Default market offer prices 2023-24

Issues paper

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Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601
Tel: 1300 585 165

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Invitation for submissions

Interested parties are invited to make submissions on this issues paper by Wednesday 30 November 2022.

Submissions should be sent to: DMO@aer.gov.au

Alternatively, submissions can be sent to:

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

Submissions should be in PDF, Microsoft Word or another text readable document format.

We prefer that all views and comments be publicly available to facilitate an informed and transparent consultative process. Views and comments will be treated as public documents unless otherwise requested. Parties wishing to submit confidential information should:

- clearly identify the information that is the subject of the confidentiality claim
- provide a non-confidential version of the submission in a form suitable for publication.

All non-confidential information will be placed on our website. For further information regarding our use and disclosure of information provided to us, see the ACCC/AER Information Policy (June 2014), which is available on our website.

Glossary

Term	Definition
ACCC	Australian Competition and Consumer Commission
AEC	Australian Energy Council
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASX	Australian Securities Exchange
CER	Clean Energy Regulator
CL	Controlled load
COAG Energy Council	Council of Australian Governments Energy Council
CPI	Consumer Price Index
DMO	Default market offer
DMO 1	Default market offer determination for 2019–20
DMO 2	Default market offer determination for 2020–21
DMO 3	Default market offer determination for 2021–22
DMO 4	Default market offer determination for 2022–23
ECA	Energy Consumers Australia
EME	Energy Made Easy
ESCV	Essential Services Commission Victoria
EWOSA	Energy and Water Ombudsman South Australia
FiT	Feed-in tariff
ICRC	Independent Competition and Regulatory Commission
kW	Kilowatts
kWh	Kilowatt hours
kVa	Kilovolt amperes
LAR	Local area retailer
LRET	Large-scale Renewable Energy Target
MMO	Median market offer
MO	Market offer
MSO	Median standing offer
MWh	Megawatt hours
NEM	National Electricity Market
NER	National Electricity Rules
NERL	National Energy Retail Law
NERR	National Energy Retail Rules
NGL	National Gas Law
NUOS	Network use of system
NSLP	Net System Load Profile
PIAC	Public Interest Advocacy Centre
PV	Photovoltaic system / solar power system
QCA	Queensland Competition Authority
QCOSS	Queensland Council of Social Service

Term	Definition
REPI	Retail Electricity Pricing Inquiry
RET	Renewable Energy Target
RPP	Renewable power percentage
SAPN	SA Power Network
SME	Small and medium-sized business customers (enterprises)
SO	Standing offer

1 Summary

The Default Market Offer (DMO) is the maximum price an electricity retailer can charge a customer on a standing offer. A customer may be on a standing offer for several reasons, for example if they have never switched to a retailer's market offer or may have defaulted to a standing offer at the end of their market offer benefit period.

The Australian Energy Regulator's (AER) role is to determine the DMO price each year. Our DMO price determination applies to small business and residential customers in South Australia (SA), New South Wales (NSW) and south-east Queensland where there is no other retail price regulation.

The DMO price for each area also acts as a reference price for comparing residential and small business electricity offers. When advertising or promoting an offer, retailers must show the price of the offer in comparison to the DMO. This aims to help customers more easily compare different offers.

The *Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019* (the Regulations) sets out the legislative framework for the DMO.

The Regulations require that we must have regard to a range of factors in setting the annual DMO price. These include ensuring that retailers can recover the costs they incur to serve customers and make a reasonable profit. In setting a price that protects standing offer customers from unjustifiably high prices, we must also ensure that retailers have incentives to compete, innovate and invest.

This issues paper is the first step in our process to determine DMO prices for 2023–24. This is the fifth time we will determine DMO prices. As such we refer to the 2023–24 DMO throughout this issues paper as 'DMO 5'.

1.1 DMO issues for consideration focuses on wholesale cost methodology, retail allowance glidepath and embedded networks

During the DMO 4 consultation, we undertook a holistic review of our methodology for setting DMO prices. We implemented these changes in our DMO 4 final determination.

In our DMO 4 final determination we flagged that we would consult further on aspects of the wholesale forecasting methodology as part of DMO 5. This issues paper discusses aspects of the wholesale methodology and seeks stakeholder feedback on whether further refinements are appropriate. This issues paper also considers the impact of wholesale movements on the retail allowance and whether we should adapt the intended glidepath to 10 and 15% retail allowances for residential and small business customers.

We do not consider the recent wholesale price increases and its impact on the retail market require a complete review of the DMO methodology. The cost-stack methodology for wholesale and network costs will ensure developments in the market across most of the 22-23 period will be reflected in the DMO 5 price. This paper includes the intended direction for these aspects of the DMO methodology we do not propose to change. Stakeholders should provide evidence if they consider a different approach to these elements is necessary.

In February 2022 the Australian Government Department of Industry, Science, Environment and Resources (DISER), now Department of Climate Change, Energy, the Environment and Water (DCCEEW), completed a post implementation review of the DMO regulations. One of the outcomes of the review was to continue consulting on how best to include embedded network customers in the DMO. We are working with DCCEEW to align our consultations on this matter as far as possible, to avoid duplication and minimise impact on stakeholders.

This issues paper focusses on a limited number of issues we are considering as part of DMO 5. These include:

- wholesale methodology
- how best to extend DMO price protections to all customers in embedded networks in DMO regions
- whether the DMO allowance 'glidepath' remains appropriate in the context of high prices

1.2 Next steps

Table 1.1 outlines our timetable for the development of DMO 5 prices.

Table 1.1 DMO 5 timetable

Milestone	Date
Publish issues paper	3 November 2022
Online stakeholder forum	November 2022
Submissions due	30 November 2022
Publish draft determination	February 2023
Online stakeholder forum	February/March 2023
Submissions due	March 2023
Publish final determination	May 2023
DMO 5 in force	1 July 2023

2 Background

The AER is the independent regulator for Australia's national energy market.

Our functions include regulating electricity networks and covered gas pipelines, in all jurisdictions except Western Australia. We enforce the laws for the National Electricity Market (NEM) and spot gas markets in southern and eastern Australia. We monitor and report on the conduct of market participants and the effectiveness of competition.

We protect the interests of household and small business consumers by enforcing the National Energy Retail Law (NERL). Our retail energy market functions cover NSW, SA, Tasmania, the Australian Capital Territory (ACT) and Queensland.

Our objectives include:

- Protecting vulnerable consumers, while enabling consumers to participate in energy markets; and
- effectively regulating competitive markets primarily through monitoring and reporting, and enforcement and compliance.

Under the *Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019* (the Regulations), our role is to set the DMO price each year for regions where there is no retail price regulation: NSW, south-east Queensland and South Australia.

2.1 Policy context for the Default Market Offer

In the final report of its 2018 Retail Electricity Pricing Inquiry (REPI), the Australian Competition and Consumer Commission (ACCC) noted electricity standing offer prices were unjustifiably high.[1]

The ACCC found that standing offers, originally intended as a default protection for consumers who were not engaged in the market, were no longer working as intended and were:

- Being used by retailers as a high-priced benchmark from which their advertised market offers were derived. This created significant complexity in comparing deals.
- Causing financial harm to standing offer customers, who were often not engaged in the market for a range of reasons.

To address these concerns the ACCC recommended the introduction of a DMO to cap the amount that retailers can charge residential and small business standing offer customers. It recommended the AER set the maximum price for the default offer in jurisdictions where there is no retail price regulation.

The Australian Government accepted the recommendation and introduced regulations giving effect to the DMO from 1 July 2019. The legislative framework for determining DMO prices is contained in the Regulations.[2]

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1 ACCC, *Retail Electricity Pricing Inquiry, Final report,* 2018.

2 Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019, https://www.legislation.gov.au/Details/F2019L00530.

The ACCC stated that the purpose of the DMO was to act as a fall-back for those who are not engaged in the market and should not be a low-priced alternative to a market offer.[3] It provided clear guidance about how the DMO price should be set. It also established the policy objectives that the DMO should:

- reduce unjustifiably high standing offer prices and continue to protect consumers from unreasonable prices;
- allow retailers to recover their efficient costs of providing services, including a reasonable retail margin and costs associated with customer acquisition and retention; and
- enable competition, innovation and investment by retailers, and retain incentives for consumers to engage in the market.

2.1.1 Customers on standing offers

Most customers on standing offers in DMO regions are served by 'Tier 1' retailers – AGL Energy, EnergyAustralia and Origin Energy. The Tier 1 retailers in the DMO regions are also the designated Local Area Retailers under the NERL.[4]

The Australian Energy Market Commission (AEMC) and ACCC have identified customers on standing offers are those who:

- have not taken up a market offer since the introduction of retail competition in that jurisdiction
- are supplied under a retailer's 'obligation to supply' (for example, if a poor credit history means other retailers will not supply them)[5]
- have moved into a premises and receive supply from the existing retailer supplying the premises but are yet to make contact with the retailer[6]
- have defaulted to a standing offer following the expiry of a market contract.[7]

All retailers must have and must publish on their websites a standard retail contract and standing offer prices.[8] A customer will always have a particular retailer (called the designated retailer) that will be required to advise the customer of the availability of the standing offer,[9] and offer that customer the standing offer prices under its standard retail contract.[10] The retailer that has this obligation will depend on the circumstances.[11]

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3 ACCC, *AER Default market Offer, Submissions to the Draft Determination*, 20 March 2019, pp.1–2.

4 National Energy Retail Law, s 11.

5 Unlike other retailers, under s. 22 of the National Energy Retail Law Local Area Retailers cannot refuse to supply customers.

6 AEMC, *Advice to COAG Energy Council: Customer and competition impacts of a default offer*, 20 December 2018, p. 15.

7 Section 10 of the Regulations makes clear the DMO price only applies to customers on an electricity retailer's standing offer. It does not apply to customers who are on ongoing market contracts where discounts have expired. In practice these customers may be paying a retailer's standing offer prices. We do not know how many customers may be in this situation.

8 National Energy Retail Law, ss. 23, 25.

9 National Energy Retail Law, s. 22.

10 National Energy Retail Law, s. 22.

11 AER, 2020, Compliance check, Obligation to make an offer to a small customer.

Table 2.1 sets out the number and proportions of customers on standing offers for DMO areas in the fourth quarter of 2021–22.

We note that while the proportion of customers on standing offers has fluctuated in recent quarters, the long-run trend is steady decline.

Table 2.1 Standing offer customers in DMO areas

	Residential customers (number and %)	Small Business customers (number and %)
New South Wales	324,990 (9.7%)	57,016 (17.7%)
South-east Queensland Figures extrapolated from all Queensland by excluding Ergon customers. We note other retailers have customers in regional Queensland so figure is approximate	155,511 (10.5%)	20,885 (19.3%)
South Australia	61,901 (7.7%)	13,289 (15.4%)
Total standing offer customers	542,402 (9.6%)	92,723 (17.9%)

Source: AER, Retail market performance update, Quarter 4 2021-22

2.2 DMO regulatory framework

The legislative framework for implementing DMO prices and the reference bill mechanism are contained in the Regulations.

Part 3 of the Regulations confer price setting functions on the AER. Specifically, we are required to determine:

- how much electricity a broadly representative small customer of a particular type in a particular distribution region would consume in a year and the pattern of that consumption[12] (the model annual usage)[13]
- a reasonable total annual price for supplying electricity (in accordance with the model annual usage) to small customers of a type in a region (the DMO price).[14]

The DMO price applies to residential and small business customers on standing offers in distribution regions that are not subject to retail price regulation.[15] These regions are:

- NSW – Ausgrid, Essential Energy and Endeavour Energy
- SA – SA Power Networks (SAPN)
- south-east Queensland – Energex.

The Regulations set out that we must determine DMO prices for 'small customers' of certain types. These types are:

12 The AER is not required to determine the pattern of consumption in the case of small business customers.

13 Regulations, s. 16(1)(a).

14 Regulations, s. 16(1)(b).

15 Section 8 of the Regulations specifies that the instrument would not apply in a distribution region if any standing offer prices, or maximum standing office prices, for supplying electricity in the year in the region to a small customer are set by or under a law of a State or Territory.

- *Residential customers* – on flat rate or TOU tariffs who use electricity mainly for personal, household or domestic use, and whose prices do not include a controlled load tariff. A controlled load tariff applies to a separately metered part of a customer's load, for appliances such as electric hot water storage systems or underfloor heating.
- *Residential customers with controlled load* – on flat rate or TOU tariffs who use electricity mainly for personal, household or domestic use, and whose prices include a controlled load tariff.
- *Small business customers* – on flat rate tariffs with no controlled load, and who use less than 100 megawatt hours (MWh) per year.

Each category includes customers with solar tariffs.

We are not currently required to determine an annual price and usage for customers on other tariff types, such as:

- tariffs with a demand charge
- small business controlled load and TOU tariffs
- tariffs offered in embedded networks.

The Regulations require us to have regard to a range of specific factors in determining a reasonable annual price. These include wholesale electricity, network and retail costs, the principle a retailer should be able to make a profit, and other matters we consider relevant.[16] Our previous determinations have set out how we have had regard to these factors in setting the DMO price.[17]

2.2.1 Reference price provisions

Part 2 of the Regulations prescribes a mandatory industry code (the Code for the purposes of Part IVB of the *Competition and Consumer Act 2010*). The Code contains the DMO reference price provisions that require:

- standing offer prices for small customers must not exceed a price determined by the AER[18]
- small customers must be told how a retailer's prices compare with the AER determined annual price[19]
- the most prominent price related feature in an advertisement must not be a conditional discount, and any conditions on other discounts must be clearly displayed.[20]

As the Code has been made under the *Competition and Consumer Act 2010*, enforcement and compliance with these provisions is the responsibility of the ACCC.

16 Regulations, s. 16(4).

17 AER, Final determination, default market offer prices 2019–20, p. 27 – 29; AER, Final determination, default market offer prices 2020–21, p. 75 – 77.

18 Regulations s. 10.

19 Regulations s. 12.

20 Regulations s. 14.

3 Market developments since DMO 4 and likely drivers for DMO 5

This section discusses how the retail market has responded to wholesale market events and the potential increases in the wholesale and network components that are key drivers of DMO prices.

3.1 Retail market developments in 2022

From 2016 to 2021, there were 4 retailer failures in total. However, in 2022, the AER has issued Retailer of Last Resort (RoLR) notices for 6 electricity retailers.[21] Customers of failed retailers were automatically transferred to other large retailers including AGL, Origin Energy and EnergyAustralia, as well as ActewAGL and Aurora for customers in the ACT and Tasmania. The substantial increase in the number of retailer failures in 2022 is a likely sign of both the pricing pressures retailers face in the wholesale electricity market, as well as differing approaches to risk management. During this same period, several small energy retailers also requested their own customers switch to another retailer. Further, some small electricity and gas retailers were actively turning away potential customers, or delaying the sign-up of new customers, due to the pricing volatility and increased costs and difficulty in managing customer load risk.

The market volatility can also be seen in the customer switching rates. Across 2021–22, customer switching rates for the electricity market increased in all jurisdictions. This increase may be due to customers either searching for a better deal or having to switch due to retailer failures because of the market volatility and price increases in both the wholesale electricity and gas markets. While there has been a significant increase in the number of RoLRs in 2022 compared to previous years, we estimate that this has affected around 0.3% of the total market.

We have observed changes in how retailers have priced market and standing offers. The median market offer in September has increased compared to offers in March 2022, reflecting retailers adjusting their prices to respond to increased costs and risk.

Due to changes in the retail market in 2022, we are considering if the approach adopted in DMO 4 for retail allowances remains appropriate. The adopted approach sets a retail allowance as a percentage of total costs. This approach means that the retail allowance increases in dollar terms as DMO cost components increases. This could further exacerbate price increases and reduce electricity affordability for all consumers.

We discuss this issue further in section 5.3, seeking feedback on whether the intended glidepath for the retail allowance remains appropriate in the likely outcome of significant increases in the DMO price.

3.2 Wholesale market volatility and increased prices

The wholesale component accounts for between approximately 30% and 45% of the DMO price. Movements in the wholesale component have a significant influence on the final DMO price.

Due to a combination of international and domestic pressures, wholesale energy markets have seen unprecedented volatility, leading to a significant increase in wholesale prices in 2022. Supply

[21] Enova Energy, Pooled Energy, Power Club, Mojo Power East, Social Energy and Elysian Energy are the electricity retailers that were issued RoLR notices. Apex Energy entered voluntary administration on 27 June 2022, triggering a RoLR event under s 122 of the NERL. However, Apex Energy has since resumed trading as normal and we have not issued a RoLR notice.

side pressures such as generator outages, fuel supply issues, generator constraints and potential supply shortages combined with extremely high international coal and gas prices led to the administered price cap being implemented and the suspension of the wholesale electricity market by the Australian Energy Market Operator (AEMO) from 15 to 24 June 2022.

Wholesale contract prices have increased significantly since early 2022 across the upcoming 3-year horizon. DMO 5 uses the financial year 2023-24 base future prices as a key input. The financial year 2023-24 base future prices have increased 130% to 200% since the start of the year, settling in the $160/MWh to $190/MWh range in early October. With 7 months left until the final DMO 5 determination, contract price movements over the coming months will be a key driver of the wholesale cost component.

Figure 3.1 FY 23/24 Base Future Prices, January 2022 onwards

The market suspension has also brought about additional costs that need to be considered for DMO 5. Participants impacted by the market suspension were able to apply to be financially compensated, with this cost being recovered via retailers and ultimately consumers. These impacts, along with potential changes to the wholesale methodology are discussed throughout section 4.

3.3 Increases in network costs

The network component accounts for between approximately 30 and 50% of the DMO price. Similar to the wholesale component, movements in network costs also have a significant influence on the final DMO price. We propose to continue our approach of directly passing all available network cost data into the DMO price.

Network revenues and prices of tariffs for the 2023–24 year are generally expected to increase due to higher inflation and rate of return than forecast.

Each year the electricity distribution networks submit to the AER a pricing proposal which sets out the revenues and prices of tariffs they propose for the forthcoming financial year. These revenues and tariffs recover:

- the costs of operating and maintaining their own distribution network

- the costs of operating and maintaining the transmission network they are serviced by
- costs related to the operation of jurisdictional schemes.

The AER regulates the revenue the distribution networks can recover and prices they charge each year. This is managed through our regulatory determinations where we set the 5-year price path and revenue control mechanism and our annual pricing approval process.

The price path is updated annually for actual inflation and cost of debt data (to calculate the updated rate of return). It is expected that both actual inflation and cost of debt will be higher than forecast in the original network revenue determinations. Transmission network revenue will also incur increases due to higher actual inflation and rates of return.

Network revenues and tariffs are also adjusted annually for cost pass-through event amounts, incentive scheme rewards, and changes in consumption behaviour.

Recently there have been several cost pass-through events related to significant weather (floods, bushfires, storms) and new regulatory obligations in DMO regions. These costs are recovered over several years, including the DMO 5 2023-24 period, to reduce the incidence of price shocks.

3.4 We expect significant price increases in DMO 5 and challenges for consumers and retailers

As the impacts of high wholesale prices during 2022 flow through to retail markets, retail prices are likely to put pressure on energy affordability, which had been improving through the end of 2021 based on subdued wholesale market conditions.

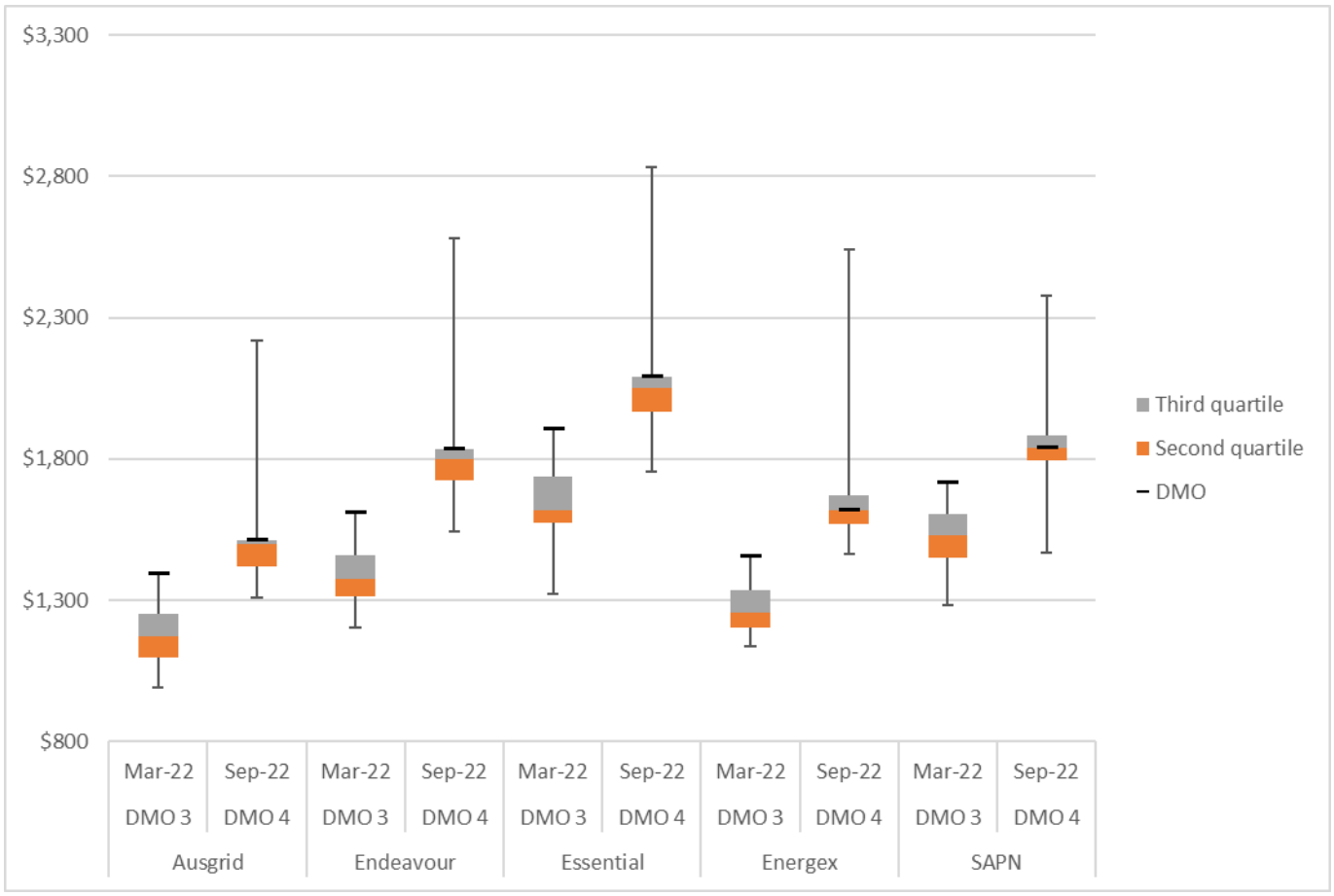
We have seen market offers in the current financial year increase for the same reason that the DMO increased in our last determination – retailers were facing higher costs.

These increases mean the median market offer is now marginally below the DMO price for all customers in all regions. In contrast, the median market offer in March 2022 was 10% to 16% below the DMO price.

We have also found that around half to 75% of market offers are at or below the DMO price in September. This is a reduction from the previous levels in March 2022 of around 95% of market offers being at or below the DMO 3 price. However, many retailers still continue to offer discounts, with the cheapest offers in the market being 9 to 20% below the DMO depending on the region.

Figure 3.2 demonstrates the spread of market offers in March and September 2022.

Figure 3.2 Residential market offers March and September 2022, minimum, maximum and interquartile ranges



Source: AER analysis of Energy Made Easy market offers, September 2022. Interquartile range represents the 25% of market offers above and below the median market offer. The second quartile (orange) represents 25% of market offers below the median market offer. The third quartile (grey) represents 25% of market offers above the median market offer.

In current market conditions, it is possible that the DMO prices may be playing less of a 'safety net' role but instead more closely represent a typical offer in the market.

Forward market prices suggest that these conditions are likely to continue into DMO 5. Retailers use these forward markets and other hedging products to insure themselves, and their customers, against high and volatile wholesale prices in the coming year. High contract prices for the 2023-24 financial year will result in increases in costs to obtain a similar level of price protection to that relied upon in the past.

Higher retail prices may lead to an escalation of consumers' debt levels in 2023. Worsening debt levels and other indicators of financial difficulties have already been observed in early 2022 data, demonstrating that some consumers are not well placed to absorb further increases in energy costs.

We are concerned about the impact of these market developments on all consumers, but particularly on customers experiencing vulnerability, recognising that a growing number of customers are in energy debt and those customers face higher average levels of debt. Customers experiencing vulnerability are also less able to adopt technology and modify their energy use in response to higher prices or shop around for a cheaper energy contract.

These market conditions highlight the important purpose the DMO will serve to protect customers from unreasonably high prices by ensuring only reasonable costs are included in the DMO and passed on to consumers. Similarly, we acknowledge the retail sector is under significant pressure and will be giving scrutiny all cost components of the DMO to ensure we understand the impacts on retailers and competition.

4 Wholesale costs

As signalled in the DMO 4 final determination, we proposed to engage with stakeholders on the wholesale methodology as part of our DMO 5 consultation.

The current wholesale forecasting approach is designed to simulate the wholesale energy market from a retailer's perspective, reflecting all cost associated with purchasing energy from the National Electricity Market (NEM). The wholesale energy costs are a combination of costs retailers face from purchasing hedging contracts to insure against volatility in the wholesale market, some spot market costs, as well as other fees related to participation in the NEM.

We have previously referred to this as a 'market based' forecast approach. Using this approach, the wholesale energy cost is influenced by energy supply and demand forecasts, the assumed hedging strategy of a retailer to manage their exposure to the spot market and any final exposure to the spot market.

The hedging strategy adopts the position of a prudent retailer, which would progressively purchase hedging contracts (ASX base, peak and cap) over a 2-3 year period, decreasing the majority of its exposure to the wholesale electricity market. Contract prices and traded volumes are based on publicly available data from the ASX, for respective contracts for DMO regions.

Using demand and supply forecasts, our consultant then produces a distribution of around 500 simulated spot market price outcomes, representative of volatility in the spot market. The cost of implementing the hedging strategy in each scenario is calculated. In DMO 4 we adopted the 75th percentile estimate of modelled price outcomes.

In early 2022 we commissioned Frontier Economics to examine the wholesale forecasting methodology which had been used in all previous DMO determinations (DMO 1 to 4). This analysis focussed on how well the methodology met the DMO objectives in the current and potential future wholesale market scenarios. Frontier's report highlighted that while the current approach had some potential to overestimate the wholesale energy cost it does meet the DMO objectives better than most alternative approaches it considered. Based on this work, we signalled to stakeholders in our DMO 4 final determination that we would look to consult further on the wholesale methodology for DMO 5. The following sections in this paper set out our current approach to this work.

As highlighted in section 3.1, the wholesale market has seen unprecedented volatility since DMO 4 was released. We consider the impacts of these events in the wholesale market should be incorporated into our review of the wholesale methodology. We intend to be able to use the same methodology for DMO 6 so are seeking to improve the method in such a way that it would remain robust to future market changes.

As Frontier's report highlighted, there are a number of alternative approaches to the methodology which could potentially improve the accuracy of the wholesale forecast, however all came at a cost to either transparency of data used, practicality of implementation or price stability.

Taking into account Frontier's findings, along with the more recent wholesale market events, our current position is that transparency, stability and certainty in our approach should be at the forefront of any potential changes to the current wholesale methodology. We are currently therefore not proposing large scale changes to the methodology, as we consider the impacts of a significant shift to an alternative approach will add further uncertainty and complexity to an already challenging time within the NEM.

We are however interested in stakeholder feedback on this proposed position, along with the trade-offs highlighted in Frontier's report around transparency in data inputs used and the overall modelling process and price stability within the wholesale component of the DMO. The following sections cover more focussed changes to the wholesale energy cost we are seeking stakeholder feedback on for DMO 5.

Question: Do you consider maintaining the existing methodology in the current wholesale environment is appropriate? If not, which improvements or other methodologies should we consider adopting?

4.1 Load profiles

The chosen load profile is a key input into the current wholesale methodology. Previously we have relied on AEMO's published net system and controlled load profiles, which are created using basic meter data. Our consultant uses this data to create an aggregated load profile which is broadly representative of residential and small business customers.

These load profiles are used in developing the hedging profile of a risk averse retailer, which the methodology seeks to represent. We noted in the DMO 4 final determination that these load profiles are becoming increasingly peaky in shape (more extremes of high and low demand). A peakier load profile is likely to result in higher hedging costs than a flatter load profile. This can occur as additional contracts need to be purchased to cover periods of higher demand, which then result in periods in which the retailer is over contracted because demand is low.

In response to this issue, we consider it is appropriate to review how alternative load profile data sources, such as interval meter or smart meter data, could be used to test whether current net system load profiles are still an accurate representation of a load retailers are likely to hedge against. We are also considering if there is a need (or benefit) to continue to use individual load profiles for each network within the New South Wales region, or one single profile could be used. Adopting one load profile may be a better representation of how a risk averse retailer would approach hedging of its customer load.

This data is not published and would need to be sourced confidentially from AEMO. This does reduce transparency, similar to the trade-offs discussed in 4.2 below.

Question: Does the use of net system load profiles in determining our hedging model reasonably reflect retailer risk management strategies? How could our load profile assumptions be improved?

4.2 Transparency of the modelling process

Currently the wholesale methodology relies on public information on futures contracts traded on the ASX for base, peak and cap contracts. Our consultant also assesses ASX trades against broker OTC data. Historically, this broker data has shown little difference in prices and therefore hasn't resulted in any adjustments to the modelling inputs. A number of stakeholders raised concerns during the development of DMO 4 that prices used in the modelling based on ASX data alone was not an accurate reflection of costs retailers face. This was especially the case in South Australia, due to the lower level of contract trading that occurs on the futures exchanges for that region.

The current methodology relies heavily on a liquid contract market, which assumes retailers can readily acquire contracts in the years leading up to the relevant time period.

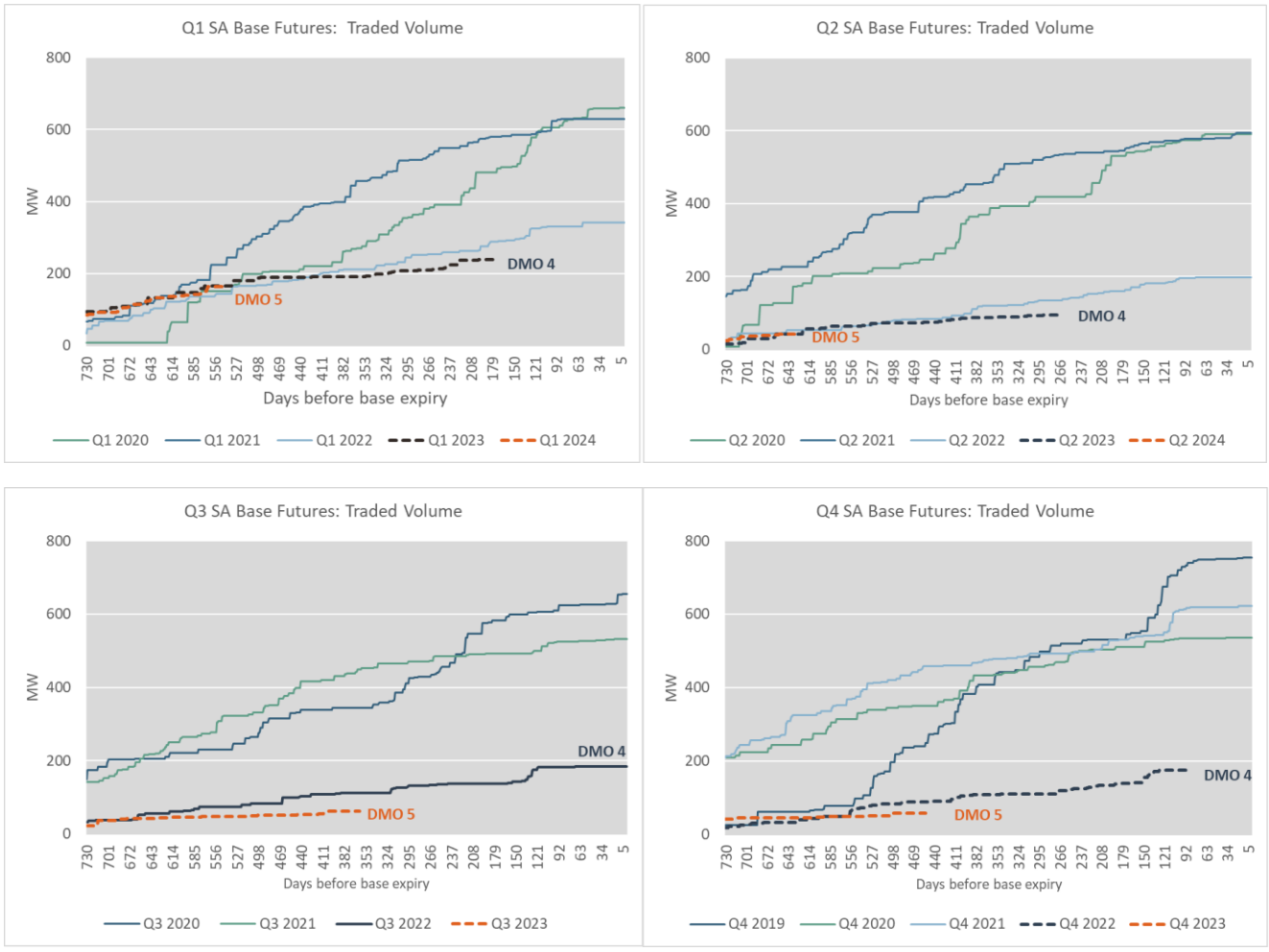
Market participants are reporting to us that the electricity futures markets are now facing liquidity challenges. This appears to be driven by:

- The very rapid increase in prices which has triggered margin calls for parties who have sold contracts. These margin calls occur daily and the outlook for further contract price rises means parties who would normally be continuing to offer contracts for sale (e.g. generators) facing greatly increased risk in doing so.
- For generators, concerns about fuel availability and, in some cases, plant reliability. These issues are reportedly contributing to an increased risk in selling contracts as generators need physical plant available to back any sold contracts in the spot market.

We are also aware of recent developments with some participants' access to clearing house services, which may further exacerbate this issue.

There are also specific issues in South Australia which has always had lower levels of trades compared to other regions. In the past 12 months, volumes have fallen further. In recent years, total traded volumes of base futures in each quarter typically totalled between 600-800MW. For each quarter from Q1 2022 onwards we have seen this volume fall to around 200-300MW (Figure 4-1). These lower levels look set to continue with current traded volumes for DMO 5 (the four quarters comprising financial year 2023-24) tracking at or below these levels when compared at the same point in time.

Figure 4-1 South Australian Base Future Traded Volumes



For DMO 5 we hold concerns about the lack of trades and subsequent data on the ASX in which to include in the book build process for South Australia. That is, low liquidity levels mean the exchange data may not reasonably reflect retailer risk management practices.

A potential option to add additional trades would be to obtain confidential contract information from market participants in South Australia and add these into the book build process, as is currently done for ASX contracts. For this to occur we would need to obtain contract terms and conditions, including but not limited to; prices, volumes and dates when contracts were entered in to. This information could potentially be sourced from broker data on OTC trades or contract information sourced directly from retailers. How vertically integrated participants value internal hedging products may also need to be considered. We could also consider this approach for other regions.

If we could access reliable alternative data on contracting and other risk management practices, we could consider including these as inputs in the current methodology. However, this approach would be less transparent.

Frontier's report also highlighted potential benefits to the accuracy of the wholesale energy cost by using a more realistic hedging strategy which includes more complex hedging products currently used by market participants (for example, power purchase agreements (PPAs), weather derivatives and options). Some products, such as PPAs, would be difficult to include as they are often contracted for over a number of years and highly dependent on physical output. However, we see merit in exploring the use of options in the modelling, which captures strike prices that were agreed to in contract terms. We understand options products are becoming more popular in the current market, as it provides some flexibility to a retailer in their hedging strategy as they are effectively paying an up-front premium to decide on whether to exercise that option, closer to the actual contracting period.

Due to the increase in popularity of options we are considering if this product should be included in the hedging profile, as it is likely to reflect a prudent retailer's hedging strategy. While this may increase the complexity of the model, it is based on publicly available information from the ASX trade log. To include this into the modelling we would base it on actual options and the outcomes of if they were exercised, from observable data from the ASX for relevant futures products. If options were not exercised, the cost of the option would also need to be included in the wholesale energy cost. We note that the use of options is far greater in New South Wales and Queensland regions than South Australia, and the model hedging strategies would reflect this.

Question: Do you support the inclusion of confidential contract information into the book build process? How could we make this process as robust, reliable and transparent as possible?

Question: Do you support the inclusion of additional contracting products in the modelling process, such as options?

4.3 Price stability of the wholesale component

The stability of the DMO price also needs to be considered against the DMO objectives of providing protection to consumers, while still enabling retailers to recover efficient costs, including a margin. Implementing a more complex hedging strategy, or potentially a change in the way the book build process occurs, may result in greater price swings year on year.

The current book build process which occurs over a 2 to 3 year period, replicating traded volumes on ASX products and prices, results in a fairly stable wholesale cost pending any large shifts in contract prices. In previous DMO engagement, some stakeholders have submitted that the book

build process should weight contract trades and prices closer to the relevant DMO period, as this would better represent price expectations during that time. If this approach was adopted in DMO 5 we would likely see larger price increases then if the current methodology was continued to be used, however the opposite would also occur with large price decreases if wholesale prices drop dramatically from current highs.

We have discussed potential changes to the hedging strategy in section 4.2. Regarding the book build process we have previously stated, and still hold the view, that we support the longer book build process as we consider price stability an important part of providing fallback price protection to consumers. We also consider that adopting a similar approach year-on-year is important to maintain consistency in the modelling, which we understand a number of retailers often replicate for their own internal purposes.

Due to the events within the wholesale market that have occurred in 2022, along with our previous statements around price stability and protections this offers to consumers, we are currently not proposing to make changes to the book build process. We are however interested on stakeholder views on this topic, to help inform our decision making on the wholesale methodology for DMO 5.

Question: Do you support the current book build process used in the wholesale methodology component?

4.4 Wholesale market events in 2022

As highlighted in previous sections, there has been significant volatility in the wholesale electricity market so far in 2022. Most notable was the suspension of the wholesale market by AEMO from 15 to 24 June. This market suspension, along with the market conditions that led to it, resulted in costs that retailers will need to bear over the remainder of the 2022-23 financial year.

Market participants impacted by the suspension of the wholesale market were able to make compensation claims under two different cost recovery regimes in the second half of 2022. While the final costs of the scheme implemented by AEMO are likely to be known in advance of both the draft and final DMO 5 decisions, we understand the costs resulting from the AEMC scheme may not be finalised and passed onto retailers.

Our current approach is to include known costs arising from the compensation regimes in the DMO 5 wholesale electricity cost component. Similarly, to the way in which RERT costs have previously been included, the inclusion of these costs will result in a lagged cost recovery, which reflects an actual known costs retailers have faced. We will continue to work with the AEMC to understand how the costs resulting from its scheme will be known to external parties.

We are also aware of contract financing and cash flow issues that market participants have faced over 2022. Within the current DMO wholesale methodology this is accounted for through a prudential cost, which represents costs a retailer would face in meeting these requirements for both AEMO and the ASX.[22]

We are not currently proposing to adjust the way in which prudential costs are included in the wholesale energy cost. We consider changes in underlying inputs resulting from the recent wholesale market events will be captured in the current methodology, providing a good

[22] Acil Allen, Default Market Offer 2022-23 Wholesale energy and environment cost estimates for DMO – Final determination, pp 23-25.

representation of any potential increases in costs retailers now face when meeting the financial requirements of their hedging portfolio and load.

Question: Are there are any additional costs stakeholders believe should be considered in the wholesale energy cost, that have not previously been included?

5 Retail costs and allowances

5.1 DMO 4 through to 6 'cost stack' approach

In DMO 4 we determined a 'cost-stack' DMO methodology was the most appropriate approach for the DMO to continue meeting the DMO objectives. We propose to continue to use the cost-stack methodology because it provides:

- additional transparency by separately determining retail costs and setting a retail allowance
- greater pricing consistency between regions by setting similar retail allowances.

5.2 Retail costs

Retailers incur several costs when selling electricity. These costs include:

- **costs to serve** – these costs include billing, call centres and hardship programs. In DMO 4 we estimated these costs by using the ACCC's November 2021 Report average retail costs for 2020-21 year, which we escalated to the end of DMO 4 using the RBA's forecasted inflation.
- **costs to acquire and retain customers** – these costs include advertising campaigns and informing new customers of their options, rights and obligations. In DMO 4 we estimated these costs by using the ACCC's November 2021 Report average retail costs for 2020-21 year, which we escalated to the end of DMO 4 using the RBA's forecasted inflation.
- **smart meter costs** – retailers are responsible for managing the installation and ongoing costs of advanced meters. In DMO 4 we requested smart meter installation and average cost information from retailers representing around 90% of DMO customers and developed an average smart meter cost.
- **bad and doubtful debt** – retailers may set aside revenue to cover instances where customers cannot repay their electricity debt. In DMO 4 we developed an estimated average bad and doubtful debt cost by taking a weighted average of the expenses due to bad and doubtful debt published in the 2020-21 Annual Reports from the three publicly listed retailers (AGL, Origin Energy and Red/Lumo).
- **depreciation and amortisation** – retailers may from time to time make up-front purchases and investments, such as software and IT system upgrades, which are depreciated over time. In DMO 4 we did not separately determine depreciation and amortisation, and instead set a retail allowance that included an EBITDA margin. This is similar to ICRC, OTTER and ESCV's treatment of these costs.

We consider that these above approaches remain appropriate for DMO 5 and propose to update these calculations with the 2021-22 information from the ACCC, information requests to retailers, and public annual reports of listed retailers. We consider these approaches that use publicly available average cost information provide an appropriate balance of transparency and accuracy, and that any changes to how we calculate retail costs would need to consider the extent to which any alternative approaches are transparent, reproducible and rely on data that is publicly available.

We are seeking additional smart meter information from retailers. This information will help us better understand the extent to which retailers are recovering smart meter costs from one-off or up-front fees when a customer requests a smart meter instead of recovering these costs through retail tariff prices, which are subject to the DMO price protection and reference price regulations. If retailers tend to use upfront fees to recover some of the annual costs they incur for smart meters

they report to us, then it could be appropriate to make an adjustment to the smart meter component included in the DMO to avoid retailers over-recovering these costs.

Question: should we consider any changes to our retail costs approach?

5.3 Retail allowance

As part of the 'cost stack' methodology, we determine retail costs and a retail allowance. The retail allowance covers retailer profit margin, and an allowance to meet the DMO objectives.

The retail allowance is set such that:

- retailers recover a reasonable margin
- retailers are incentivised to invest, innovate and compete in the market
- customers are incentivised to engage in the market
- customers are protected from unreasonable prices

The level of the allowance therefore needs to reflect a return on retailer risk, provide some leeway for differences in retailers costs relative to our model and provide room for competition

Our analysis of the retail allowance in the DMO 4 final determination demonstrated that retailers with higher operating costs would still be able to recover a reasonable margin within the retail allowance.[23]

We consider that to date the DMO 4 retail allowance has met the DMO objectives. While the number of offers and the level of discounts has decreased from previous years, retailers continue to compete and offer discounts off the DMO 4 price. This means there are incentives for customers to shop around and switch from a standing offer (which is capped by the DMO price).

While 6 electricity retailers selling to a small proportion of market share (0.3%) have been issued RoLR notices in 2022, we consider these events were not due to the retail allowance or the overall DMO 4 price, but rather the business models of some retailers that exposed them to greater risks, when volatility and high wholesale prices emerged.

In our DMO 4 draft determination we set out an intended 'glide path' for the retail allowance across DMO 4, 5 and 6, with the retail allowance converging on 10% and 15% for residential and small business customers respectively. The proposed DMO 5 retail allowances are set out in Table 3.

Table 3 proposed DMO 5 retail allowances as set out in DMO 4 draft determination

Region	Residential no CL	Residential with CL	Small Business
Ausgrid	10%	10%	20%
Endeavour	10%	10%	16%
Essential	10%	10%	17.5%
Energex	9%	10%	16%
SAPN	8%	8%	15%

The glidepath and the intended eventual retail allowances of 10 and 15% in DMO 6 discussed in the DMO 4 draft and final determination were consistent with the implicit overall retail allowances in the DMO 1 and DMO 3 residential and small business prices.[24] However, our analysis of the retail

[23] AER, Default Market Offer Final Price Determination 2022-23, May 2022, p. 46-48.

[24] AER, Default Market Offer Draft Price Determination 2022-23, February 2022, p.42-45.

allowance glidepath and our intention to approach target retail allowances of 10 and 15% was based on our assumption of reasonably stable DMO prices across DMO 4, 5 and 6.

We seek stakeholder feedback on whether the retail allowances envisaged in the glidepath published in our DMO 4 draft determination remain appropriate in the context of significant price increases expected for DMO 5. The likely increase in wholesale and network costs since DMO 4 raises some issues:

- The retail allowance has been expressed as a percentage of the final DMO price. This means that increases in input costs such as wholesale costs and network costs result in a larger retail allowance in absolute terms. This increase further exacerbates price increases for customers.
- Such an increase in the retail allowance allows retailers to recover greater margin from customers on dollar per customer basis. However, this may appropriately reflect the risks they face.
- If we don't change the retail allowance in percentage terms, retailers could recover a much larger amount of retail allowance than what was available in DMO 1 and 3. This increase could amount to an improper balance of the DMO objectives. It could be appropriate for the retail allowance to be set at a lower percentage to reflect a greater weighting of the DMO objective to protect consumers from unreasonably high prices, rather than the other DMO objective of incentivising retailers to compete by discounting off a higher DMO price.
- Customers standing to pay more for electricity and meeting rising costs of living may not require the same percentage discount off the DMO reference price to switch to a cheaper market offer. This could mean that the retail allowance set at a lower percentage could continue to meet the objective of incentivising customers to engage in the market.

There are also intermediate options that could also be considered.

Alternatively, we could maintain the proposed retail allowance targets of 10% and 15% but bring these forward to occur in DMO 5 instead of DMO 6. This would result in reductions in the small business retail allowance in NSW and south-east Queensland and increases for residential customers in South Australia and south-east Queensland.

Question: Should the retail allowance be changed and, if so, in what way?

6 Embedded networks

In February 2022 the Australian Government completed a post implementation review of the DMO regulations. In that review, the Australian Government indicated it would continue consulting on how best to implement changes to the regulations to extend DMO pricing protections to customers in embedded networks.[25]

There are two ways in which embedded networks can currently operate in the market – as exempt sellers and as authorised retailers. Exempt sellers are required to sell energy at or below the DMO prices but embedded networks served by authorised retailers are not. The AER supports extending the DMO pricing protections to all customers in embedded networks but we do not consider it necessary to extend the reference price provisions to embedded networks.[26]

The AER's functions with respect to extending the DMO to customers in embedded networks would depend on the specific nature of any regulation changes. However, this section discusses how we are currently minded to implement this reform, if it were to occur.

6.1 DMO prices should avoid double charging network costs

Authorised retailers can either charge a bill that covers both the energy and passed-through network costs, or sell an 'energy only' offer, with customers being issued a separate bill from the network owner/operator for the network costs. The network charges are capped at a 'shadow price' which is the network tariff that the customer would have paid were they connected to the DNSP[27]

If the full DMO cap applied to the authorised retailer, then the customer could end up paying the DMO price plus the network costs. As the DMO price already includes recovery of the DNSP network costs customers could be double charged for network costs.

6.2 Current DMO customer types should apply

We believe the definitions of the current DMO customer types (residential, residential with controlled load, small business) are sufficient for customers in embedded networks.

We regard this approach is preferable to introducing an additional customer type (or customer types) for customers in embedded network for several reasons:

- It would avoid separate analysis and information gathering and reduces regulatory burden for embedded network operators to determine the specific input costs for selling electricity in Embedded Networks.
- It would reduce regulatory complexity by avoiding the creation of up to an additional 15 price determinations.

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[25] Australian Government Department of Industry, Science, Energy and Resources, Review Outcomes – Post-implementation review for Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019.

[26] AER, Submission to the review of the DMO directions paper February 2022; AER, Submission to the review of the DMO and reference price September 2021.

[27] AER, Electricity Network Service Provider – Registration Exemption Guideline, p. 61-63.

- This approach applies a consistent level of price protection for customers that only differ by the nature of their connection.
- This approach is consistent with the price protection already in place for exempt sellers.

Question: What issues should the AER consider for customers in embedded networks in the DMO?

7 Other DMO costs

The following section discusses the approaches for determining environmental and network costs as well as annual usage and timing and pattern of supply.

We consider the methodologies and assumptions we used in the DMO 4 final determination remain appropriate for DMO 5, however we welcome any feedback from stakeholders on these aspects of the DMO determination.

7.1 Environmental costs

Environmental schemes applied by Federal and State governments require retailers to procure electricity from renewable sources and improve customer energy efficiency. The costs of these schemes are incurred by retailers and recovered through retail prices. Environmental costs fall into 2 main categories — the national Renewable Energy Target (RET) scheme, and jurisdictional green schemes.

The majority of environmental costs relate to complying with the RET. Retailers have an obligation to purchase renewable energy certificates and surrender them to the government in proportion to the overall amount of energy consumed by their customers.

The RET is made up of the Large-scale Renewable Energy Target (LRET) and the Small-scale Renewable Energy Scheme (SRES). LRET costs are incurred in acquiring Large-scale Generation Certificates (LGCs). LGC surrender for each retailer is determined by the electricity consumed by its customer base in that year, multiplied by the Renewable Power Percentage (RPP) set annually for a calendar year by the Minister for Energy.[28] For the SRES, small-scale technology certificates (STCs) are similarly surrendered by retailers. These certificates correspond to electricity generation by rooftop solar PV units and solar water heaters. Retailers have the option to either purchase STCs on the market or from the STC Clearing House. STC surrender for each retailer is estimated annually for a calendar year using the Small-scale Technology Percentage (STP).[29]

In addition to the RET costs, a retailer typically also passes through jurisdictional scheme costs. These schemes include incentives to assist consumers in reducing their energy consumption and to drive the uptake of solar PV generation. For some schemes, such as the NSW Climate Change Fund (CCF) and South Australian jurisdictional scheme obligations (JSO), the distribution network businesses pass associated costs on to retailers through their annual tariffs. For others, such as the NSW Energy Savings Scheme (ESS) and South Australia's Retailer Energy Productivity Scheme (REPS), retailers incur costs directly and pass them on to their customers.

We decided in the DMO 4 final determination to continue to retain our market-based approach[30] to environmental cost forecasting with updates for new and amended schemes.

We consider this approach remains reasonable, noting that the submissions to our DMO 4 draft determination that commented on environmental cost forecasting generally supported retaining the existing methodology.

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28 See CER website: http://www.cleanenergyregulator.gov.au/RET/Scheme-participants-and-industry/the-renewable-power-percentage, viewed 17 September 2019.

29 See CER website: http://www.cleanenergyregulator.gov.au/RET/Scheme-participants-and-industry/the-small-scale-technology-percentage, viewed 17 September 2019.

30 Reference to discussion on market approach in DMO 4 options paper – page 48 section 6.1

7.2 Network costs

Network costs in a retail electricity bill represent the cost of transporting electricity through transmission and distribution networks, and the cost of meters operated by network businesses to measure customers' electricity consumption. In some regions, network costs also include a component to recover the cost of jurisdictional schemes.

Under the National Electricity Rules (NER), the AER regulates network charges. The distributors set network charges under a range of tariff structures for each class of customer annually.

The DMO price is adjusted each year to reflect changes in network costs for the relevant customer classes.

We decided in the DMO 4 final determination to continue to base the DMO network costs on flat rate tariffs only, and not to extend our analysis to capture costs under TOU tariffs for residential customers.

We consider this approach remains reasonable given most customers are on flat rate tariffs, while altering our approach would add complexity and reduce transparency without providing major benefits to stakeholders.

7.3 Annual usage and ToU pattern

Under Part 3 of the Regulations, we are required to determine 'broadly representative' annual supply amounts for residential and small business customers in each distribution region, from which a DMO price and reference price can be calculated. In this document we refer to annual supply as annual usage.

We must also determine the timing and pattern of supply to residential customers. The Regulations refer to these elements in combination as the 'model annual usage'.

In our DMO 4 final determination we decided:

- for residential customers, to retain the same usage amounts for general usage and controlled usage as in previous determinations
- for small business customers, to adopt a 10,000 kWh per year annual usage benchmark.

To provide consistency and continuity for stakeholders, we propose to use these settings for the DMO 5 and DMO 6 determinations. Our intention is to review these as part of the next DMO methodology review as part of the 2025–26 (DMO 7) process.

The ACCC released its May 2022 Electricity Report, which includes the most recent findings on residential and small business usage. We consider suggest that our DMO 4 assumed annual usage amounts remain broadly representative of their respective customer groups.

When compared to the ACCC observations that represent residential customers[31] with and without controlled load, we note that the corresponding residential annual usage amounts assumed in previous DMO determinations:

- sit comfortably within the interquartile range
- are reasonably close to the medians observed by the ACCC
  - customers without controlled load are around 5 to 26% under the ACCC observed median

[31] ACCC, Inquiry into the National Electricity Market, May 2022 report, June 2022, Appendix E Table A3.2.

- customers with controlled load are around 22 to 42% above the ACCC median

The ACCC observed a much wider range of annual usage for small business customers,[32] reflecting the variety of small businesses and the different ways they use electricity to produce goods and services. The 10,000 kWh small business usage amount assumed in the DMO sits above the median but within the interquartile range.

Noting that such a wide range in usage amounts among small businesses makes it difficult for any single figure to accurately represent all small businesses, we consider the 10,000 kWh usage which is situated within the interquartile range, to be a broadly representative usage amount.

In our DMO 4 final determination we decided to update the timing and pattern of supply usage profiles using new AEMO interval meter data but retain our key assumptions from previous determinations. That is:

- assume the same usage occurs every day (with no variation for weekday, weekend or season), as in previous determinations
- use the same proportional allocations of annual controlled load usage across multiple controlled loads
- retain a single 24-hour usage profile
- update these using the AEMO interval meter data for each region, averaged over 3 years
- specify usage at 30-minute intervals.

We consider this approach remains reasonable given most customers are on flat rate tariffs, while altering our approach would add complexity and reduce transparency without providing major benefits to stakeholders.

[32] ACCC, Inquiry into the National Electricity Market, May 2022 report, June 2022, Appendix E Table A9.8.