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Default Market Offer 2023-24 Draft Determination

The Australian Energy Council ('AEC') welcomes the opportunity to make a submission to the Australian Energy Regulator's ('AER') *Default market offer prices 2023-24 - Draft Determination* ('Draft Determination').

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.

Given the position of the AEC as a representative of competitor businesses, we operate in strict compliance with the Competition and Consumer Act (the 'CCA'). The CCA prohibits the AEC discussing with members confidential information relating to costs and how they set their prices. This submission has been drafted in line with our CCA obligations and will focus on matters pertaining to the Draft Determination. It does not consider the preferred methodologies of individual members. Our members will provide more detailed views on the issues raised in their own submissions.

The AEC understands that the AER seeks to balance the DMO process across its three pillared objective - protecting customers, ensuring retailers recover their reasonable costs and supporting competition in the electricity market. Noting that affordability challenges have come to the fore in recent times, the AEC encourages the AER to apply a balanced approach and not discount the impact this price determination will have on retailer confidence, and the bearing this then has on the depth of retailer participation in competitive markets and innovation investment.

Wholesale energy costs (WEC)

One of the most valuable contributions retailers make in the electricity supply chain is to manage wholesale price volatility for and on behalf of their customers. And, in a regulated price environment, system stability can only be maintained if retailers can recoup the cost of undertaking this vital function.

Modelled outcomes

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. The AEC has previously 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 12 months.

Hedging strategy

The AEC also notes that there is a higher reliance on caps in the hedging strategy applied in determining draft DMO 5 when compared to the method adopted in DMO 4. In the AEC's view this revised approach provides a lower level of cover (being a higher risk strategy) and does not represent the hedging strategy of a prudent retailer. The AEC strongly suggests that the AER conducts a test on the proposed hedging structure by applying it to a 2022-23 wholesale price trace scenario to determine the degree to which it protects (or exposes) a theoretical prudent retailer.

The AEC notes the AER's view that the WEC allowance would be overstated if the hedging strategy underpinning its calculation is designed to "*protect retailers from the risks associated with extreme circumstances*".¹ In the AEC's view, the DMO methodology should support an efficient prudent retailer's survival through extreme market conditions. Any lesser approach, particularly during current times of heightened uncertainty, would leave too many customers exposed to ROLR events - risking overall market stability and indeed flies in the face of a retailers' key role in the supply chain to manage (and survive) volatility risks.

Extreme market movements allowance

Therefore, in the AEC's view, if the AER remains committed to utilising a 75th percentile outcome cover with the hedging structure applied in the Draft Determination, this should be coupled with an allowance for working capital capacity to hold retailers viable during periods of extreme market movements. Various extreme market scenarios should be contemplated in such an allowance including scenarios of peak price and demand (whereby retailers can lose large sums in a small number of traded periods) along with scenarios where, over an extended period of time, demand sits above the base swap covered position simultaneous to prices landing above the WEC allowance (where, by virtue of the number of trade periods retailers can incur sizable losses over time – particularly where hedging is heavily reliant on caps).

Wholesale spot prices

The AEC notes that the observed pool prices in NSW so far this (calendar) year appear significantly higher than the modelled numbers used in the draft DMO 5. Given this discrepancy, the AEC considers it important for the AER and ACIL Allen to provide clarifying explanations (within the bounds of acceptable disclosure given ACIL Allen's proprietary tool) to stakeholders in its final decision. Without this clarity, the AEC is concerned that confidence in the methodology will be affected.

Load profile data

The AEC notes and agrees with ACIL Allen's comments in their report '*Default Market Offer 2023-24, Wholesale energy and environment cost estimates for DMO 5 Draft Determination*'- "*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*"², and "*... 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*".³ 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 recommends that the AER utilise the interval meter data alongside the NSLP in

¹ Draft Determination, p27.

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

³ n2, p17.

calculating the WEC allowance for all future determinations - including the DMO 5, 2023-24 final determination.

In addition, the AEC encourages the AER to monitor (for potential future material impacts) for consideration in the 2024-25 determination and beyond the impacts on settled load shape of unaccounted for energy (UFE). As a body of trending data becomes available since the implementation of global settlements, impacts on the 'true' NSLP shape material impacts on retailer hedging costs (up or down by network zone) may become apparent.

Retail costs

Cost to serve

Regarding retail cost to serve, the AEC notes that because the AER does not have visibility of the data used by the ACCC, the manner with which the AER have converted variable retail costs (cents per kWh) into a fixed charge (dollars per customer) creates a risk that the AER has understated the true cost. We encourage the AER to make better use of retailer ACCC cost information submissions to improve the accuracy of values applied.

Advanced metering

For advanced metering, the AEC notes that the DMO method involves a one-year delay in retailer reimbursement. That is, retailers carry (and incur a cost of) one year of smart meter working capital requirements and this means for a smart meter cost of \$120, retailers incur an additional \$8 in capital costs for the year (assuming a WACC of 6.7%). The AEC notes that the DMO does not provide for this working capital cost. In the AEC's view this approach does not align with AEMC's target objectives to have this technology available to customers in the near term.

Bad and doubtful debts

The AEC has also been informed by its members that in determining the draft DMO 5 bad and doubtful debts allowance, the AER has sourced data from retailer published information which includes values from other lines of business with lower debts per customer (meaning non-reflective product lines such as commercial and industrial electricity, broadband and gas) which are materially skewing the AER's calculations. To determine a more accurate value the AEC recommends the AER source bad debts information from the ACCC process, and in particular, consider the higher comparative cost attributable to residential and small business electricity customers.

The AEC notes that the Draft Decision applies bad and doubtful debts on an equal 'dollars per customer' basis across all customer types. This costing allocation methodology produces a cross-subsidy whereby smaller consumers are at risk of being overcharged to the benefit of larger electricity users. In reality, bad debt expenditure is a function of the risk of customer default and the quantum of customer bills - in essence, a variable cost which is proportionate to retailer income. To apply these costs more accurately by customer size (and thereby reduce the risk unintended customer cross-subsidies) the AEC recommend that the AER apply a percentage of turnover method in determining the bad and doubtful debts DMO amount.

Retail allowance

The AEC is concerned that there are calls to reduce the retail margin allowance at this time. The AEC supports the AER decision to not reduce the retail allowance percentages applied in the Draft Decision as reduction of the margin at this time risks triggering ROLR events in the market.

The AEC notes that the retail allowance includes compensation to retailers for the following items: depreciation and amortisation, retail headroom, (weighted) cost of capital for debt and (weighted) risk-adjusted return on equity – including the cost of capital for ordinary business trade – for example the capital required to support a seven day wholesale settlements cycle compared to a 92 day customer metering cycle and also (to the extent that it is not incorporated into the WEC allowance), the cost of capital to support retailers through extreme market events. We note 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 and it is reasonable to assume that such risk factors may have increased since the AER's May 2022 decision. 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 margin allows them to invest in innovation and product development initiatives with long lead times which ultimately benefit customers.

The AEC is disappointed that concerns raised in our [submission](#) at the time of DMO 4 regarding subjectivity employed in determining the retail allowance percentage and risk of inconsistency have come to fruition for the low margin SAPN and Energex regions with the AER choosing to pause the retail allowance 'glidepath'. In the AEC's view when the AER published margin glidepaths in May 2022, retailers should have been able to rely upon those representations less than 12 months later, noting that at the time of the May 2022 decision, many of the factors resulting in an increased DMO 5 were beginning to present themselves.

Any questions about this submission should be addressed to Jane Sing – Interim Retail Policy Lead, by email to Jane.Sing@energycouncil.com.au or by telephone on (03) 9205 3100.

Yours sincerely,



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