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Default Market Offer prices – Options paper on the methodology to be adopted for the 2022-23 determination

AGL welcomes this opportunity to provide comments on the Australian Energy Regulator's (AER) *Default Market Offer prices - Options Paper on the methodology to be adopted for the 2022-23 determination (and subsequent years)* (Options Paper) published on 25 October 2021.

AGL is a leading energy retailer with about 4 million electricity and gas customers in New South Wales, Queensland, South Australia, Victoria and Western Australia as of 30 June 2021.

The Options Paper emphasises that to date, the DMO has met its policy objectives of:

- reducing high standing offer prices and protecting consumers from unreasonable prices;
- supporting competition, innovation and investment in the retail electricity market, and
- improving transparency for customers by providing a reference price.

AGL agrees that these policy objectives have been achieved and therefore supports the continuation of an indexation approach.

The Options Paper considers three alternatives for the future DMO methodology:

- 1. A cost build-up approach using requiring the estimation of retail costs and a DMO allowance;
- 2. Continuing the current indexation methodology, including CPI indexation of the retail residual component; and
- 3. Continuing the indexation methodology but adjusting the retail residual component to reflect changes in retail costs according to ACCC data.

AGL believes that Option 1, which is a traditional cost build-up approach, is challenging as it will require the AER to explicitly determine several additional cost components including retailers' operating cost, retail margin and an allowance to ensure retail competition is maintained. These components are difficult to identify and objectively substantiate. Furthermore, AGL has concerns with retail costs published through the



ACCC's Inquiry into the National Electricity Market and whether they could be used effectively in a cost build-up, as proposed by the AER.

AGL's initial preference is to continue with Option 2 which includes the indexation of the DMO residual. Option 3 has advantages but is problematic given the published data from the ACCC reports is not timely and will not fully reflect the costs which retailers will face.

Instead, AGL believes the AER should look to amend its current indexation method to:

- Correct the variation in the residual retail component across the regions through a one-off adjustment;
- Continue with the CPI escalation; and
- Keep in place the step change framework in case of significant changes in the underlying costs for retailers.

AGL would also encourage a more detailed assessment of whether the market modelling for estimating wholesale energy costs in South Australia is appropriate given the illiquidity of the futures markets in that region.

In relation to annual representative usages, other than small business usage, we do not recommend making any changes to avoid customer confusion and issues with price comparison.

More detailed comments in response to the questions raised in the Options Paper are included in Attachment A.

If you have any questions in relation to this submission, please contact Patrick Whish-Wilson on (02) 9921 2207 or Meng Goh on (02) 9921 2221.

Yours sincerely

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Elizabeth Molyneux GM of Policy and Market Regulation



Attachment A: AGL Responses to the Options Paper

Retail costs, profit margin and DMO allowance

Option 1 - Estimating retail costs and a DMO allowance

The bottom-up methodology for determining the retail costs and margin available to retailers in the DMO price will require the AER to:

- estimate retailers' operating costs, including costs to acquire and retain customers
- determine an allowance to cover retail margin and to meet the DMO objectives.
- 1. What is the most appropriate approach to estimating retail operating costs under a cost-based approach?
- 2. What information should we have regard to in estimating retail costs?

It is important that the retail cost benchmark fully reflects all the costs of operating a business. Not only should it include the cost to serve and customer acquisition and retention cost, but it should also include any:

- depreciation and amortisation expense which represents the costs of software and IT system development, and
- corporate costs or centrally managed expenses relating to running a retail business.

Potentially, the retail costs from the ACCC's Inquiry into the National Electricity Market reports could provide a useful guide to the movement in retailers' costs but the AER will need to ensure that these costs represent the full costs of operating a retail energy business. In addition to the costs above, we understand that bad debt expense has not been accounted for as part of retail costs in the ACCC reports.

As an illustration of the difference in estimation of costs, we refer to the following cost to serve (CTS) reported by the ACCC in its November 2019 report¹:

Region	2018-19	2017-18
Victoria	85	85
NSW	74	73
SA	74	69
SEQ	84	79
NEM	81	78

Table 1 Average CTS per residential customer by NEM regions (\$/customer)

Source: ACCC 2019

¹ ACCC, Inquiry into the National Electricity Market. November 2019 Report, 29 November 2019, p 72-73



AGL is one of the largest energy retailers in Australia and is a Tier 1 retailer. In its Annual Report, AGL reported an average CTS² (nationally) of \$97 per customer for 2018-19³ and \$84 per customer for 2017-18. This is higher than each of the CTS by NEM regions reported in Table 1. This is surprising as AGL is a retailer with significant scale, and we would expect AGL's average CTS to be low relative to smaller retailers. The ACCC analysis includes the AGL data which raises further concerns on what is and is not included in the analysis.

Furthermore, compared with Table 2, the average cost to serve of \$69 per customer assessed by the ACCC for Tier 1 retailers is about 30 per cent lower than AGL's reported CTS.

Retailer type	2018-19	2017-18
Tier 1	69	67
Non-Tier 1	114	117

Table 2 Average CTS per residential customer by retailer tier, (\$/customer)

Source: ACCC 2019

Retail costs will vary across different retailers depending on many factors such as retailer size, business model and strategic positioning. Estimating a benchmark retailer costs will therefore require the AER to pick an 'average or typical retailer'. The figures in Table 2, while underestimating actual retailer costs, do highlight the range of costs and the difficulties of selecting an average retail cost for the industry.

3. What are the impacts on retailers facing a time lag for recovery of retail costs?

The retail energy market is highly competitive, so it is important that prices reflect costs which are likely to be incurred over the same period. If there is a delay in reflecting the costs in prices, there is a risk that any step change in costs will not recovered as customers churn and the competitive environment changes.

One of the benefits of estimating retail operating cost under the cost build-up approach is it will better take account of any step change in cost. However, significant timing delays would erode this benefit.

Setting a DMO allowance

- 4. Is the DMO protecting customers from unjustifiably high prices? If so, why?
- 5. What factors are relevant in considering whether a price is excessive?

The introduction of the DMO significantly reduced standing offer prices and DMO prices have subsequently been indexed in line with changes in the cost of supply. This directly protected standing offer customers from unreasonably high prices.

Furthermore, the DMO now sets the reference price for retail market offers. This resolved the confusing practice of any retailer setting high standing offers with large, advertised discounts where the discounted offer may only have been in line with other retail offers which were advertised with lower discounts. It should be noted that the practice is intended to gain customers on the discounted offer, not on the standing offer.

² AGL's cost to serve includes bad debt expense and no allocation of centrally managed expenses.

³ AGL Annual Report FY2019, p 47



In our view, ensuring retail competition is the most effective way to protect engaged customers from unjustifiably high prices but believe the use of the DMO as a reference price is successfully protecting customers from unreasonably priced offers.

One way to consider if a standing price is excessive is by reviewing the level of discounts available on market offers. For example, low market discounts may suggest that the standing price is set too low. While this is relevant only after the standing price has been set, it does provide an important guide for future price resets. Importantly, it is only a guide as the level of competition in a retail market and changes in underlying costs over time can also impact on the level of discounts. In reviewing the level of discounts, it is also important to consider the median market offers, not just the lead offers by retailers.

Governments and regulators have previously assessed retailer margins as a direct way of concluding if a price is excessive. However, there is a range of retailer models which makes judging retail margin a difficult exercise. In addition, there are some components of the cost stack, particularly wholesale energy costs and retail costs, where different procuring practices and business models will result in very different margin outcomes. This method is therefore also only a guide on price levels.

- 6. What other factors should we consider when assessing the DMO allowance required to incentivise customers to engage in the market?
- 7. Should the margin above efficient costs in the DMO price be consistent across all DMO regions and customer types?
- 8. What is an appropriate DMO margin to achieve the policy goals?

As noted by the AER, the DMO allowance provide retailers with the opportunity to discount the reference price with sufficient savings to encourage customer to switch. In addition, this also provides retailers with an incentive to compete on non-price and service offerings.

Another factor to consider is that since the DMO limits the standing offer price, it should incorporate a value for the role of the standing offer as a safety net. When setting electricity standing offers for regional Queensland, over a number of years, the Queensland Competition Authority has incorporated a standing offer adjustment for the value of more favourable standard contract terms and conditions relative to market.

AGL also strongly support the AER's view that this allowance, which provide incentives for competition, innovation, investment and customer engagement, should be fairly consistent across the DMO regions. As the residual retail component currently provided in South Australia is significantly lower than in either NSW or Southeast Queensland, it is reasonable to expect that an allowance or margin needed in the SAPN region is higher than the current year's allowance.

The AER has estimated that the weighted average nominal retail margin plus additional allowance available in the current DMO prices is around 15-20 per cent based on the ACCC's average retail cost. As discussed above, AGL believes that the ACCC's published assessment of retail costs does not adequately reflect the full cost of operating a retail business and the AER's estimated nominal margin in the current DMO is therefore over-stated.

We understand that assessing an appropriate DMO margin is difficult. Historically, the retail margin has been set by regulators in the 5 to 6 per cent range with additional allowances for competition previously around 5 per cent of total price. These benchmarks result in a total allowance of 11 per cent.



In our view, the allowances in the current DMO prices would generally be at this level if assessed using a more realistic retail cost estimate. The exception is in South Australia and AGL encourages the AER to review the residual retail component in South Australia accordingly.

Option 2 - continued indexation of the DMO residual

- 9. Should we continue indexing the current residual?
- 10. What are the benefits and disadvantages of this approach?
- 11. How could the step change framework be improved?

AGL generally supports the continuation of the indexation of the DMO residual as the current DMO methodology is meeting its objectives.

The main advantage of the indexation approach being that it:

- avoids the requirement to establish individual estimates for retail costs, retail margin and other allowances, each of which cannot be objectively determined; and
- measures change in underlying cost which is considerably simpler than attempting to accurately
 estimate the quantum of each underlying cost.

The main disadvantage of this approach is that the initial residual was set at a point in time, under conditions at that time, which may not be appropriate in the longer term. This has resulted in residuals which differ for each region as noted in the Options Paper.

However, in our view, the continuation of the indexation approach does not preclude changes being made to improve the outcomes. It is clear that the residual retail component in South Australia is significantly lower than in other regions. AGL cannot see any reason why the AER cannot directly adjust the SA residual retail component so that it is line with the component in other states such as Southeast Queensland.

While it is important for some consistency in the residual, we do not anticipate the residual to be the same across regions and customer classes due to the differences for example in bill amounts, cost to serve and bad debts.

AGL also agree that there are challenges in implementing the step change framework due to the quality and consistency of information required. In our view, the CPI allowance and the materiality threshold should prevent the need for step change adjustment in normal circumstances. However, the step change framework should be in place in case of significant change such as an introduction of a new tax or certificate scheme. In our experience, the impact of these changes can be estimated within a reasonable range.

Option 3 – adjust the residual for changes in retail costs using ACCC data

12. Should we perform an adjustment to reflect movement in retail costs and, if so, should this be performed on an annual basis?

Option 3 does provide the benefit that if retail operating costs change significantly then this, over time, should be reflected in the retail residual component.

However, it appears this option is reliant on the ACCC retail cost data to provide a transparent annual adjustment to the residual.

As stated above, we have concerns about the use of the ACCC data as well the lag in recognising cost changes. Due to the timing of the release of the reports, the use of the ACCC data will result in a lag of up to



two years which will create significant risks for retailers operating in a competitive market. Retailers will not be able to recover costs such as COVID-19 bad debts or new taxes.

In our view, where costs are escalated annually at the rate of change in CPI (although this is also a lag), it is more appropriate to forecast and adjust for foreseeable and material step changes in costs.

Duration of the methodology

13. How long should we retain the methodology we adopt in this review?

Considering an appropriate duration for a detailed review of the DMO methodology and assumptions will be dependent on the chosen methodology and assumptions. If an indexed approach is used with a CPI escalation of an updated residual, we would be comfortable with a longer duration.

However, the question seems revolves around the availability of the ACCC retail reports but as discussed above, we have concerns about the validity of the ACCC retail costs for pricing purposes.

Regardless, AGL believes it is appropriate to review the methodology and inputs after a 3-year period to ensure that there is an appropriate balance of customers' and retailers' interests.

Wholesale costs

Market based approach

14. Is our existing wholesale cost forecasting methodology, in terms of its approach and considerations (modelling of demand and supply, spot price, hedging etc.) complete, appropriate and representative of costs to supply energy?

AGL has generally supported ACIL Allen's approach to forecasting wholesale energy costs using a marketbased approach. The consistent use of this methodology and its assumptions has been an appropriate method to estimate the change in wholesale energy cost for the indexation of the DMO.

In saying this, AGL is not proposing that the annual estimates produced by the modelling are accurate reflections of AGL and the broader markets' cost of supplying electricity. If AER is seeking to apply a cost build-up approach, then further consideration will be needed on several input assumptions, such as the appropriate load profile and spot price forecasts used for the forecast year.

Irrespective of the overarching framework, AGL would encourage the AER to explore whether full reliance on ASX data is still relevant for estimating the wholesale electricity cost in South Australia.

The South Australian market has undergone a decade of rapid change with:

- residential customer exports from rooftop solar rapidly expanding over the last 6 years;
- a large increase in negative pricing intervals driven by a combination of rooftop solar, low demand and high wind; and
- substantial increases in AEMO directions to maintain systems security which now contribute a substantial part of the total energy supplied in the state, often at below cost given the default compensation method.

These and other factors have resulted an illiquid forward contract market in South Australia with infrequent trades of very small volumes (see figures 1 and 2). AGL is of the view that these are not representative of



the underlying cost, nor are they representative of what it actually costs retailers to manage risk in SA, particularly in respect of cap products.





This raises doubts over the efficacy of the market and especially the relevance of these forward contract prices on the actual 'market price', being the price paid by retailers to cover capacity risk. AGL has formed the view that the prices on the ASX are now below the cost of supply.

AGL believes that the AER needs to carefully consider sourcing alternative benchmarks/data points for determining the relevant 'market price' for use in the determining the wholesale electricity cost in South Australia.

Hedging strategy and forecast error margin

- 15. Should our existing assumed hedging strategy be adjusted to allow for a higher level of spot market exposure? And if so, what is the appropriate level of exposure? (please also consider this question in conjunction with Margin for forecast error discussion below)
- 16. Does our assumption of a retailer building their hedge book from the time of the first trade recorded by ASX Energy, remain appropriate, or is a shorter period justified? What is an appropriate period and why?
- 17. Does the 95th percentile hedged WEC estimate remain appropriate, in context of the hedging strategy? What alternative percentile could be applied and what would the justification be?

Under a continuation of the indexation approach, AGL supports ACIL Allen's current assumptions with regard to:

- a hedging strategy that minimises volatility in the wholesale price;
- a longer hedge book build period to smooth out price fluctuations; and
- the 95th percentile WEC estimate.

This has been generally supported by retailers and the AER as providing a reasonable estimate of the annual change in wholesale costs for a variety of different retailers.

Under a cost build-up approach, these assumptions may need to be considered further based on the modelling outcomes and how they compare to individual retailers' annual costs.



AEMO Directions costs

In the Options Paper, the AER accepts that AEMO directions costs are a cost faced by retailers and should be taken into the account in the DMO methodology if they are ongoing.

To date, the AER has not included these costs due to:

- the complexity of doing so under an indexation approach; and
- expectation that these costs will be mitigated by synchronous condensers going forward.

It is unclear how many directions will be needed to continue to satisfy the inertia and system strength requirements in South Australia with the introduction of the synchronous generators. However, the system strength advice published by AEMO on 25 Oct 2021⁴ indicated that even when the 4 synchronous condensers are operational, directions are still likely to maintain system strength under system normal indications although at lower levels.

If the AER moves to a cost-build-up approach, then including the cost of AEMO directions is straightforward. However, AGL has significant concerns on how the AER includes this new cost component under an indexation methodology.

The premise is clear. If the AER is introducing new elements to the costs considered in the DMO, then the new costs must be estimated (as was implicitly done via the ACCC report for other cost inputs) for the year in question, and the previous year should be assumed to be zero. That way, new costs can be captured. Including estimates of the new cost into both years of the indexation will simply measure the change in cost which will result in perverse outcomes given the DMO has not accounted for the cost in previous years.

Environmental costs

18. Do you agree with the appropriateness of our environmental cost forecasting methodology for DMO 4?

The methodology for forecasting environmental costs has taken a market-based approach. AGL is comfortable with this existing methodology under the DMO when using an indexation methodology as the method is focussed on the change in environmental cost year on year.

Under a cost build-up approach, AGL would need to revisit the estimated level of some of these cost elements such as the Retailer Energy Efficiency Scheme in South Australia.

⁴ <u>https://aemo.com.au/energy-systems/electricity/national-electricity-market-nem/system-operations/congestion-information-resource/limits-advice</u>



Network costs

- 19. Should the calculation of network costs for residential customers continue to be based on flat rate tariffs only? If yes, as what level of TOU tariff penetration should this approach be reassessed?
- 20. If TOU network tariffs are included in our assessment, should we use a simple weighting of customers on each tariff type across all jurisdictions, or a separate weighting for each network area?
- 21. Is the DMO daily load profile (provided to retailers to calculate annual market offer costs for TOU offers) sufficient for calculating annual TOU network costs?
- 22. Should we assess metering costs separately from network costs?

The DMO applies to residential TOU customers but is estimated using the network costs for residential customers on flat rate network tariffs.

The penetration of TOU tariffs varies across the network regions. In some networks, up to 40 per cent of AGL's standing offer customers are on TOU tariffs while in the Energex and Endeavour Energy network regions, there are no standing customers on TOU tariffs. Note that SAPN is reassigning customer on smart meters to network TOU tariffs (including standing offer customers) and AGL is following accordingly with retail TOU tariffs.

A high-level assessment of TOU vs flat network charges has shown little difference in network costs so that it is currently still reasonable to use the flat rate tariffs. However, this will need to be monitored for future divergences in pricing approaches by the distribution networks.

If the AER chooses to use a weighting of tariff types, then a separate weighting should be applied for each network region due to the different penetration of TOU tariffs in the various jurisdictions.

Regarding the DMO daily load profile, AGL has compared its half hourly data with the AER's daily load profile and have observed that there are significant differences. For example, in the Endeavour network region, there is a significant variance in the shoulder component. Further assessment may be needed to account for the application of off-peak on weekends and public holidays. AGL therefore recommends further assessment of the daily usage profile.

Metering costs for flat rate tariffs are charged by the distribution networks while charges incurred in relation to smart meters under the Power of Choice framework are incurred under contract arrangements with metering coordinators. Whether setting a regulated price using a cost build-up or indexation approach, AGL believes it is simpler and reasonable to include the metering costs as part of network costs.

23. Do you agree with our preferred position to not true up network costs in calculating the DMO price?

AGL generally support the AER's preferred position to not true up network costs when calculating a DMO price. Under the indexation approach, this support is contingent on the closing network charges used in one period being used as the opening network charges for the subsequent year's network charges.

AGL agree that it can be difficult to assess the network charges in a reset year and it will depend on information available at that time. Other than a reset year, the use of proposed charges by the distribution networks should be generally reasonable as these are often approved without any change.



Advanced meter costs

24. Should the DMO 4 methodology include an allowance for advanced meter costs? And if so, is the proposed approach above viable to calculate and account for its cost?

The number of smart meters will continue to grow over time so that it is important that advanced meter costs begin to be accounted for in the DMO prices. They are costs which retailers cannot avoid and are becoming material.

Ideally, there should be separate DMOs for customers with and without smart meters. However, this will expand the regulated pricing process and there is a trade-off between providing a simple price cap and a comprehensive but potentially confusing array of regulated tariffs.

It would also be inequitable to apply the full cost of an advanced meter to the DMO price for customers who do not have a smart meter.

Consequently, AGL on balance support the AER's proposed approach of applying a weighting to meter costs based on the market penetration of smart meters in each network region.

Many retailers currently absorb these metering costs and smear them across their market contract customer base so the AER's proposed approach would mirror this averaging of cost for standing offer customers and improves its relevance as a reference price.

Model annual usage and TOU determination

25. Do you support our use of DNSP data, cross-checked with other sources, to determine residential annual usage?

AGL's residential profiles are broadly consistent with the DNSP data used by the AER. We note that on average, customers on TOU tariffs consume more than customers on the flat rate, and there are some differences in the controlled load profile in some instances but on a relatively low number of customers.

For comparative reasons, we also recommend against changing the residential annual usage unless the change is material.

- 26. Do you support applying a single figure of 10,000 kWh for small business usage across all DMO regions?
- 27. Do you support applying individual ACCC reported median usage figures in NSW, SA and south-east Queensland? If so, please outline the advantages of this approach.
- 28. Do you support averaging across 3 years of data to calculate annual usage?

AGL's average small business usage profiles vary significantly from one network region to another. However, it is clear that the current usage of 20,000 kWh is not representative. AGL's average small business usage range from about 6,000 kWh in the SAPN region to over 15,000 kWh in the Endeavour region.

In our view, applying a single figure of 10,000 kWh is broadly representative for small business customers.

However, we do not consider it to be unreasonable that a median usage figure for each network region is used although the usage of small business customers is so diverse that the median usage in each network region is not necessarily a more representative figure.



Similarly, AGL understand the argument for averaging across 3 years of data due to the pandemic which has disrupted the normal pattern of consumption but in our view, the representative usage is indicative only and represents only a proportion of customers.

We agree with the AER's preference to use a single small business usage for simplicity.

It is important to also consider the value of maintaining consistency and price comparison reasons from one period to another. The representative usage should only be updated if the change is material and considered to be structural.

Reducing the usage figure from 20,000 to 10,000 kWh will significantly reduce DMO annual revenue figure and consequently, the residual retail component. The AER will need to carefully assess the impact of this change on the residual component to take into account that some portion of this residual was fixed as part of retail cost.

Usage considerations for TOU customers

- 29. Would you prefer we reflect TOU usage in annual usage estimates, or calculate annual usage based on flat rate usage, given most customers are flat rate customers?
- 30. Do you support updating the usage profiles by averaging across 3 years of usage data?
- 31. Do you support maintaining the profiles based on a mix of TOU and flat rate offers?

Although the DMO has been based on flat rate tariffs, it is also applicable to TOU customers and AGL's data indicates that average TOU usage is general higher than flat rate usage. Accordingly, we support reflecting TOU usage in annual usage estimates.

As noted above, it is important to keep in mind that the representative usage is indicative only and there is value in maintaining consistency in one period to another.

Given the difficulty in obtaining data specific for TOU customers, we support the current use of AEMO meter data which includes TOU and flat rate usage.