AGL Energy Limited
ABN: 74 115 061 375
Level 24, 200 George St
Sydney NSW 2000
Locked Bag 1837
St Leonards NSW 2065
t: 02 9921 2999
f: 02 9921 2552
agl.com.au

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

By email: DMO@aer.gov.au

1 December 2022

Default Market Offer prices (DMO) 2023-24: Issues Paper

AGL welcomes the opportunity to provide comments on the Australian Energy Regulator's (AER) *Default market offer prices 2023-24: Issues Paper* (Issues Paper) published on 3 November 2022.

AGL operates nationally across the energy supply chain and delivers 4.3 million gas, electricity, and telecommunications services to our residential, small and large business, and wholesale customers across Australia. We operate Australia's largest electricity generation portfolio, with a generation capacity of over 11,000 MW, accounting for approximately 20% of the total generation within Australia's National Electricity Market.

In this year's DMO consultation process we note the Issues Paper is mindful of the potential impacts of the current wholesale electricity market and is therefore focussing on whether refinements can be made to:

- the wholesale methodology so that it better reflects retailers' costs; or
- the new retail allowance methodology and proposed glidepaths to help mitigate the DMO price increases that are likely for 2023-24.

Firstly, AGL believes the AER should avoid amending its current wholesale cost methodology simply as a response to current market conditions. The AER has raised matters in its Issues Paper that are worth exploring for future improvements to the wholesale modelling but given the current market environment, these changes may not be beneficial to retailers or consumers.

Second, the policy objectives of the DMO are clear in that it is to:

- protects consumers from unreasonable prices, specifically those on standing offer prices;
- allow retailers to recover their efficient costs, including a reasonable retail margin and costs associated with customer acquisition and retention; and
- enable competition and retain incentives for consumers to engage in the market.

In previous years, the AER has conducted competition analysis including a comparison of market offers versus current DMO prices in each jurisdiction. This analysis has allowed the AER to make better decisions when judging what amendments should be made to the DMO methodology to ensure it meets its policy objectives.

The AER will need to make similar analysis of competition for its draft decision and AGL believes further analysis will show that:

- market discounts to the DMO prices are severely reduced or not available as retailers are facing higher costs;
- the average median market offers will therefore be near the level of the DMO prices; and
- little margin is available to retailers and there is little to no allowance remaining to engage competitively for customers.

In AGL's view, this state of the competitive market means that the AER should not lower the retail allowance. Such a change has little to no impact on the DMO price but is in contravention with the DMO objective to enable competition and incentivise customers to engage in the market. The adopted approach to set the retail allowance as a percentage of total costs remains appropriate.

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

If you have any questions in relation to this submission, please contact Patrick Whish-Wilson on pwhish-wilson@agl.com.au.

Yours sincerely

[redacted]

Chris Streets
A/ General Manager
Policy, Market Regulation and Sustainability

Attachment A: AGL Responses to the Issues Paper

Wholesale costs

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?

AGL generally supports the AER's current market-based approach to forecasting the wholesale energy cost.

The AER's position in the Issues Paper is that retaining the current approach is sensible given the shift to an alternative approach will only add additional uncertainty and complexity. We also note the Frontier Economics review of the wholesale forecasting methodology highlighted that the current approach meets the DMO objectives better than most alternatives it considered. AGL agree with the AER. We do not believe there is any reason to move to a different methodology at this time with no indication that a different methodology would deliver better outcomes for retailers or customers.

However, for the 2022-23 DMO, the wholesale energy cost methodology was changed to be based on the 75^{th} percentile of the 560 model simulations rather than the 95^{th} percentile that was used in previous DMO calculations. This increased the probability that the modelled wholesale electricity cost could be below the actual cost of retailers which is likely the case in 2022-23, given current market conditions. We do suggest that the AER review and reconsider this significant methodological change of last year.

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?

AGL supports the use of the net system load profiles in building the load profiles for modelling the wholesale energy cost. This reasonably reflects our approach with the major differences in recent years only arising from differing forecast of PV uptake and its impact on the load profiles.

AGL is also not averse to the AER using a single load profile for the New South Wales region as this would reflect our retail modelling approach.

However, applying NSW as single region will create different DMO price changes for different NSW customers depending on their original network region. These changes should not be material though.

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?

As the AER is aware, AGL has previously raised concerns in DMO consultations regarding the lack of liquidity of ASX contract data in South Australia and that this raised doubts on whether the ASX data accurately reflected the costs retailers faced in South Australia.

At that time, AGL has formed the view that the contract prices on the ASX were below the cost of supply and AGL has previously provided OTC contract data to support this view.

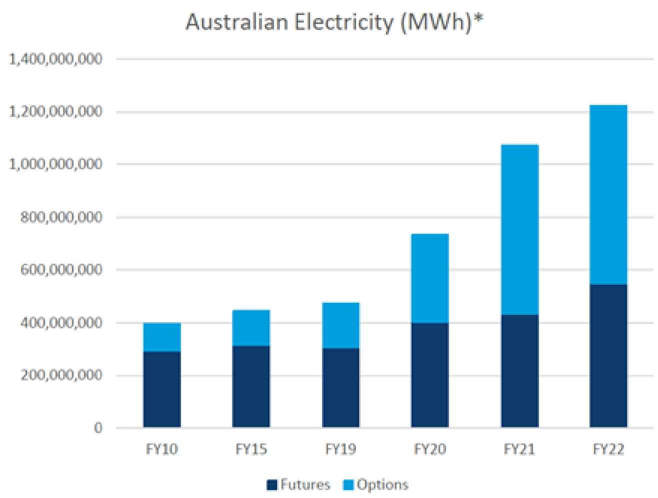
The issue of liquidity remains with regard to the South Australia futures market and therefore the question of the relevance of the ASX forward contract prices for determining the wholesale electricity cost in South Australia. As such AGL would support the use of additional contract information such as OTC contracts in the AER's wholesale energy cost modelling although it is difficult to see how such a process can be transparent.

We note the AER also questions whether the means by which vertically integrated retailers value their internal hedging should be closely considered. The problem is that finding alternative benchmarks that represent the market costs in the absence of a liquid contract market is the concern. Including internal hedging and attempting to value it will only expand the scope of the issue rather than resolve it.

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

As identified by the AER and highlighted in figure 1, options are becoming much more popular in the current market. The value of these options has also escalated exponentially in 2022 in line with increases in the futures market.

Figure 1: Growth in ASX Futures[1]



It is therefore appropriate that the AER consider its treatment of options in its methodology.

Firstly, it should be recognised that calendar year options must be exercised 6 weeks prior to the start of the calendar year or mid-November and at that point, the quantity and strike-price of the option is included in the ASX forward contract data. Similarly, financial year options must be exercised 6 weeks prior to the start of the financial year in the middle of May with any exercised options then being counted in the ASX forward contract data.

Given the modelling calculations for the DMO usually are to the end of April or early May, this infers that the data for calendar year options has always been included in DMO calculations whilst the data around financial year options has always been excluded. Of course, the smaller option volumes and values in previous years would not have had a material impact on the modelling of the wholesale energy cost.

The AER question of whether it needs to accommodate the use of options in its hedging strategy is therefore appropriate as it appears to be already using calendar year options in the book build of forward contract data. However, given the complex and varied hedging strategies that can be used once you include options, this is not a straightforward exercise. As such, AGL believes this should be a target for future consultation and amendment and is not appropriate to include in this DMO review.

[1] ASX, Australian Electricity Market Overview, Energy Derivatives, Financial Year 2022

Instead, AGL believes the AER has two practical alternatives to appropriately account for options in its calculation of the wholesale energy costs for 2023-24, namely it:

- removes the data for the calendar year options that were exercised in November 2022 from the book-build of the trade weighted forward contract prices; or
- retains the options data in the trade weighted average calculation but then seperately accounts for the values of the options premium that were paid to enable these option volumes and values to be struck and then exercised.

It would be inappropriate to account for the options without then considering the premium paid.

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

AGL supports the current book build period of 2 to 3 years as it provides a fairly stable wholesale energy cost but also accurately reflects any marked changes because it is trade weighted.

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

The market suspension and administered price periods that occurred this year have resulted in costs that retailers will be incurring throughout 2022-23.

AGL supports the AER's proposed approach of including costs arising from the market compensation in the wholesale electricity cost component as a lagged cost recovery.

However, AGL suspects that the final cost of some of the direct and indirect compensation are unlikely to be finalised before the final decision on the DMO.

Despite this, AGL would recommend that the AER estimate these residual compensation claims to allow them to be included in the 2023-24 DMO and accounted for in the next financial year in line with when retailers will be making the relevant payments. Otherwise, the AER will need to include these residual costs in the 2024-25 DMO, up to 12 months after the payments are made by retailers.

Retail costs and allowance

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

AGL is interested in seeing how the ACCC data is aggregated, analysed and reflected in the AER's retail cost determination for the 2023-24 DMO and how this data compares to company data released to the market.

AGL does have concerns with how the AER is considering treating interval meter costs. The AER is suggesting that if it finds retailers are using one-off or upfront fees then they may reduce the proportion of interval meters costs that a retailer can recover through the DMO retail prices.

However, the DMO applies to all retailers so the corollary is that any retailer not charging up front metering fees will be recovering less of its actual interval metering costs than previously.

This may actually incentivise other retailers to begin using upfront fees to recover some of the annual costs they incur for smart meters.

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

The AER first used this retail allowance methodology for residential and small business customers in setting the 2022-23 DMO. After consultation with stakeholders, the AER designed it to ensure that:

- retailers can recover a reasonable margin; and
- that there is a competitive component that incentivises customers to engage in the market.

The retail margin component of the retail allowance, although not specifically identified by the AER, is clear when you consider that Australian energy regulators have consistently used a retail margin of 5.4 to 6 per cent for the last 20 years. For example, the Essential Services Commission currently uses a retail margin of 5.7 per cent when setting the Victorian Default Offer.

Retail margin has always been determined as a percentage of total revenue to ensure:

- it accounts for retailers' risk (and investment) – a retailer's risk increases as costs increase;
- it covers the cash flow challenges of retailers being required to carry all debt in the energy supply chain and therefore forced to carry higher debts at times of high costs and subsequent prices; and
- the retailer can access necessary working capital.

After extracting the necessary retail margin, the remaining 4 to 4.3 per cent of the retail allowance is considered the competition allowance that is discounted in market contracts and assists with maintaining a competitive retail energy market.

AGL would contend that this is only part of the retail allowance that the AER can amend without impacting on the actual costs of supply. However, in seeking to lower this allowance the AER will not be aligned with its objective of sustaining competition. AGL also suspects that it will be the smaller retailers that are most affected by this change.

AGL has consistently maintained that, at a minimum, a headroom allowance of 5% is needed to engage customers and ensure a sustainable level of competition. This is consistent with the headroom determined by IPART in the 2013-16 review of NSW retail electricity prices and also aligns with analysis of the Queensland Competition Authority in its setting of a headroom allowance for southeast Queensland electricity prices.

AGL would also reiterate that any change to retail allowance:

- will have a minor impact on electricity prices;
- would only directly affect standing offer customers; and
- there is only a small proportion of customers on standing offer prices.

However, any analysis of the retail market that looks at the level of discounts available on market contracts would highlight major concerns regarding the level of retail competition.

Given this situation, we believe that the appropriate balance is for the AER to leave the retail allowance unchanged and support the DMO objective of enabling competition, rather than taking a narrow focus on protecting standing offer customers with a limited effect.