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Mr Mark Feather
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Australian Energy Regulator
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By email: DMO@aer.gov.au

10 March 2020

Dear Mr Feather,

Draft Determination – Default Market Offer Price 2020-21

AGL welcomes the opportunity to provide comments to the Australian Energy Regulator (AER) in relation to the Draft Determination on the Default Market Offer (DMO) Price for 2020-21 as published on 10 February 2020. AGL previously made a submission on the AER's DMO Position Paper in October 2019.

AGL supports the AER's approach to set the DMO for 2020-21 by adjusting the current 2019-20 DMO price for forecast cost changes. We agree that this approach allows retailers to recover the costs of servicing customers while providing customers with incentives to participate in the market. We appreciate the transparency provided in the Draft Determination, including the changes in the cost components for the model customers in each distribution area of New South Wales, South East Queensland and South Australia.

There are four general cost categories considered in the Draft Determination – wholesale energy costs, environmental costs, network costs and residual costs – and AGL supports:

- ACIL Allen's modelling of future wholesale energy costs as reasonable;
- the AER recognising that the non-binding Small-scale Technology Percentage (STP) is too low; and
- the application of CPI to residual costs.

However, AGL does have serious concerns with:

- the continued use of a market-based approach for estimating the cost of the Large-scale Renewable Energy Target (LRET); and
- the proposed approach for passing through the network costs for Distribution Network Service Providers (DNSPs) that are currently undergoing a revenue determination.

Our comments are discussed in more detail below.

Wholesale energy costs

ACIL Allen's modelling of wholesale energy costs uses a market-based approach that reflects the net impact of lower futures contract prices and the increased peakiness of the load. We recognise that the ACIL Allen model has been used for several years by the Queensland Competition Authority.

While the outputs of any model are subject to the inputs and methodology, we believe that the ACIL Allen model provides a reasonable assessment of the change in future wholesale energy costs, particularly if it is used consistently from one year to another.

We note that these costs include transmission losses, NEM fees, ancillary services, prudential costs and the Reliability and Emergency Reserve Trader (RERT).

AGL does have some concerns regarding the potential costs of the RERT as well as the cost impact of market directions by the Australian Energy Market Operator (AEMO) on small electricity customers. However, we agree with ACIL Allen that it is difficult to forecast these costs into the future and the AER's selected methodology of indexing the 2019-20 DMO prices partially mitigates our concerns.

Environmental costs

The major environmental costs are the LRET and the small-scale renewable energy scheme (SRES), as well as the state-based energy efficiency schemes.

LRET

With regard to LRET, AGL does not agree with ACIL Allen's view that:

> *"…using contemporary forward LGC prices represents the most reliable indicator of the current market consensus view of the price of LGCs in the near-term."*

AGL has covered LRET obligations through long term power purchase agreements (PPAs), as we understand is the case with many retailers. In our view, a prudent retailer will primarily meet its LRET obligation through PPAs as a large retailer would not be able to procure sufficient LGCs from the market to meet its obligation. Consequently, the market price of LGCs does not represent a retailer's cost of actually meeting its LRET obligations.

The LRET scheme was designed to encourage investment in generation and many investments in renewable generation were underwritten by PPAs. AGL recognises that it is difficult to assess the costs of these PPAs for price setting purposes due to the reasons outlined by ACIL Allen. However, the market-based approach will not reflect the costs to retailers.

AGL encourages the AER to consider alternative methodologies rather than continue to base its assessment on LGC market prices that are clearly not representative of the costs of the scheme.

These could include:
- as the AER methodology is focussed on an index cost approach, a reasonable option to account for LRET is to simply make no further downwards adjustment to reflect that retailers' underlying PPA costs have not changed;
- modelling the cost of the LRET based on historical PPA prices and LGC formation with future LGC price changes then only impacting LRET costs at the margin; or
- use a floor price for LGCs in its modelling to ensure that unrealistic low LGC prices do not unduly impact the forecast cost of LRET.

SRES

AGL believes the non-binding STP estimates in recent years have significantly underestimated the final binding STPs. As such, we welcome the AER and ACIL Allen's recognition that the current non-binding estimates for 2020 and 2021 are likely to be too low and that ACIL Allen will provide their own estimates of these STPs.

Network costs

The AER has proposed that for the DMO Final Determination, forecast network charges will be based on the following approaches:

- for DNSPs currently within a regulatory period i.e. the NSW DNSPs – use the appropriate annual tariff proposals; and
- for DNSPs undergoing a revenue determination i.e. Energex and SAPN – use the change in revenue in the Final Determination.

AGL agrees with the proposed approach for the DNSPs within a regulatory period as the networks' annual tariff proposals are usually unchanged when approved by the AER. This approach will be applicable to the NSW DNSPs for the 2020-21 DMO.

However, AGL does not believe the proposed approach for DNSPs undergoing a revenue determination is appropriate. Energex and SAPN are currently undergoing a revenue determination in respect of the 2020-25 regulatory control period and will not submit tariffs for approval in time for them to be used for the DMO Final Determination. AGL believe that using the annual change in revenue from the final network determinations for Energex and SAPN (the P^0) will not adequately reflect the change in network costs for the model residential and small business customers in the DMO determination.

In their revised Tariff Structure Statements, Energex and SAPN have proposed increasing the fixed supply charges to small customers despite significant revenue reduction or P^0 reductions. This is to increase costs reflectivity of the network tariffs. This tariff re-balancing between fixed and usage charges as well as between tariff categories results in changes in annual network costs for the model customers that are materially different to the overall change in revenue.

This issue is clearly illustrated by examining the network cost changes in the Energex and SAPN Draft Determinations where the network costs are based on the indicative tariffs provided with the revised revenue proposals and comparing them with the proposed overall change in revenue. This comparison is shown in Table 1 below.

Table 1: Forecast network cost changes in 2020-21 for SEQ and SA (including GST)

Model customer	2019-20 Annual network charge ($)	2020-21 change ($)	2020-21 change %
Energex			
Residential without CL	661	-57.9	-8.8%
Residential with CL	786	-108.3	-13.8%
Small business without CL	2,241	-252.0	-11.2%
2020-21 P^0 revenue			-17.8%[1]
SAPN			
Residential without CL	842	-47.5	-5.6%
Residential with CL	1,057	-67.3	-6.4%
Small business without CL	3,623	-504.2	-13.9%
2020-21 P^0 revenue			-9.8%[2]

Source: Draft Determination p 84-91, Energex and SAPN 2020-25 revised proposals

[1] Based on 2020-21 change in revenue (P^0) in Energex revised proposal of -19.31% and CPI in Draft Determination of 1.85%

[2] Based on 2020-21 change in revenue (P^0) in SAPN revised proposal of -11.4% and CPI in Draft Determination of 1.85%

Table 1 clearly shows that:

- In the Energex distribution region, the network cost for the model residential customers is forecast to decrease by 8.8% and 13.8% in the Draft Determination based on the indicative tariffs provided in Energex's revised proposal. In contrast, the 2020-21 P^0 nominal change in revenue in Energex's revised proposal is 17.8%;
- In the SAPN distribution region, the network cost for the model residential customers is forecast to decrease by 5.6% and 6.4% in the Draft Determination based on the indicative tariffs provided with SAPN's revised proposal. In comparison, the 2020-21 P^0 nominal change in revenue in SAPN's revised proposal is 9.8%.
- For a model residential customer without controlled load, the AER's proposed approach using the revised proposals would overstate the reduction in Energex's network costs by 9% and SAPN's by over 4%.

These differences are material and demonstrate that the change in revenue in the network determinations do not adequately represent the changes in network costs.

AGL therefore strongly recommends that the AER either:

- engage with Energex and SAPN and obtain indicative estimates for network tariffs which reflect the final network revenue determination and can be used in calculating the 2020-21 DMO; or
- adjust the percentage change in network costs in the revised proposals (used in the Draft Determination) by increasing or decreasing it by the percentage difference between the revenue in the revised proposal and the Energex and SAPN Final Determinations.

AGL accepts that there may be some differences between these estimates and the final approved tariffs but the outcomes are likely to be significantly more accurate than using the change in revenue as currently proposed.

Residual costs

The residual costs, after accounting for the cost components above, represent the costs of operating a retail business including margins. In the Draft Determination, the AER has only allowed a CPI increase in residual costs with no allowance for step changes in residual costs.

Currently, there are many significant changes and proposals on frameworks and rules in the wholesale and retail energy markets as well as general consumer laws. There are material costs involved in engaging, managing and implementing these changes. Some of these changes are jurisdictional.

However, AGL does not separately account for each of these step cost changes and therefore accept that increasing the residual costs by CPI is appropriate without a clear assessment of these costs. Over the medium term, increasing residual costs by CPI each year should be the baseline assumption to implicitly allow for these costs.

If you have any questions in relation to this submission, please contact Meng Goh, Senior Manager Regulatory Strategy, on mgoh@agl.com.au or (02) 9921 2221.

Yours sincerely

Elizabeth Molyneux
General Manager Energy Market Regulation