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Dear Mr Feather

AER Draft Determination — Default Market Offer Prices 2020-21 — February 2020

EnergyAustralia is one of Australia's largest energy companies with around 2.5 million electricity and gas accounts across eastern Australia. We also own, operate and contract an energy generation portfolio across Australia, including coal, gas, battery storage, demand response, wind and solar assets, with control of over 4,500MW of generation capacity.

We support the AER's draft determination approach of adjusting the current default market offer (DMO) for changes in costs for 2020-21. This high-level approach provides the AER appropriate discretion in balancing the objectives of providing a safety net for customers on standing offer tariffs while also preserving incentives for retailers to compete and innovate in their provision of market offers. The AER's analysis of market pricing outcomes, including under its periodic monitoring reports as well as reports from other agencies, supplements the AER's judgement on the appropriate level of the DMO as a 'backstop' for genuinely disengaged customers.

As outlined in detail below, our specific feedback on the AER's draft decision is as follows:

- the AER's method of estimating compliance costs arising from the Large-scale Renewable Energy Target (LRET) has various shortcomings, is out of line with recent cost trends and other recently regulatory decisions. There are better, and practical, alternatives to estimating LRET compliance costs
- the AER should give careful context for estimates of wholesale costs generated by consultants as these can materially differ due to proprietary (i.e. non-transparent) methods
- we have some minor observations relating to the AER's draft decision to impose the same DMO annual bill for time of use (TOU) customers and its associated usage profiles.

The AER's method of estimating LRET costs has various shortcomings

Our view is that the AER has not had regard to the cost of complying with the laws of the Commonwealth in estimating LRET costs under 16(4)(c)(iii) of the *Competition and Consumer (Industry Code—Electricity Retail) Regulations 2019*.

The AER has relied on a "market-based" approach which, in its view, is preferable because it is transparent, uses publicly available information and is a function of current market conditions.[1] This approach, however, necessarily produces estimates that are not representative of expected retailer costs, which retailers have now pointed out in submissions. The AER acknowledges that its approach indeed does not reflect retailer practice by noting the presence of PPAs, under which the "the cost of the green component (the LGCs) may be higher than the cost of acquiring the LGC's through a brokerage firm".[2]

The AER has chosen not to rely on information from PPAs because of what it considers to be various complexities in estimating an "efficient price" for LGCs over 2020-21 from this information.[3] The AER's consultant similarly states that one of the AER's objectives in setting the DMO is "to allow retailers to recover their efficient costs in servicing customers".[4] In response to stakeholder submissions, the consultant justifies its preferred approach on the basis of a conceptual argument that regards retailers' actual costs as "sunk" and subject to market evolution, and that PPAs do not provide retailers with a guaranteed return.[5] This view is not explicitly supported by the AER, although it notes that brokerage prices are the best available proxy for LGC costs in part because they are a "function of market conditions".[6]

The Regulations contain no reference to efficient or any other notion of benchmark costs or retailer behaviour. This is not a drafting oversight. The Government contemplated creating a DMO that reflects the "efficient" cost of operation, for example as was proposed for the VDO, however it explicitly decided to adopt an alternative model.[7] By the same token, the Regulations do not refer to estimates or forecasts of "actual" costs, although it is standard practice for regulators, and indeed all forecasters, to use actual observations as a starting point for setting expectations about the future, particularly in the case of recurrent costs like those arising out of compliance obligations. At a minimum, we question why the AER has not sought to validate the outcomes of its market-based approach against cost information published by the ACCC. We referred to this as a source of useful information in our response to the AER's position paper, and it is now replicated for the AER's convenience below.

We acknowledge the AER's view that market-based approaches have the appearance of transparency, and the desirability of relying on public information. The reason why this is important is because it allows stakeholders to see and verify decisions with respect to independent data or other evidence. The AER, however, appears to have given primary weight to transparency, at the expense of satisfying stakeholders that the underlying method and its outputs are reasonable, which should be its ultimate objective. In particular, the draft decision does not consider the variations of, or shortcomings involved in, using market-based approaches. The AER has expressed reservations about how drawing information from PPA poses challenges in determining how retailers obtain and surrender associated LGCs. The approach recommended by its consultant merely

[1] AER, *Draft Determination Default Market Offer Prices 2020-21*, 10 February 2020, p. 39.
[2] ibid.
[3] ibid.
[4] ACIL Allen, *Default Market Offer – Estimating Wholesale Energy and Environmental Costs – Phase 2: Application of methodology for 2020-21 Draft Determination*, 5 February 2020, p. 2.
[5] ibid., p. 17.
[6] AER, p. 39.
[7] Australian Government, *Regulation impact statement – the introduction of a Default Market Offer (DMO) price cap and reference bill on retail electricity prices*, 4 April 2019.

assumes how a notional retailer behaves, and this is not questioned by the AER. We consider that an approach which is validated by observable retailer behaviour, as well as public information on costs, is more transparent and therefore acceptable to stakeholders than a theoretical construct that would be subject to ongoing dispute. Such disputes are fuelled in the current case where the AER's method produces results that clearly diverge from reported historical costs, as well as alternative applications of "market-based" approaches.

We have concerns with the assumption that retailers procure LGC certificates over two years prior to each compliance year. To our knowledge, no retailer does this. If it is prudent or otherwise commonplace for retailers to procure LGCs over a two-year lead time, this would have been insufficient to provide investment certainty for developers of renewable generation. In turn, retailers and customers would have been exposed to the full LGC penalty price, and the LRET would have failed as a policy. In reality, EnergyAustralia and various other parties have underwritten significant renewable generation capacity, contributing to a cleaner energy mix. Where the AER and other regulators adopt theoretical approaches that undermine cost recovery e.g. in the event the LRET is extended, this may have real consequences on retailer behaviour and broader market implications.

Finally, the AER's consultant generally dismisses the concerns raised by several retailers regarding its estimation approach:

> ACIL Allen's view is that a market-based approach using contemporary forward LGC prices represents most reliable indicator of the current market consensus view of the price of LGCs in the near-term.[8]

We consider this view to be correct, but irrelevant. The market consensus of the near-term price of LGCs has no bearing of the majority of costs incurred by retailers in meeting their LRET liabilities. The number of LGCs traded in the market are a small fraction of those surrendered each year. Methods that infer costs from prices for a relatively small number of LGCs can only provide an accurate estimate of retailer compliance costs by coincidence. As outlined below, the AER's estimate is significantly out of line with published information on retailer costs. The AER should squarely address these considerations in satisfying 16(4)(c)(iii) of the Regulations.

There are alternative ways to estimate LGC certificate costs

The AER and its consultant have formed a view that drawing data from PPA contracts infeasible because these contracts do not separately identify LGC prices. The AER observes that "not all PPAs divide out LGC prices, but have a bundled price."[9]

In our earlier submission, we recommended the AER examine a sample of PPA contracts to explore alternative methods to using market data. To our knowledge, the AER has not examined any PPA contracts, and the challenge posed by bundled prices appear to be assumed. The AER footnotes the AEMC's 2018 price trends methodology report, which states:

[8] ACIL Allen, p. 17.
[9] AER, p. 39.

> Modelling the forward price of LGCs is complicated by PPAs which bundle the energy component with LGCs in a single price. Over time, if there is any change in the energy price component, the residual certificate price will also be adjusted but in the opposite direction as the bundled PPA price is constant over the period.[10]

Notably, the AEMC's LGC price estimates are based on the subsidy required for a new generator to enter into a PPA in order to recover its costs. This approach presumes LGC values are not contained in PPA documentation or otherwise ignores actual retailer practices and compliance costs in favour of a theoretical 'forward looking' approach. LGC prices are generally stated in PPA documentation ("Green Confirmation") at prices that reflect the share of value between electricity and LGCs at the time the contract was struck.

In the event LGC prices are not stated or considered irrelevant, LGC values could be derived from the "bundled" PPA price by establishing the fair value of energy and LGCs at the time the contract was struck. This would include consideration of the dispatch profile, the market electricity price and the market LGC price. Once the share of value between electricity and LGCs is determined, that can be applied to the bundled PPA price proportionately.

We cannot comment on the contractual details of PPAs however the AER should explore this for itself.

The AER should also explore how retailers determine their own LRET compliance costs. In the instances where a separate LGC price cannot be directly observed from PPAs, retailers will have reliable methods of ascribing values to them. Such information is necessary in determining how costs are to be budgeted for, and recovered in retail prices, on an ex ante basis. It is also necessary in monitoring compliance costs on an ex post basis.

As the AER is aware, the ACCC has a time series of retailer cost data gathered under its market monitoring functions. The ACCC's templates require retailers to separately identify LRET costs as a separate line item, for all states, for different customer types. The ESC also recently requested similar information for Victorian customers when making its VDO determinations. Each retailer would be determining these costs from any PPAs in a manner that is satisfactory for the purposes of meeting the ACCC's and ESC's requirements. Costs arising from LGCs procured in the market will also be included in these data.

In summary, our suggestions for the AER are similar to those put in our earlier submission:

- challenge the view of its consultant that the only approaches to estimating LGC prices are either from market data or a theoretical marginal cost approach[11]
- investigate LRET costs that have been reported by retailers to the ACCC, and seek to understand what methods retailers have employed to generate these data

[10] AEMC, *2018 Price Trends Methodology Report - Final report*, 21 December 2018.

[11] ACIL Allen, *Estimate wholesale energy and environmental costs – Phase 1: initial scoping and assessment of forecasting options*, 10 September 2019, pp. 18-19.

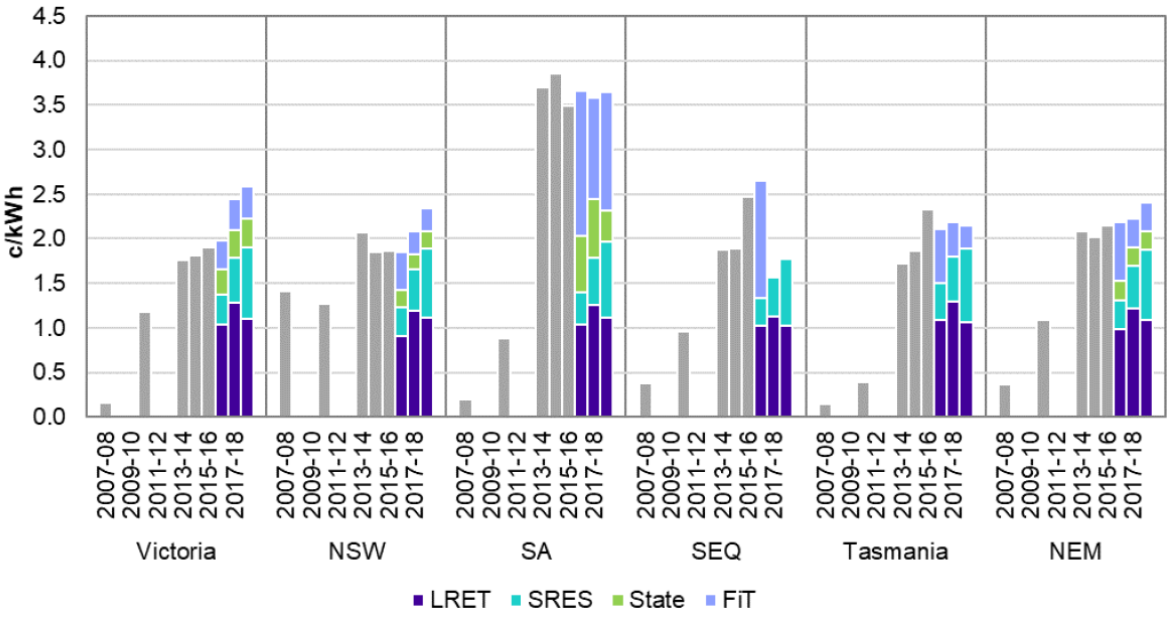
- request and examine a sample of PPA contracts from retailers to understand the prevalence and nature of bundled prices, as well as understand the source of cost information reported by the ACCC.

The AER's LRET cost estimates are out of line with cost trends and other regulatory decisions

Where it cannot view the entirely of retailer submissions to the ACCC, at the very least the data published by the ACCC should be useful for the purposes of substantiating trends in LRET compliance costs.

The latest ACCC Electricity Inquiry report suggests LRET costs of around $10 per MWh for the years 2016-17 to 2018-19. [12] Moreover, the values are consistent across all states, suggesting a stable underlying set of LGC values. We would not expect compliance costs for 2020-21 to change materially from recent historical observations given the majority of certificates are generated from long-term PPAs. The use of the ACCC's public data to develop a cost trend represents a stand-alone method for estimating LRET costs that is transparent, accurate and defensible. LRET costs will change as long-term PPAs expire, and the AER's method will need to accommodate this transition, rather than assume this transition has already taken place. We expect the ACCC will explore the drivers for any such change in costs as it is observed in its published data.

Figure 2.32: Average effective price for environmental costs per residential customer by NEM regions, 2007–08 to 2018–19, real $2018–19



Source: ACCC, November 2019, p. 63

[12] ACCC, *Inquiry into the National Electricity Market - November 2019 Report*, 29 November 2019, p. 63.

The AER's consultant estimates LRET costs to the consumer of $9.38 per MWh in 2019-20, which is in line with the ACCC's reported trend. However, the consultant's estimate for 2020-21 is $4.56 per MWh. This is based on its estimates of LGC certificate prices of $30.51 for 2020 and $16.17 for 2021. These certificate prices are significantly out of line with others produced recently by other regulators, specifically:

- LGC price of $43.30 for 2020, estimated by the ESC in November 2019.[13] This estimate reflected a volume-weighted average of LGC futures trades for 2020 reported by Demand Manager.

- LGC prices of $55.34 for 2020 and $44.50 for 2021, estimated by the ICRC in February 2020.[14] The 2021 LGC estimate was calculated as the 7-month average of LGC prices from 1 July 2019 to 29 January 2020, with data sourced from ICAP.

One would reasonably expect some differences in estimates due to different time periods, however all stem from a "market-based" approach and both the ICRC and the ESC observe the same falls in LGC prices in the market since mid-2018. Roughly speaking, the ICRC and ESC's estimates corroborate a current market price of around $45 per certificate. In this context, the $30 certificate price for 2020 estimated by the AER's consultant is implausibly low.

We note the AER's estimate is based on using data provided by "broker TFS", with the costs inferred from forward prices over the two years prior to each compliance year. It is not clear if these reflect any weightings or assumed profile of purchases over the two years. The ESC's estimate is similarly based on forward contract prices, however is generated on a trade-weighted basis and with prices from a different data provider. The ICRC's estimate uses half-hourly load weights provided by ActewAGL to convert calendar year values to financial years and again uses a different data provider to the AER.

These differences appear subtle yet produce a wide variance in costs for the same compliance period. The AER and its consultant may wish to explore the variations possible within the "market-based" approach and justify which set of methods, assumptions or data sources produces accurate estimates of retailer compliance costs in accordance with 16(4)(c)(iii) of the Regulations.

Observations on wholesale cost methods

The AER's wholesale cost estimates are a further illustration in reliance on different methods. For example, the AER's estimates for 2020-21 diverge from estimates published recently by the AEMC in its latest residential price trends report. We note the AER's consultant has provided a comparison of its and the AEMC's methods in its report to the AER.[15]

Similar to the above observations on LRET costs, we would be unsurprised if a comparison of cost estimates produced by a range of consultants identified materially divergent results, yet be defended in their own right. Similarly, the cost estimates of each individual retailer would diverge as they reflect different practices, all of which would be argued as prudent as they reflect competitive market behaviour.

[13] ESC, *Victorian Default Offer to apply from 1 January 2020: Final decision*, 18 November, p. 39.
[14] ICRC, *Retail electricity price investigation 2020–24 – Draft Report*, pp. 49-50.
[15] ACIL Allen, Appendix A.

We expect that consultants' estimates of wholesale costs are highly sensitive to assumptions around how the notional retailer purchases cap contracts. These assumptions typically form part of consultants' proprietary modelling and are not disclosed to stakeholders. Regulators and other stakeholders accept such proprietary methods forming part of wholesale cost estimation. To this end the AER should be mindful of how it deals with the need for transparency, relative to other objectives, across different elements of its decision.

We encourage the AER to give appropriate context to the uncertainties involved in estimating wholesale cost trends arising from different methodologies. As the AER would appreciate, the political environment is sensitive to changes in expected costs, and any individual forecast can raise expectations that they accurately reflect retailers' actual costs, and prices of individual retailers should follow suit[16] regardless of their actual costs or preceding price levels. This is critical now that retailers face penalties for various classes of prohibited conduct, including where prices do not reflect sustained and substantial reductions in costs.[17]

Network costs uncertainty

We acknowledge the issues created by the timing of the AER's DMO determination with respect to the pricing approval process for Energex and SAPN. The AER has proposed that *'the best available forecast is the annual change in revenue provided in the AER's network revenue determinations'*[18], we will address our concerns with this below and our preference that the AER use as close to the actual values or rates as reasonably possible.

The Draft Determination provides forecast changes to cost components. Highlighted below are the network cost of Energex and SAPN, for the most prevalent residential tariff.

Table 6: Forecast changes in cost components and DMO bill impact – 2019-20 to 2020-21 (excl GST, nominal)

Description	Network cost	Wholesale cost	Environmental cost	Overall price impact
Residential without CL				
Ausgrid	+1.8%	+1.9%	-11.2%	**+1.1%**
Endeavour	-1.9%	+4.3%	-11.6%	**+0.5%**
Essential	+0.3%	+2.0%	-12.0%	**+0.5%**
Energex	-8.8%	-4.3%	-14.2%	**-5.5%**
SAPN	-5.6%	-4.3%	-12.3%	**-4.4%**

Source: AER DMO Draft Determination, February 2020, p.31

[16] Channel 7 News, EnergyAustralia to flag higher tariffs, 7 January 2020
[17] Prohibiting Energy Market Misconduct, Clause 153E (b)
[18] AER DMO Draft Determination, February 2020, p.41

If the AER adopts the annual change in revenue provided in the network revenue determinations, this will absorb the overall change in annual network revenue for the whole market; not solely residential. The tables below highlight the total network revenue reduction of Energex[19] and SAPN[20] for their entire customer base, including commercial and industrial.

Energex	Unit	Regulatory Proposal	AER Draft Decision			Revised Regulatory Proposal		
		Forecast	Forecast	Difference from RP	Difference from RP (%)	Forecast	Difference from RP	Difference from RP (%)
Revenue and pricing								
Revenue (smoothed)	$m nominal	6,541.17	5,839.97	-701.19	-11%	5,900.32	-640.84	-10%
P_0 (initial price decrease in 2020/21)	%	10.25%	20.32%	10.07%	98%	19.31%	9.05%	88%
X-factor (annual price change in remaining years)	% p.a.	0.00%	0.00%	0.00%	0%	0.00%	0.00%	0%

Source: Energex Revised Regulatory Proposal, December 2019, p.14

Table 4.1.1: Building block revenue parameters

$million, nominal	Original Proposal	AER Draft Decision	Revised Proposal
Return on capital	$1,277	$1,054	$1,046
Regulatory depreciation	$1,233	$1,188	$1,219
Operating expenditure	$1,671	$1,585	$1,560
Revenue adjustments	$40	$39	$84
Tax allowance	$0	$38	$10
Unsmoothed revenue	$4,221	$3,903	$3,919
Smoothed revenue	$4,215	$3,905	$3,916
P0	2.83%	13%	11.40%
X	0%	0%	0.80%
WACC	5.43%	4.95%	4.79%

Source: SAPN Revised Regulatory Proposal, December 2019, p.17

We believe it is safe to assume that the total network revenue reduction for Energex and SAPN are likely to be within AER's draft decision and the revised proposal of Energex and SAPN (highlighted in yellow); with the most likely to be a further reduction in line with the AER's draft decision, the adjustment factor for Energex is a 5.23% further reduction (-20.32%/-19.31%), and for SAPN a further reduction of 14% (-13%/-11.4%).

The DMO is only applicable to residential customers, as such we do not consider it appropriate to apply the annual change in revenue that is calculated based on the impact to all customers within a distribution area. We believe the AER's forecast changes in cost

[19] Energex Revised Regulatory Proposal December 2019
[20] SAPN Revised Regulatory Proposal December 2019

components is a fairer and more accurate representation of the networks costs that relate to residential customers.

EnergyAustralia believe the AER should consider using the actual rates published in the revised proposals from the respective distributors, or – if needed – the AER's Draft decision for network cost and apply the corresponding adjustment factor; a 5.23% reduction for Energex, and 14.3% reduction for SAPN (or a mid-point).

Treatment of controlled load customers

As raised in consultation for the current DMO, we consider that setting a single DMO annual bill for all controlled load customers requires retailers to allocate peak usage rates across a fixed amount of consumption. This has the unintended consequence of flattening both controlled loads into a single price which in turn will remove any intended pricing signal. These signals generally work by providing a lower price signal to shorter duration appliances, compared to those that operate for longer.

Hourly usage profiles for TOU tariffs

We are grateful that the AER has undertaken its own analysis of mismatches between network costs and revenues arising from its current usage allocations between different TOU windows.

We note that the hourly profiles in its draft decision are a simple pro-rata of these TOU window usage allocations. This will still allow a more accurate comparison across tariffs than currently takes place. Some factors relating to this for the AER's further consideration are:

- Rounding hourly usage values to four decimal places, to ensure annual usage calculation matches the flat tariff annual usage.
- Allowing for different usage profiles between weekends and weekdays.
- In appendix D[21] of the Draft Determination, examples are provided explaining how to tally total peak, off-peak and shoulder usage for the year using the daily profiles. Providing a more detailed example for the forward-looking year, will provide certainty on the TOU application on seasonal tariffs, and public holidays; in particular, how weekends and public holidays are considered in seasonal tariffs, which can vary by Distribution Network Service Provider, or year (seasonal date changes in weekends/public holidays e.g. Easter, etc).
- Whether or how these profiles will be reflected in the AER's EME comparator tool. In discussions last year with AER staff we flagged this as an issue, and understand the AER is currently making revisions to EME. The primary reason we highlighted these issues is to ensure retail offers are fairly compared and EME is an important channel to market for many retailers.

[21] AER DMO Draft Determination, February 2020, p.92

If you would like to discuss this submission, please contact me on 03 8628 1655 or Lawrence.irlam@energyaustralia.com.au.

Regards

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