sumo

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Default Market Offer Price – Draft Determination

Sumo welcomes the opportunity to comment on the Draft Determination of the Australian Energy Regulator on the Default Market Offer Price.

Sumo is a small, innovative energy retailer primarily offering electricity and gas to small customers in Victoria and New South Wales. Sumo is a stand-alone retailer with no generation assets.

Price regulation generally

While Sumo supports sensible measures that apply downward pressure on energy prices and that encourage and enable consumers to compare offers effectively, we oppose retail price regulation. A critical role of an energy retailer is to manage energy price volatility on behalf of consumers. However, retailers cannot control all costs – particularly a stand-alone retailer with no upstream generation assets. Retailers need to be able to pass on increases in costs to consumers. A poor regulatory price decision could mean retailers cannot recover all such costs and make an adequate return. Even before a regulatory price decision is made, its very existence impacts the availability of investment funds, which a sub-scale retailer relies on to fund its growth.

Attempting to set a Default Market Offer (**DMO**) at a level that reduces standing offer prices for consumers who are not engaged in the market, but also allows retailers to recover their efficient costs in servicing customers, is a challenging task. While it may be easy to set a price that reduces the average standing offer price, it is critical that the price is not set too low. If prices are too low, retailers will not be able to recover their costs and achieve an adequate return, causing them to exit the market, either in an orderly manner or otherwise. This would be disruptive in the short term, and would be a terrible outcome for consumers in the medium to long term. Small retailers apply the competitive pressure that ensures prices remain low. With a lessening of competition, consumers will ultimately pay more in the long run.

The almost unprecedented wholesale electricity pricing event in Victoria in late January 2019 sends an important warning. These events increase wholesale costs and the prudential capital required by retailers. A DMO that doesn't anticipate such events could have catastrophic impacts.

The AER's proposed methodology

The AER's draft determination is that the DMO price point for each distribution zone will be the mid-point of the range between the median market offer and median standing offer, based on generally available offers in Energy Made Easy in October 2018.

Sumo considers that the choice of the mid-point of the range is too low. In our view, the AER should take the 80th percentile of the range. Doing so will reduce high standing offer prices in a meaningful way. Importantly also, it is more likely to allow retailers to continue to recover the efficient costs of providing services, even in a market that is experiencing rising costs.

Rising costs

Retailers are facing rising wholesale electricity costs, rising SRES costs, increasing levels of bad debt and additional costs for meeting regulatory obligations, such as the new metering obligations introduced via Power of Choice:

1. Rising wholesale costs

   A typical small retailer hedges its wholesale electricity costs over a period of around 12 months. When viewed 12 months ahead, the electricity price on the ASX for the period July 2019 to June 2020 has traded higher than it did for the period July 2018 to June 2019. This is most notable in the March Quarter, where the energy price for Q1 2020 is more than $10/MWh more expensive than it was 12 months out from Q1 2019 ($98.35 for Q1-20 vs $87.77 for Q1-19).

   We are also seeing market fundamentals that support a continued bull market:

   - drought conditions contribute to higher priced hydro
   - higher gas prices contribute to higher cost of gas-fired generation
   - base coal price increases connected to rising international coal prices over the past two years
   - connection issues for new wind and solar. Recently there was another derating of margin loss factor from AEMO – up to 25% for large renewable farms in northern Victoria / southern NSW
   - political uncertainty is lending to increased volatility
   - aging coal generators are contributing to more unreliable generation and more unplanned outages – more likely during peak heat and demand
   - new wind and solar projects are frequently delayed by 3-15 months from original projected date
   - high spot prices are driving high forward prices (as has been seen in Victoria in particular)
   - demand has remained relatively stable over the past five years but prices have increased – so even as more solar PV is expected to come online, NSW population is expected to grow, giving the demand growth a neutral outlook
   - Liddell is expected to be decommissioned by 2022, which has a current capacity rating of 2,000 MW, and there is speculation that Eraring (2,880 MW) and Bayswater (2,640 MW) may be decommissioned sooner than the expected 2034 and 2035. This uncertainty may cause higher prices
   - uncertain impact of the new Retailer Reliability Obligation

   Wholesale costs have been rising for some time. Retailers are likely to have absorbed much of these rising costs; as a result, not all of these costs will have been passed through to retail customers, and so the generally available offers made in October 2018 are unlikely to fully reflect wholesale costs even at that time.

2. Rising costs of SRES

   The AER notes in the Draft Decision that the STP will be significantly higher in FY20 than in FY19. This has turned out to be the case, and should be reflected in the final decision.

3. Increasing bad debts

   Bad debts reflect a significant component of a retailer's operating costs. Economic conditions are continuing to put pressure on household and business spending. We expect bad debts to continue to increase for electricity retailers in the regulated period.

4. New regulatory costs

   With the roll-out of Power of Choice metering contestability, metering costs – particularly for smaller retailers – have gone up. Smaller retailers have less bargaining power to achieve efficient metering costs, and so these costs are higher than they otherwise would have been prior to metering competition.

Market offer prices don't necessarily reflect efficient costs

The AER's draft position is that the lower bound of the range, being the median of market offers, should provide a reasonable indication of the efficient costs of supply. Sumo is not convinced this is the case. The AER methodology does not include any bottom-up analysis of underlying costs, and so we do not think an assumption can be made that the median market offer price reflects efficient costs. Rather, we believe that the practice of retailers engaging in below-cost pricing strategies is widespread, and it is quite possible that such below-cost offers would result in the median market offer reflecting less than the efficient cost of supply. While we don't propose an alternate data point for the lower bound of the range, we do think it is appropriate for the AER to select a higher price point within the range to adjust for this risk.

We would be happy to meet with the AER to discuss the draft decision or any matter raised in this submission.

Yours sincerely

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