

Gavin Fox  
A/General Manager, Market Performance  
Australian Energy Regulator  
GPO Box 3131  
Canberra ACT 2601

3 November 2023

### Default market offer prices 2024–25 issues paper

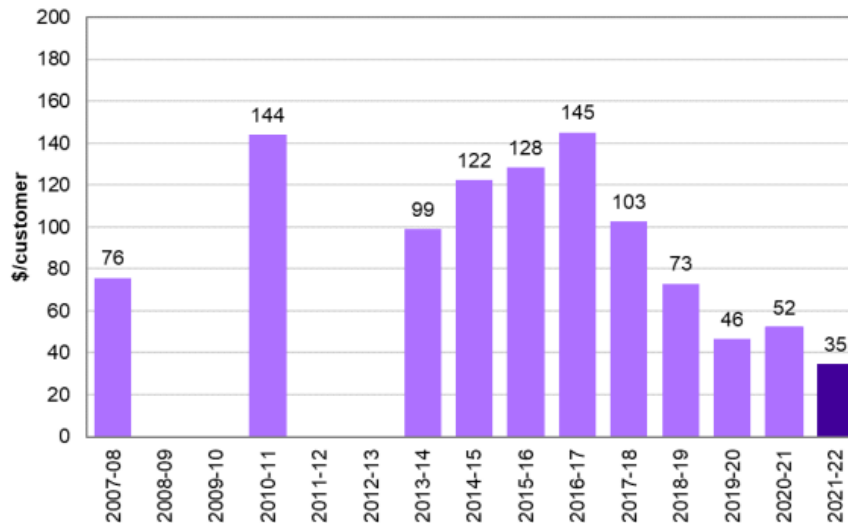
The Australian Energy Council ('AEC') welcomes the opportunity to make a submission on the Australian Energy Regulator's ('AER') *Default market offer prices 2024–25 issues paper*.

The AEC is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. AEC members generate and sell energy to over 10 million homes and businesses and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 per cent emissions reduction target by 2035 and is committed to delivering the energy transition for the benefit of consumers.

Retailers have been competing in a highly volatile and challenging environment as the below graph from the ACCC shows:<sup>1</sup>

**Figure 4.5: Retail margins in 2021–22 declined to the lowest on record**

*Average retail margins (as earnings before interest, tax, depreciation and amortization or EBITDA) per residential customer across the NEM, 2007–08 to 2021–22, real \$2021–22, excluding GST*



Source: ACCC analysis based on retailers' data.

The AEC understands the balance the AER needs to find when setting the DMO price, between protecting customers from unreasonably high prices, supporting reasonable and efficient margins and supporting competition. The AEC considers that in recent years the pendulum has swung well away from supporting reasonable and efficient margins and that the retail market is becoming increasingly unattractive as a site for equity investment. The AEC notes the record levels of RoLR events over the

<sup>1</sup> ACCC (2022) Inquiry into the National Electricity Market – November 2022 Report at <https://www.accc.gov.au/about-us/publications/serial-publications/inquiry-into-the-national-electricity-market-2018-25/inquiry-into-the-national-electricity-market-november-2022-report> p.73

last year and that as the AER itself notes, the market remains vulnerable to supply or demand shocks. The AEC believes that it is important for the AER to ensure that DMO6 adequately supports reasonable and efficient margins and competition.

The AEC addresses key consultation questions below.

### **Wholesale costs**

*What approach should we take towards estimating load profiles? Should we retain profiles based on the NSLP and CLP, create blended profiles using the NSLP/CLP and advanced meter data, or take another approach towards estimating load profiles? Which is most reflective of a reasonable retailer's approach?*

The AEC recommends that the AER utilise the interval meter data alongside the NSLP in calculating the WEC allowance for all future determinations, given the growing proportion of customer load settled under interval meter data (in response to market trends and the flagging of targets by the AEMC). The AEC proposed this approach for DMO5 as we then noted and agreed with ACIL Allen's comments for the DMO 5 Draft Determination<sup>2</sup>:

*"The use of interval meter data improves the estimation of the costs of supplying energy to small customers because the interval meter data in addition to the NSLP better reflects the shape of small customers' load."*

*"...that it is better to commence using the interval meter data in combination with the NSLP data sooner rather than later as it removes the risk of a step change in WEC estimate."<sup>2</sup>*

*Is the lack of transparency of AEMO's advanced meter data a major issue for stakeholders? What information could we provide stakeholders to address issues with transparency of data?*

The AEC supports accuracy and considers that measures such as making the blended data available could be considered if transparency was identified to be a major issue.

*Should the AER have a singular profile for the entire NSW region instead of individual load profiles based on distribution zone? Is this reflective of a reasonable retailer's approach?*

The AEC believes that in principle, the AER should use the best information it has available, noting that AEC members may have different views on this issue.

*What additional data should we consider when assessing contract pricing for DMO 6, given the lack of liquidity in South Australia remains?*

*In the absence of sufficient exchange traded South Australian contract data, what other methodologies could the AER investigate to determine the wholesale cost in South Australia? Would consideration of a retailer holding Victorian futures contracts with SRAs be reflective of the practice of a reasonable retailer? How would we model this?*

The AEC understands the issue of more limited market liquidity in South Australia but considers utilising the ASX data is still the best option. The AEC believes that consideration of a retailer holding Victorian futures contracts with SRAs would be a very high-risk strategy and not reflective of the practice of a reasonable retailer.

The AEC recommends that the AER consider supplementing ASX data with the use of broker curves, which take into account over-the counter activity and inter-regionals and indicate their view of the fair value of contracts at the end of each trading day.

---

<sup>2</sup> ACIL Allen (2023) Report to Australian Energy Regulator - Default Market Offer 2023-24, Wholesale energy and environment cost estimates for DMO 5 Draft Determination, February 2023, p16.

*Should we consider any other changes to the wholesale cost methodology in light of a changing wholesale market?*

The AEC notes that the AER has continued with its DMO 4 approach determining a WEC which covered the 75th percentile of modelled outcomes, as opposed to using the previously adopted 95th percentile. In 2022, the AEC submitted points of disagreement on this method change on the basis that it derives a WEC which is both inadequate and inconsistent. These points are particularly pertinent during a period of high price volatility as seen over the past 2 years:

*In DMO 4, the AER opted to change its previous approach from factoring in the 95th percentile outcome in its consultant's WEC model, to instead factor in the 75th outcome. This decision in effect meant that the DMO – which had provided retailers with confidence that in almost all modelled outcomes, they would be able to recover their WEC – now only allowed such an outcome in three out of every four years. In the current market, even a 95th percentile approach would have likely been below the actual costs; using the 75th has made it almost certain that the WEC in DMO 4 was materially lower than actual costs. The AER should consider undertaking a post-review of its modelled outcomes to determine the level of risk a retailer that did hedge at the 75th percentile would have faced, including whether they would have been exposed to a RoLR event.*

*Given the current market conditions, it would be prudent for the AER to revert to the 95th percentile to provide retailers greater certainty in what will clearly be a volatile period for electricity prices. This additional certainty would benefit customers by “unlocking” more value than would otherwise be the case from engaging with the competitive market to seek out a cheaper energy deal. The challenge that has been illustrated since 1 July 2022 is that when the DMO does not allow retailers to recover the costs of a new customer, competition is materially affected, and customers are much less able to reduce their energy costs through engagement. In effect, it results in more customers paying more, to ensure the declining percentage of customers on the DMO pay marginally less than is efficient.<sup>3</sup>*

As noted by the AER in its State of the Energy Market Report:

*While wholesale prices have subsided since a peak in 2022, the market remains vulnerable to supply or demand shocks. Reliability issues with coal-fired generation assets and managing the increasingly peaky shape of customer demand could also put upward pressure on wholesale costs.<sup>4</sup>*

### **Retail costs**

*Do you consider these current methodologies used appropriate, and if not, what alternatives should be considered?*

To derive the retail operating costs for SME customers, the AER converts the variable operating cost data published by the ACCC in its Inquiry into the NEM report into a fixed retail operating cost so that it can be applied on a per customer basis. The AEC is concerned about an underestimation of retail operating costs for SME customers caused by the use of this approach.

The AER approach involves deriving an assumed average usage for a SME customer by dividing the amount of energy consumed by ‘non-residential customers not on demand tariffs’ (non-demand customers) by the number of customers on these tariff types, sourced from network Regulatory Information Notices (RINs) provided to the AER. The AER then multiplies this value by the ACCC’s average variable cost rate to determine its average cost for inclusion in its DMO cost stack. The AEC is concerned that the SME customer data in the RINs are made up of both non-demand customers and ‘non-residential low voltage demand tariff’ (demand customers). The AEC considers that this is an issue because the

---

<sup>3</sup> AEC (2022) Default Market Offer 2023-24 Issues Paper pp.3-4

<sup>4</sup> AER (2023) State of the Energy Market at <https://www.aer.gov.au/publications/state-of-the-energy-market-reports/state-of-the-energy-market-2023> p.230

demand customer data includes both SME and C&I customers with no way of identifying or separating the SME from the C&I information. As a result, the AER has used non-demand customers as a proxy for SME customers.

There has been a significant reduction in both customer numbers and usage for non-demand customers and as a result, the AER's calculated average usage for a SME has also decreased significantly. When multiplied by the ACCC usage rates the outcome is a much lower allowance for operating costs in all jurisdictions despite an increase in the ACCC's reported costs in Queensland and South Australia. This explains why the current approach results in SME retail costs being understated. If this issue is not addressed, the AEC expects the gap between the ACCC's costs and the AER's allowance to further widen as more SME customers transition from non-demand tariffs to a demand tariff, largely because of network tariff re-assignments.

### **Advanced meters**

*Is the method for cost recovery of advanced metering costs appropriate for DMO 6 and/or future DMO decisions? If not, what alternative methods should the AER investigate to recover the cost of advanced meters?*

In DMO5, the AER made an adjustment to its meter cost allowance by subtracting up-front/one off advanced meter costs, to prevent customers from overpaying and retailers that charge up-front fees over-recovering (i.e., they recover costs up-front and then through the metering allowance). It is important that retailers should not over-recover costs and that customers should not continue to pay for a service when they have already paid for it. However, those retailers that do not apply an up-front fee should not be prevented from recovering their metering costs over time. As the AER notes, the AEMC's Metering Review final report is moving in the direction of limiting retailers' ability to levy up-front charges to customers.<sup>5</sup> Under the AER's DMO5 approach, those retailers that have already recovered their costs from their up-front fees will continue to recover metering charges through the metering allowance in the DMO. Those retailers that rely on an annual allowance will not be able to fully recover their costs because their actual costs have been reduced by the amount of up-front fees charged by other retailers.

*Should the AER project advanced meter installations instead of using historic data in future DMO decisions?*

*What operational or cash flow considerations should the AER consider in determining the cost recovery of advanced metering costs? How do these considerations differ between large and small retailers?*

While the AER approach to derive its allowance has been reasonably effective to date, as retailers proactively install greater numbers of meters and with the AEMC's proposed accelerated rollout, the AEC expects to see significantly more meters installed each year. This will result in the annual costs incurred by retailers being significantly higher than the allowance. While in subsequent years the allowance will capture the increasing number of installations, there will always be a one-year lag until 100 per cent penetration is achieved. This financial exposure of retailers will be significant.

### **Retail allowance**

*Are there methodological changes that would allow us to better balance the objectives in the retail allowance?*

*Should the retail allowance be a fixed dollar amount, and if so, why?*

*Alternatively, should the retail allowance be cast as separate components of efficient margin (percentage based) and additional competition allowance? How would these be calculated?*

*What components are missing from the retail allowance and why?*

---

<sup>5</sup> AEMC (2023) Final Report – Review of the regulatory framework for metering services Final Report – Review of the regulatory framework for metering services at <https://www.aemc.gov.au/market-reviews-advice/review-regulatory-framework-metering-services>

The AEC notes that DMO4 set the target rate for the retail allowance to reflect the market-wide aggregate retail allowance available in previous DMOs of 10% for residential customers and 15% for small business customers, however given where the margins were sitting prior to the 2022 DMO, the AER opted to implement a glide path towards 10% and 15% over a three-year period.

Last year, with wholesale prices escalating, the AER decided to deviate from their glide path decision from 12 months earlier and stick with the previous year's margin. NSW was artificially deflated to 9.3% and the AER decided to maintain the south-east Queensland and South Australian residential retail allowances at the DMO 4 values of 8.4% and 6% respectively.

The AEC is concerned that there may be calls to reduce the retail allowance at this time. The AEC notes that the DMO regulations and objectives make the DMO different from other regulated prices. The DMOs twin objectives to incentivise retailer investment, innovation and competition in the market and the ability for customers to engage in the market mean that the DMO has additional objectives when compared to other regulated prices.

The AEC notes that the retail allowance includes compensation to retailers for the following items: costs to serve, costs to acquire and retain customers, advanced meter costs, bad and doubtful debt, depreciation and amortisation. The AEC notes that domestic, international and weather-related events, alongside regulatory interventions, have given rise to heightened uncertainty (i.e., risk) for retail market participants in recent periods. Moreover, these risks are not expected to subside for retailers in the near future. Providing confidence to retailers that these factors are covered in the retail allowance allows them to invest in innovation and product development initiatives with long lead times which ultimately benefit customers.

The retail allowance should continue to be expressed as a percentage of the final DMO price. Retailers note various concerns relating to increased risk, potential bad and doubtful debt increases, working capital costs and impacts to competition that could arise if the AER lowered the retail allowance percentage. The AEC believes that continuation of the current approach of calculating the retail allowance as a percentage of the DMO price is supported in terms of consistency, simplicity and provision of regulatory certainty.

The AEC understand that where the retail allowance has been separated into a percentage-based efficient margin component and a fixed competition allowance component in other jurisdictions, the effective retail allowance would be 10% or greater. The AEC does not believe the case has been made to move away from the current approach. The opening comments in this submission highlight the risks associated with adjusting the allowance. As stated earlier, the AEC considers that in recent years the pendulum has swung well away from supporting reasonable and efficient margins and that the retail market is becoming increasingly unattractive as a site for equity investment. The AEC notes the record levels of RoLR events over the last year and that as the AER itself notes in its 2023 State of the Energy Market report, the market remains vulnerable to supply or demand shocks. The AEC believes that it is important for the AER to ensure that DMO6 adequately supports reasonable and efficient margins and competition. The AEC believes the onus is on the AER to demonstrate that the current margin is not operating effectively i.e., achieving the DMO objectives.

In relation to the options under the AER's consideration, the AEC notes:

- Setting the retail allowance as a fixed dollar amount may not adjust for changing market conditions and may need regular re-evaluation to ensure it is still appropriate.
- Separating the retail allowance into a percentage-based efficient margin component and a fixed competition allowance component would be administratively complex (for regulators and retailers). The AER would need to determine what constitutes an "efficient margin" or a fair "competition allowance" and it is not obvious how this would be done.

Any questions about this submission should be addressed to Jo De Silva, General Manager Retail Policy by email to [jo.desilva@energycouncil.com.au](mailto:jo.desilva@energycouncil.com.au) or by telephone on 03 9205 3100.

Yours sincerely,

***Jo De Silva***

**Jo De Silva**  
General Manager Retail Policy