leading energy retailer with approximately 700,000 customer accounts across Victoria, New South Wales, South Australia, Queensland and Western Australia. Simply Energy is owned by the ENGIE Group, one of the largest independent power producers in the world and a global leader in the transition to a zero-carbon economy. 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.

In this submission, we provide feedback on the Australian Energy Regulator's (AER) wholesale cost methodology and retail allowance glidepath. We also provide some high-level feedback on the DMO and retail prices.

The DMO has faced challenges in meeting its policy objectives in a rising price environment

The AER has found that less than 75 per cent of market offers were priced either at or below the DMO price in September 2022, which was a reduction from round 95 per cent of market offers in March 2022. This aligns with Simply Energy's observations since the start of DMO 4, that most market offers are priced either at the same level as the DMO or marginally below the DMO.

In this context, it appears that DMO 4 did not meet the DMO objective of a 'backstop' price with a generous level of headroom above the reasonable cost of supplying customers. The significant wholesale price increases that occurred mid-year meant that standing offers were capped at a level that closely represented typical market offers, rather than providing fallback protection from excessively high prices.

While there were elevated wholesale prices at the time of the AER's DMO 4 determination, the market conditions rapidly deteriorated soon after and led to the Australian Energy Market Operator (AEMO) announcing a suspension of the wholesale electricity spot market on 15 June 2022. While the AER could not anticipate how quickly and significantly wholesale prices would increase, the events of 2022 demonstrate the challenges in setting electricity price caps in a rising price environment.

In our submission to the AER's DMO 4 draft determination[1], we continued to support the inclusion of a step-change framework or re-opening mechanism in the DMO. We expect that a re-opening mechanism may have proved useful in 2022, as it could have been used to avoid the price cap effectively becoming a binding constraint on electricity prices. A re-opening mechanism would also enable retailers to pass-through significant unexpected cost increases (or cost savings) that occur during a period, such as market suspension compensation costs that are recovered via retailers.

The wholesale cost methodology should not be significantly changed

Simply Energy considers it is appropriate to maintain the existing wholesale cost methodology in the current wholesale environment. While there may be opportunities to refine and improve the methodology, we note that the higher wholesale cost estimate in DMO 5 will be due to market factors (that is, the recent volatility in wholesale prices) rather than issues with the accuracy of the current methodology.

In the following sections, Simply Energy provides some feedback on the wholesale cost methodology. Broadly, Simply Energy considers that the AER should seek to adopt risk averse settings and forecasts in its wholesale cost methodology, to ensure that the DMO is set at a level that provides fallback protection from excessively high prices.

Margin for forecast error

Simply Energy asks that the AER revisit its decision in DMO 4 to change the margin for forecast error from the 95th percentile estimate to the 75th percentile estimate. At the time of that decision, we did not support the AER adopting less risk averse settings while the market was entering a period of higher volatility (due to the accelerations in the energy market transition and the risks of international volatility affecting the Australian market). We were particularly concerned that this change may have been implicitly signalling to retailers that they should be less risk averse in their approach to hedging against wholesale price exposure.[2]

In the content of market events since DMO 4, we consider there is a strong case to reconsider this decision and reinstate the more risk averse settings that were in place prior to DMO 4.

Load profiles

Simply Energy considers there is value in the AER assessing whether interval or smart meter data can provide an accurate representation of load profiles in each jurisdiction. However, due to the relatively low uptake of smart meters in Australian jurisdictions (apart from Victoria), we expect the AER may not be able to rely on interval meter or smart meter data for this purpose.

If the AER concludes that this data does not significantly improve the accuracy of its wholesale cost forecasts, we support maintaining the current load profile approach, as the AEMO net system and controlled load profiles are publicly available and provide transparency to stakeholders.

Transparency of the modelling process

Similar to our comments on load profiles, we support maintaining the current modelling process unless an alternative and less transparent process would result in significant improvements in the

[1] Simply Energy 2022, Submission to Default Market Offer 2022-23 – Draft determination, 10 March, p. 3, available at; https://www.aer.gov.au/system/files/Simply%20Energy%20-%20DMO%202022-23%20Draft%20determination%20submission%20-%2010%20March%202022.pdf

[2] Simply Energy 2022, Submission to Default Market Offer 2022-23 – Draft determination, 10 March, p. 4.

accuracy of wholesale cost forecasts. It is not clear to us how the AER would determine how a 'prudent retailer' would adopt these additional contracting products into their hedging strategy.

While it may be reasonable to include additional contracting products in the modelling process (such as options), Simply Energy does not support the inclusion of confidential contract information in the modelling process. In addition to the sensitivities of this contract information, we consider that the inclusion of this type of information would needlessly complicate the modelling process for limited improvement in accuracy.

Price stability of the wholesale component

Simply Energy would support the continued reliance on a longer book build process of two to three years for DMO 5, as this would maintain consistency in the wholesale cost methodology and promote price stability over time. We would not support the book build process being shortened solely to avoid a higher wholesale cost estimate in DMO 5. If the AER were to consider changing the book build process, this type of change should occur over a transition period to enable retailers to consider the changed methodology in their own hedging strategies.

The current retail cost methodology should remain in place

As noted in our submission to the AER's DMO 4 draft determination[3], we did not support the AER's proposed change in its retail cost methodology to a bottom-up cost methodology. However, as the AER made this methodological change in DMO 4, we are supportive of the new methodology continuing until the AER next undertakes a broad review into the DMO methodology.

The retail allowance glidepath should be maintained despite an increasing cost stack

The retail allowance is not currently transparent and is difficult to assess

Simply Energy has previously stated that the AER's approach to estimating the retail allowance is not transparent or objective and this makes it challenging to assess whether it is set an appropriate level. In order to transparently estimate the retail allowance, the key questions that arise are; what are the components of the retail allowance and what are the reasonable values for those components? Simply Energy considers that a retail allowance should include:

- An estimate of the sustainable retail margin in the competitive electricity retail market;
- A component that represents the headroom of the DMO and provides incentives for innovation and consumer engagement in the market; and
- An uplift to cover the risk of forecast errors that are not included elsewhere in the cost stack (for example, risks that the ACCC cost data underestimates actual retail costs, and risks introduced through the wholesale cost and network cost methodologies).

A percentage-based allowance should be maintained

The AER notes in the issues paper that a percentage-based retail allowance results in a larger retail allowance in real terms when other cost stack components are increasing. Simply Energy suggests that the AER would have been aware of this occurring at the time of the DMO 4 final determination, as wholesale price forecasts had begun accelerating upwards and wholesale market risks were at elevated levels. Regardless, we note that the percentage-based retail allowance has alternating outcomes depending on the direction of cost movements in each year (that is, a percentage-based retail allowance would result in a relatively lower allowance in real terms when costs are low, providing further price relief for customers).

[3] Simply Energy 2022, Submission to Default Market Offer 2022-23 – Draft determination, 10 March, p. 2.

From the perspective of the risks faced by retailers, we consider it is appropriate that the allowance is relatively higher in real terms when electricity prices are increasing and relatively lower in real terms when electricity prices are decreasing. We expect that the higher retail electricity prices over the next couple of years will lead to higher customer debt and higher bad and doubtful debt costs. In the context of the DMO's bottom-up retail cost allowance that has a lagging indicator of bad debt costs, we consider it is appropriate that the retail allowance retain a higher uplift to reflect the risk of forecast errors in bad debt costs. We also note that during a period of high wholesale prices and market volatility that retailers require a higher working capital buffer to ensure they can continue to meet their obligations in the market.

Adjusting the retail allowance would not alleviate electricity affordability issues

Simply Energy agrees that electricity affordability is a significant issue, and we want to help our customers manage their energy costs and bills through this challenging period. However, we consider that government policy[4] is a more appropriate tool for providing customers with relief from price increases than making intermediate changes to the DMO methodology. In addition, as most customers are not on standing offer contracts, any changes to the retail allowance methodology would not directly lower the retail electricity prices that customers are paying.

In the DMO 5 draft determination, we would be interested in the AER's analysis on the overall price difference that would occur if the AER maintained the current retail allowance approach or adopted an intermediate option, as considered in the issues paper. As the retail allowance is a relatively small percentage of the overall DMO price, we would not expect that changing the retail allowance methodology for DMO 5 would result in a significant alleviation in electricity affordability issues for customers. If that is the case, it would likely strengthen the case to maintain consistency in the methodology until the next broad review of the DMO methodology.

The timing of the DMO final determination condenses timeframes for retailers to update prices

While we recognise that the timing of the DMO final determination is set out in the Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019, Simply Energy remains concerned that the recent change in the determination date significantly condenses internal timeframes to implement price changes for our standing offer customers on 1 July each year. This has heightened the risk of errors occurring during the price change process, which would result in poor outcomes for our customers. As the timing of Victorian price changes have now also moved to mid-year, this has further increased the workload on staff members implementing price changes.

Simply Energy urges the AER to work with the Department of Climate Change, Energy, the Environment and Water to implement a long-term solution that still enables the AER to rely on final network prices when making its DMO determinations. This could be achieved by amending the National Electricity Rules to bring forward the timing of the annual network pricing proposal process, which could enable the AER to publish its DMO final determination around two weeks earlier.

Concluding remarks

Simply Energy looks forward to working actively with the AER to ensure that the DMO 5 price accurately reflects forecast changes in the cost of supplying electricity retail customers and meets the DMO objectives.

---

[4] For example, the Victorian Government has provided Victorian households with a 'Power Saving Bonus' in 2022 and 2023, which is partly intended to provide households with relief from energy prices.

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
General Manager, Regulation
Simply Energy