

6 April 2023

Ms Stephanie Jolly
General Manager, Market Performance
Australian Energy Regulator

By email: DMO@aer.gov.au

Dear Ms Jolly,

Default Market Offer Prices 2023-24 – Draft determination

We appreciate the opportunity to provide a submission to the Australian Energy Regulator's Default Market Offer Prices 2023-24 ("DMO 5") Draft determination.

Sumo is an energy retailer operating in Victoria, New South Wales, Queensland and South Australia. We have approximately 38,000 electricity customer accounts in jurisdictions impacted by the DMO.

Wholesale hedging methodology

The AER's current methodology for determining wholesale electricity costs involves adopting what it considers to be the hedging strategy of a "prudent" retailer. Part of this methodology is the assumption of progressively purchasing hedging contracts on the ASX over a two-to-three year period. We understand the AER uses contract prices and traded volumes based on publicly available data from the ASX.

Sumo would like to raise two problems with this methodology that we believe needs to be corrected before the issue of the final version of DMO 5.

1. *Using only ASX futures prices*

The ASX energy futures are no longer liquid like they once were. In fact, most energy retailers (especially the smaller ones) cannot trade ASX energy futures contracts due to the exit of ASX clearing participants (citing the risk and capital requirements of clearing ASX energy futures as being too high). As a result, more and more energy retailers are using Over the Counter ("OTC") contracts to hedge wholesale costs. Sumo does not use the ASX to hedge its wholesale costs. Our contracts are all OTC contracts which trade at a, sometimes material, premium to ASX futures prices.

For this reason, using published ASX prices is no longer a reasonable representation of forward prices retailers pay when entering into hedge contracts. The AER should consider OTC contract information retailers have recently provided, in conjunction with ASX prices when calculating wholesale costs.

This issue is relevant for both NSW and QLD but is much more material in South Australia, which has particularly poor liquidity as evidenced by the very low traded volume. Most trades in South Australia occur as OTC contracts, which trade at prices significantly above those seen on the ASX.

Only using ASX published prices and not referring to OTC traded prices means retailers will have higher wholesale costs than DMO 5 assumes. This problem is materially higher in South Australia.

2. *Factoring in the cost to retailers of the Retailer Reliability Obligation ("RRO")*

We don't believe the AER's methodology includes the true cost to retailers of complying with the Retailer Reliability Obligation ("RRO").

The AER has made a T-1 Reliability Instrument for South Australia based on a forecast gap between supply and demand. The RRO requires retailers to enter into sufficient hedge contracts to meet their share of AEMO's one-in-two year peak demand forecast during the forecast reliability gap period.

ACIL Allen's model optimises a hedge portfolio which allows for some spot exposure under these shortfall periods. However, the RRO forces retailers to enter a sub-optimal portfolio of hedge contracts, at significantly higher cost.

Indeed, in section 5.3.5 ACIL Allen is quite forthright about the additional costs of hedging for extreme circumstances stating that "we consider the estimate of the wholesale energy costs should not be overstated to protect retailers from risks associated with extreme circumstances", whereas the RRO explicitly drives retailers to enter hedge contracts for extreme circumstances. The cost of this far exceeds the amount that the AER has allowed.

It is therefore suggested that ACIL Allen re-run the model incorporating the sub-optimal hedge portfolio required by the RRO to demonstrate the additional cost.

If necessary, Sumo can provide a confidential estimate of the cost it will incur as a result of the RRO. This cost was explicitly built into the cost of our OTC contract for 2023-24.

Retail Costs – Bad and Doubtful Debts

The AER estimates bad and doubtful debt using the weighted average cost of three publicly listed retailers that reported bad and doubtful debt expense.

Sumo's concern with this approach is that bad and doubtful debt cannot be accurately determined for residential and small business customers based on the information that these listed retailers provide. Generally, a listed retailer's bad and doubtful debt expense will be distorted as they include financial information for large commercial and industrial customers as well. This will make it an unreliable point of reference for DMO customers and means their reported bad and doubtful debt expense understates the bad and doubtful debt expense for small customers.

Regardless, bad and doubtful debt expense is generally measured as a percentage of revenue. If the revenue increases, which is expected to occur (i.e. DMO 5 v DMO 4), the bad and doubtful debt expense per customer will necessarily increase even if bad and doubtful debt as a percentage of revenue remains constant.

Sumo believes that the bad and doubtful debt expense should increase proportionally with the increase in the DMO.

If you have any questions about this submission, please contact Alex Fleming, GM Legal & Regulatory.

Yours sincerely



Dominic Drenen
Managing Director, Sumo