



EnergyAustralia

LIGHT THE WAY

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AER Default market offer prices 2023-24 Issues paper - Public

EnergyAustralia is one of Australia's largest energy companies with around 2.4 million electricity and gas accounts in NSW, Victoria, Queensland, South Australia, and the Australian Capital Territory. EnergyAustralia owns, contracts, and operates a diversified energy generation portfolio that includes coal, gas, battery storage, demand response, solar, and wind assets. Combined, these assets comprise 4,500MW of generation capacity.

EnergyAustralia welcomes the opportunity to make this submission to the AER's Issues Paper on the Default Market Offer for 2023-24 (Issues Paper).

We appreciate the challenges faced by the AER in setting the DMO in the context of rising energy costs, primarily caused by geopolitical supply side issues around gas and coal. Overall, we urge the AER to maintain a long-term perspective on DMO price regulation. Reducing the DMO as low as possible now with the intent of providing short-term customer bill relief could irreversibly damage competition in the retail electricity market in the longer term, with reverberating effects throughout the clean energy transition. Regulatory consistency around the DMO is paramount in providing the stability to allow Retailers to invest in customer solutions now and throughout the clean energy transition.

In summary, our position is:

- EnergyAustralia firmly believes the AER should maintain the level of the Retail Allowance at the 10% and 15% level for residential and small business customers, respectively. There is no evidence that changing this now is warranted in the current volatile wholesale market environment:
 - Market developments in 2022 indicate that the Retail margin i.e. EBITDA (in percentage terms) actually needs to increase since the AER's final decision for DMO 4 in May 2022. This supports an increase to the Retail Allowance, rather than a reduction.
 - Competition indicators show mixed results and that the state of retail competition is uncertain and retail viability is at risk. In this context, we firmly believe that now is

the time to retain a higher Retail Allowance to better enable and promote competition and investment from existing Retailers and new entrants.

- The Retail Allowance should not be reduced as it is a critical buffer for under-recovery in other parts of the cost stack. This is particularly the case for smaller Retailers who often have higher Retail Operating Cost than the Retail Operating Cost allowance reflects, and Retailers with significant amounts of depreciation and amortisation.
- We agree with the AER's general approach to not adopt large scale changes to the DMO wholesale cost methodology, with the exception of exploring potential changes for the South Australian market for DMO 6, at the earliest.
- There is one issue we would like to flag on wholesale cost methodology, which involves the expiry of call options for CAL23 swap contracts. The sheer volume of these in-the-money call options and large gap between the strike price and prevailing market price (strike price is much lower than market price) mean that the trades will inaccurately deflate the wholesale cost calculation for the DMO. This will result in a Wholesale Electricity Cost component that is too low, and an under-recovery on wholesale cost.

If you have any questions in relation to this submission, please contact me (Selena.liu@energyaustralia.com.au or 03 9060 0761).

Yours sincerely,

Selena Liu
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EnergyAustralia submission

1. Retail Allowance

EnergyAustralia urges the AER to maintain regulatory consistency in its setting of the Retail Allowance at the 10% and 15% level for residential and small business customers.

The AER seeks stakeholder feedback on whether the Retail Allowances envisaged in the DMO 4 remain appropriate, and has explained that the percentage approach will result in a larger Retail Allowance when applied to increased input costs, which will exacerbate price increases for customers.

We consider the AER might change the Retail Allowance in two ways, both of which we do not support:

- (i) Reduce the Retail Allowance from 10% and 15% to a lower percentage, which would mean an effective reduction in the Retail margin and/or the part of the allowance directed at meeting specific DMO objectives (for ease of reference, we refer to this as “headroom”).
- (ii) Adopt an alternative approach to setting the Retail Allowance which is not percentage based e.g. a fixed Retail Allowance based on DMO 4’s Retail Allowance in dollar terms (perhaps adjusted for CPI).

In relation to (ii), we strongly advise against the AER changing from a percentage-based approach to a different approach. The Independent Competition and Regulatory Commission (ICRC) in the ACT proposed (ii) to change its price regulation of ActewAGL’s standing offer prices in 2017 and ultimately decided against it to retain consistency with established regulatory practice and its previous decisions. There is firm Australian regulatory precedent (including from the ICRC and the Queensland Competition Authority) backed with strong policy reasoning to support the Retail margin adjusting in proportion to the rest of the cost stack. As the QCA summarised:

“Conceptually, we consider it reasonable to assume that variable retail costs (*including the required margin*) would increase as underlying costs increase. This is because Retailers face greater risk as underlying costs (and customer bills) increase — Retailers should be compensated for this additional risk.”¹ (emphasis added). Increased risk and impact on Retail margin is discussed more in section 1.1 below.

The AER might look to the UK to support an alternative approach, where Ofgem is considering a similar policy question of whether it should depart from a percentage-based approach (their current *EBIT margin* is 1.9%)² in view of increases in the cost stack. However, the UK context is entirely different. Since December 2021, Ofgem has introduced several interventions to mitigate the risk of wholesale market price volatility, which then might warrant changing the Retail margin for UK Retailers where it addresses those same risks i.e. to avoid compensating Retailers for the same risk twice.³

The AER’s Issues Paper appears to lean towards the Retail Allowance being set at a lower percentage, (i) above, rather than adopting an alternative approach. We therefore focus the rest of this section on discussing several policy reasons as to why the AER should not lower the percentage adopted for the Retail Allowance.

¹ QCA, Regulated retail electricity prices for 2016-17 | Final determination, May 2016, p. 119. For more on this topic and a summary of the relevant issues and positions (which EA agrees with), see HoustonKemp’s 2017 report for ActewAGL: <https://houstonkemp.com/wp-content/uploads/2019/01/Implications-of-ICRCs-change-to-the-retail-margin-final-report-Im5I.pdf>

² EBIT is typically lower than EBITDA (the DMO’s Retail margin) as it does not include depreciation and amortization.

³ [Consultation on amending the methodology for setting the Earnings Before Interest and Tax \(EBIT\) allowance | Ofgem](#)

1.1. Increased risk in the current energy market should be reflected in increases to Retail margin

Market developments in 2022 indicate that the Retailer margin i.e. EBITDA (in percentage terms) actually needs to increase since the AER's final decision for DMO 4 in May 2022. This supports an increase to the Retail Allowance, rather than a reduction. This section outlines the reasons why the Retailer margin (in percentage terms) has risen since the AER's final decision for DMO 4 in May 2022, specifically:

- (i) the increased riskiness of providing retailing services in the national electricity market (NEM);
- (ii) the higher working capital costs for a benchmark efficient Retailer; and
- (iii) the higher estimates of the required Retail margin using methods previously adopted by Australian regulators such as the expected returns methodology.

Increased riskiness of electricity retailing in the NEM

Electricity retailing is essentially a margin business, with the Retail margin representing the returns that an electricity Retailer requires in order to attract the capital investment needed to provide a retailing service.⁴ Intuitively any increase in the riskiness of providing retailing services should lead to an increase in the Retail margin (as a percentage of sales) of the electricity Retailer. Conversely, reductions in the riskiness of electricity retailing should lead to a fall in the Retail margin required.

To this point we note that the riskiness of electricity retailing in the NEM has increased since the AER made its decision for DMO 4, with:

- a substantial increase in the number of Retailer failures, with six occurring in 2022, compared with four over the entire 2016 to 2021 period;
- Retailers withdrawing from the market either offering the DMO only or not accepting new customers;
- increased wholesale electricity costs and greater wholesale price volatility; and
- increased customer switching rates.

In addition to a general increase in market risk, EnergyAustralia has also observed a reduction in the liquidity in the wholesale electricity hedging market, especially in NSW. We understand that this relates to thermal generators being less willing to hedge their potential output due to concerns about generator reliability. A consequence of Retailers being unable to fully hedge their customers' expected load, is that this risk must then be absorbed by Retailers. This heightened risk would be expected to result in increased Retail margins being priced into both competitive market offers as well as the standing offer (DMO).

Higher working capital costs

The need for working capital arises from differences in the timing of a Retailer's accounts receivable (payments received from standing offer customers) and accounts payable (payments made to suppliers such as networks and energy purchasing costs). Working capital represents a significant cost to an electricity Retailer since wholesale energy purchases must be settled daily, whilst the revenue from small customers on standing offers is billed in arrears, typically monthly or even quarterly.

⁴ SFG, Estimation of the regulated profit margin for electricity Retailers in New South Wales, 30 November 2009, p 5.

Working capital costs are a function of the following two elements:

- (i) the size of the working capital requirement of the firm, which depends on its cashflows which in turn are determined by:
 - a. the Retailer's total sales (i.e. accounts receivable) and average collection days for accounts receivable; and
 - b. total costs (i.e. accounts payable) and the average payment days for accounts payable (which will also reflect the level of bad debts, which are increasing due to both default rates and the amount of customer debt rising); and
- (ii) the required rate of return on assets.

In relation to the first element, as an electricity Retailer's working capital requirement are a function of the Retailer's cashflows, if the Retailer's cashflows increase by 30 per cent, then its working capital requirement would also increase by 30 per cent.⁵ Wholesale electricity costs are a key driver of these cashflow impacts for Retailers for their DMO customers.

The second element is the return that the Retailer should earn on its working capital requirement, to reflect the opportunity cost of this capital. The recent rises in the risk free rate (shown in Figure 1 below) mean that the required rate of return for a benchmark efficient Retailer will be substantially greater for a Retailer in DMO 5 compared to DMO 4 or DMO 3.

Figure 1: 2 year risk free rate



Source: RBA, statistical table F2, downloaded 26 November 2022.

To summarise, the expected amount of working capital held by a benchmark efficient Retailer is a function of cashflows and so would be expected to increase by the same percentage amount as any increase in wholesale energy costs in DMO 5. However, a consequence of recent rises in market rates is that the return on a Retailer's working capital requirement will also have risen and so the cost of working capital (as a percentage of cashflows) will be higher in DMO 5 compared to previous periods.

⁵ Noting that there are no expectations that customer billing cycles or AEMO settlement timings will be materially different in DMO 5 compared to DMO 4.

Expected returns approach to estimating Retail margins

Some regulators in the past, such as IPART and the ESC in Victoria, have estimated the Retail margin required by a benchmark efficient energy Retailer.⁶ One method deemed to provide an unbiased estimate of the Retail margin is the 'expected return approach' developed by SFG Consulting for IPART and replicated by Frontier Economics for the ESC.⁷

The expected return approach seeks to estimate the minimum Retail margin required to compensate investors in a notional Retailer for systematic risk they bear when committing capital to a Retailer. This methodology utilises the following three key inputs:⁸

- (i) benchmark weighted average cost of capital (WACC) for a notional Retailer;
- (ii) forecast future cash flows and returns of the notional Retailer under different economic conditions; and
- (iii) forecast future returns on the market in different states of the market.

Assuming that the risk of expected returns of the notional Retailer and the market are unchanged, then the recent rise in the WACC would result in the expected returns approach estimating a higher Retail margin (in percentage terms) in DMO 5 compared to DMO 4.

1.2. Reducing the Retail Allowance will change the original policy intent of the DMO and weight shorter term objectives at the expense of longer term objectives

The ACCC originally advised on the policy intent of the DMO:

"The DMO was not intended to be the lowest priced or near lowest priced offer, and should not be set so low as to constrain competition and innovation, or disincentivise customer participation in the market".⁹

The ACCC therefore provided a clear direction on how to balance the competing DMO objectives by specifying where the DMO should sit relative to acquisition market offers. i.e. DMO was clearly not intended to be near the lowest priced offer.

From the AER's graph below (Figure 2), DMO 3 was appropriately positioned well above almost all market offers (in March 2022). Today however, due to increases in wholesale cost and DMO 4 not reflecting these costs completely, the DMO is positioned close to the lowest offer, contrary to the ACCC's original recommendations. When determining DMO 5, the AER should ensure that DMO 5 returns to the DMO's position relative to market offers in line with March 2022.

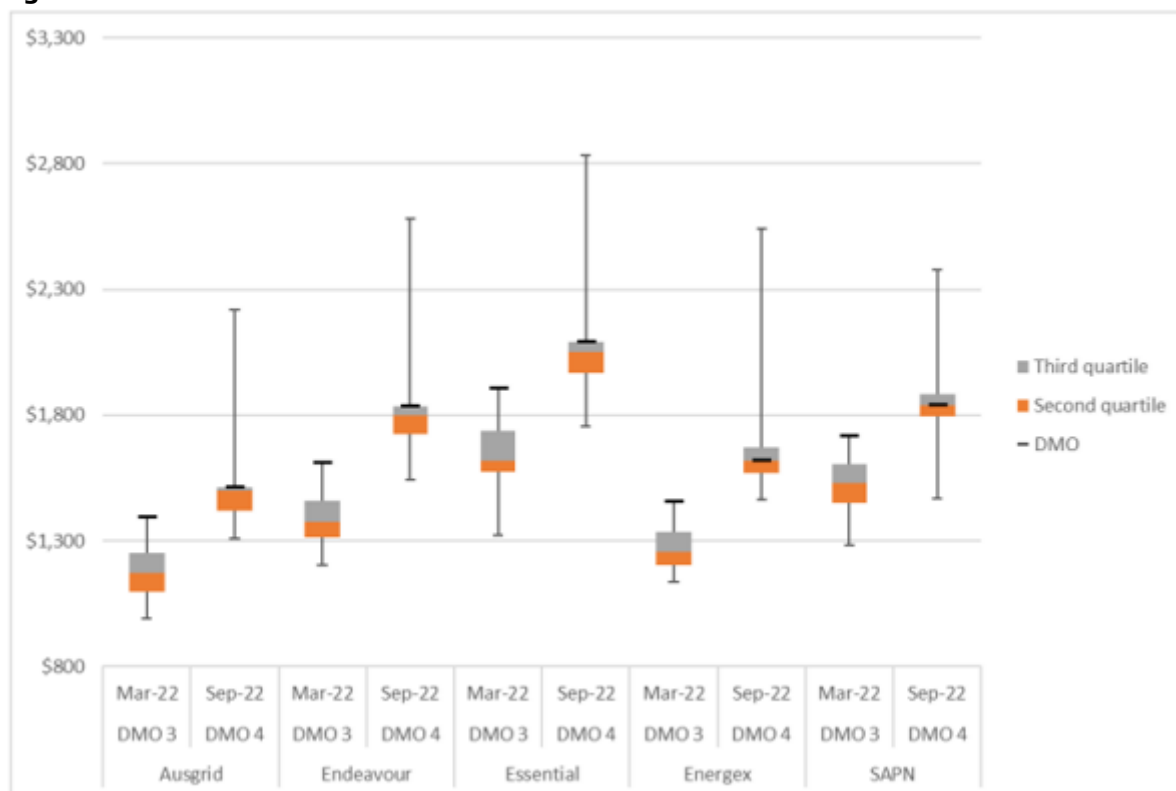
⁶ ESC, Victorian Default Offer to apply from 1 July 2019, 3 May 2019, pp 77-88. IPART, Review of regulated retail tariffs and charges for gas 2010-2013, June 2010, pp 31-35.

⁷ SFG, Estimation of a competitive profit margin for gas Retailers in New South Wales, 24 May 2010. Frontier Economics, Retail costs and margin | A report for the Essential Services Commission, 24 April 2019.

⁸ Frontier Economics, Retail costs and margin | A report for the Essential Services Commission, 24 April 2019, pp 23-30.

⁹ ACCC, Retail Electricity Pricing Inquiry – Final Report, Commonwealth of Australia, June 2018, p. 249-251.

Figure 2



Source: AER Issues Paper

We are concerned that reducing the Retail Allowance and lowering the DMO further, will only continue the current positioning of the DMO or exacerbate it further. This would effectively shift the balance of DMO objectives to place greater weighting on the first DMO objective, at the expense of the other objectives. The DMO objectives are:

- 1) reduce unjustifiably high standing offer prices;
- 2) allow Retailers to recover their efficient costs of providing services; and
- 3) enable competition, innovation and investment by Retailers, and retain incentives for consumers to engage in the market.

We discuss these objectives and the implications of lowering the Retail Allowance below.

Objective 1: Protect against "unreasonably high prices"

The AER proposes to place greater weighting on the DMO objective to protect consumers from *unreasonably* high prices (and lower the Retail Allowance). This falsely assumes that the cost increases forecast for DMO 5 are unreasonable when increases to wholesale and network costs are real and have been substantiated. It also assumes that any commensurate increase in Retail Allowance is also unreasonable, when proportionate increases to Retail Allowance are also justified due to greater risk (as discussed above) and to retain the original balance between the DMO objectives as intended by the ACCC.

As these price increases are real and reasonable, the AER would be using the DMO to prevent real increases in cost inputs from being recovered by Retailers. The DMO should not be used as a tool to artificially keep prices low. This would directly undermine Objective 2 (allow recovery of efficient costs) and Objective 3 (enable competition, innovation and investment).

Objective 2: Allow Retailers to recover their efficient costs of their service

The DMO sets the level of costs that Retailers will be able to pass through to customers. In today's context, the DMO is the price cap for a material proportion of standing offer customers (around 7–11% of residential customers and 15–20% of small business customers).¹⁰ If Retailers cannot recover their costs under the DMO then it undermines their viability and their ability to invest over the long term.

There is a real question over whether the DMO provides for a Retailer's efficient cost of supplying customers with electricity. The DMO will not exactly reflect every Retailer's cost, but because the retail market is effectively competitive, it should align with Retailer's actual cost data because those costs will reflect efficient price outcomes. [

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We believe this shortfall likely results from data limitations and a lack of flexibility in the DMO's pricing methodology:

- due to the use of ACCC data for Retail Operating Costs, which excludes smaller Retailer data and more heavily weights the largest Retailers,
- a lack of benchmarking of actual depreciation and amortisation (D&A) data from Retailers against the D&A allowance in the Retail margin (noting that only two Retailers provided this data to the AER). We discuss D&A more in section 1.5.
- Differences in the calculation of wholesale and environmental costs, i.e. the DMO assumes one hedging strategy and one way to acquire environmental certificates.

Some difference with the DMO is to be expected due to variation in how Retailers manage their costs and different business models. However, it is critical that the DMO should allow a reasonable buffer for these differences as they reflect different business models that exist today in the competitive market. In this way, providing a reasonable buffer via the Retail Allowance is important to encouraging diverse competition and is therefore connected to the third DMO objective. We discuss clear examples where the DMO acts as a buffer for under-recovery on certain costs in section 1.5.

Objective 3: Enable competition, innovation, investment and incentivise customer engagement

EnergyAustralia believes that this third DMO objective is a key distinguishing feature of the DMO, compared to regulated prices in other jurisdictions such as Victoria. If this DMO objective did not exist, there would be no need for headroom. As it does exist, the AER needs to provision for it in a meaningful manner.

We also recognise the possible tension between DMO objective 1 (although in our view it is not undermined) which would lower the DMO, and DMO objective 3 which supports a higher DMO. We believe that the AER struck the balance well in DMO 4 with the 10% and 15% Retail Allowance initially, but with costs moving, DMO4 is now not positioned appropriately (as per discussion above).

We urge the AER to maintain the Retail Allowance of 10% and 15%. While there are risks of setting the Retail Allowance too high and too low, these risks are asymmetric. As the AEMC stated in the context of providing guidance on setting headroom¹¹:

“The risks of setting a regulated retail price too high, or too low are asymmetrical. If a regulated retail price is set too high, then there may be higher costs for the customer in

¹⁰AER, [State of the energy market 2022 - Chapter 6 - Retail energy markets.pdf \(aer.gov.au\)](#), p 184

¹¹ Note the AEMC's concept of headroom is focussed on encouraging competition via new entry. In contrast, the AER's is broader and focussing on benefits provided by existing Retailers, as well as new entry. E.g. incentivising customer engagement arguably applies to existing Retailers.

the short-term. The Commission considers that it is likely that over time prices would be reduced through competition, with competitors entering the market and eroding the higher prices down to efficient cost levels. [Note the DMO is a price cap which can be undercut by both standing and market offers].

In contrast, if a regulated retail price is set too low the consequences are likely to be more detrimental to customers' long term interests. Retail investment may not occur, and so competition may not eventuate. The benefits from competition (lower prices, improved quality, increased innovation etc) will not be realised. Further, dependent on the extent to which regulated prices are set too low, this may create financial difficulties for current Retailers, potentially resulting in underinvestment in products and services valued by customers, and ultimately Retailer failure".¹²

1.3. State of competition is uncertain, Retail Allowance should therefore enable competition to its fullest

Our analysis of competition indicators show mixed results and that the state of retail competition is uncertain, reflecting challenging conditions for Retailers as they adjust to manage risk in a more volatile wholesale cost environment. In this uncertain context, we strongly believe that now is the time to retain a higher Retail Allowance to enable competition and new entry, to ensure that energy retail markets are not irreversibly damaged by the global energy shock at a time when the energy sector is also trying to play a role in addressing climate change.

According to the AEMC's competition indicators¹³:

- a) *Customer activity in the market* – As noted above, customer churn across all Retailers appears to have increased in 2022. [

] However, as the AEMC cautions, "a focus on switching rates alone is unhelpful because high or low switching rates in isolation are not a sign of a well-functioning market". It is important to consider other indicators which provide a mixed view on the state of competition.

[Confidential:

¹² [Microsoft Word - Best Practice Retail Price Regulation - Final Report - EMO0027 - 26 September 2013 \(aemc.gov.au\)](#) , p 72¹² [Microsoft Word - Best Practice Retail Price Regulation - Final Report - EMO0027 - 26 September 2013 \(aemc.gov.au\)](#) , p 72

¹³ As per the AEMC's last Approach paper to its Retail Competition Review, [Approach-Paper-FINAL-FOR-WEBSITE-22-10-15.pdf \(aemc.gov.au\)](#) Note we were unable to look at the indicator Customer satisfaction with market outcomes without customer survey data.

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- b) *Barriers to Retailers entering, expanding or exiting the market* – There has been no actual new entry this year in NECF states.¹⁴ Telstra paused its entry into the retail energy market, which suggests that barriers to retail entry are currently very high if an established and very large Retailer such as Telstra is unwilling to enter. In the current market, low contract market liquidity and the exiting of traditional contract suppliers, such as coal and gas plants, is a likely barrier to new entrant Retailers trying to hedge and manage risk for new customer load. []. This supports ensuring that the Retail Allowance and DMO as a whole is set at a level which facilitates new entry.
- c) *The degree of independent rivalry in the market* – While customer switching is high, the market is technically more concentrated as a result of Retailer exits (albeit very small Retailers), but rivalry between Tier 1 and non-Tier 1 Retailers remains strong.

However, product differentiation across Retailers has reduced, as many Retailers have fallen back to supplying only one energy plan to meet their Standing offer obligations. As of 22 November, roughly a third of Retailers are only supplying the DMO standing offer in the Ausgrid zone.¹⁵ As of 23 November, 12 Retailers across the NEM and Victoria are not accepting new customers. This is an improved state compared to June 2022, where 21 Retailers had either stopped selling or were advising customers to go elsewhere.

- d) *Whether retail energy prices are consistent with a competitive market* – Consistent with the AER’s graph above, there has been a pronounced drop in discounting off the DMO for acquisition offers suggesting reduced competition. In the Attachment, we show graphs illustrating the vast reduction in the Ausgrid zone. Generally, the lowest discount in the market has halved between March 2022 and 22 November, across all distributor zones:
- In Ausgrid NSW, the lowest offer has increased from 28% off the DMO in March 2022, to 15% off the DMO in August and November 2022. The median offer in November is 5% off the DMO.
 - In Queensland, the lowest offer has increased from 21% off the DMO in March 2022, to 10% off the DMO in August, and 13% in November 2022. The median offer in November is priced at the DMO.

¹⁴ While Ampol and Incite Energy Pty Ltd obtained retail authorizations but are not actively offering products to market. Three companies, ARC Utilities Management Pty Ltd, ERC Energy Pty Ltd, and iGENO Pty Limited are embedded network Retailers which obtained retail authorization this year, but probably held an retail exemption prior to that given they have been registered companies since 2017, 2018, and 1997. i.e. they did not actually enter the market this year, rather they are changing their licence type.

¹⁵ []

- In SA, the lowest offer has increased from 25% off the DMO in March, to 20% in August, and then to 7% in November 2022. The median offer in November is at level with the DMO.

Considering the median offer is at the same level as the DMO, there is essentially no or very limited room for Retailers to compete under the DMO. The lowest offers in market are potentially loss leading and not sustainable. Any further adjustment to lower the DMO, via lowering the Retail Allowance or otherwise, will only make it more difficult for Retailers to compete. According to the ACCC, the DMO was not meant to place downward pressure on prices but only address the disproportionate profitability of Standing Offer customers. Even in today's market, the DMO already unduly places downward pressure on prices, with over 90% of offers priced at or below the DMO. ¹⁶

If the DMO is set unrealistically low, there is a risk that it could become the lowest offer in the market with the result that more customers would shift to the DMO, further exacerbating any under-recovery of the DMO and undermining Retailer viability. The UK has experienced this effect, with more than 90% of customers now on the regulated tariff (compared to 53% previously), which only worsens problems caused by the regulated tariff being slow to update for increases in cost. This has contributed to more Retailer failures.

Lastly, if the DMO is lowered too much, there is likely to be a flow on impact to market offer pricing in that Retailers may no longer compete very strongly below the DMO price level. As noted earlier, this is already occurring in most states. The AEMC found that this occurred with the VDO, "because price caps remove higher priced offers in the market due to reductions in line with the VDO, Retailers have less incentive and financial ability to offer lower priced market offers."¹⁷

1.4. Retail Allowance should continue to be set high to support innovation and investment

Retailers make investments in non-price elements of their electricity service to benefit their entire customer base. The associated costs of these investments should be recoverable from both Market and Standing Offer customers.

[Confidential:]

¹⁶ For example, 23 out of 25 of the lowest priced offers by Retailers are priced at or below the DMO in the Ausgrid zone

¹⁷ [2020 Retail energy competition review - Final report \(aemc.gov.au\)](https://www.aemc.gov.au/2020-Retail-energy-competition-review-Final-report), p 64

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The clean energy transition will require new investment by Retailers, separate to changes in generation mix. Retailers will increasingly need to ensure that electricity plans offered to customers support decarbonisation. These new de-carbonised retail products often apply across Standing Offer and Market Offer customers.¹⁸ A price regulatory framework that impedes these changes, will lead to a transition that is ultimately more costly than necessary for consumers.

1.5. Retail Allowance should not be reduced because it would remove a critical buffer for under-recovery in other parts of the cost stack

In DMO 4, the AER moved to a cost build-up approach for retail costs, using ACCC data for Retail Operating Costs. There were some advantages such as allowing the cost figure to be updated yearly, but also disadvantages due to ACCC retail cost data being a weighted average of only the 15 largest Retailers’ costs. Stakeholders raised concerns about whether the allowance for Retail Operating Costs was sufficient to reflect smaller Retailers, and some Retailers also raised questions as to whether the DMO adequately reflected depreciation and amortisation (D&A). In response, the AER relied on the Retail Allowance as providing sufficient buffer for any under-recovery. In its Issues Paper for DMO 5 it recognises this: “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”.¹⁹

If the AER were to now reduce the Retail Allowance, this would remove any buffer and result in an under-recovery of efficient cost and/or under-recovery of Retail Allowance. More detail is provided below.

	Issue	AER’s determination for DMO 4	Effect of reducing the Retail Allowance
1.	Higher Tier 2 Retailer costs	The ACCC has observed that Tier 2 Retailers have higher operating costs than Tier 1 Retailers and the overall average (\$57 higher than overall average Retailer costs). The AER conducted further analysis to test what impact a \$57 increase in retail costs would have on the available Retail Allowance. It finds that the Retail Allowance (EBITDA) is tight for DMO 4 (e.g. 2.7% in SA) but that by DMO 6 this improves and the Retail Allowance will be at least 6.2% above the notional Retail margin set by other regulators (however this is still far less than the full Retail Allowance of 10%)	The AER heavily relied on the Retail Allowance as a buffer to address these concerns. Reducing the Retail Allowance would remove this buffer meaning an under-recovery in cost for Tier 2 Retailers or further reductions in Retail Allowance when they won’t be receiving the full Retail Allowance in the first place.
2.	Depreciation & Amortisation	In setting Retail Allowances in DMO 4 under a cost build-up approach, the AER estimated the Retail Allowance as a percentage of the DMO 1 and DMO 3 prices. These were equivalent to EBITDA Retail margins, including D&A. The Retail Allowances of 10% and 15% provide Retail Allowances that are in aggregate equivalent to the amounts in DMO 1 and 3. The AER therefore concludes these Retail Allowances allow recovery of D&A expenses (p 37, Final Determination on DMO 4). The AER then tests its conclusion by adding depreciation costs based on two Retailers data to see what the remaining Retail margin would	Reducing the Retail Allowance could mean an effective reduction in D&A or insufficient Retail Allowance, where these Retailers would not be receiving the full Retail Allowance in the first place.

¹⁸ For example, EnergyAustralia’s solar feed-in tariffs and carbon offset program are available to Standing Offer customers and we are providing or trialling other plans, products and pricing that facilitate the further decarbonisation of the electricity and gas usage for our customers (our scope 3 emissions).

¹⁹ [AER - Default market offer - Price determination 2023-24 issues paper - 3 November 2022 0.pdf](#), p 19

		be and finds that the margins are in an acceptable range by DMO 6 (post glide path) (8-8.8%), although this is less than the full Retail Allowance of 10%.	
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1.6. Alternative to changing Retail Allowance: Remove Glide Path

We anticipate that if the AER were to make changes to the Retail Allowance, they would apply permanently, even after high wholesale costs end. We see an AER adjustment to the Retail Allowance as a high risk change with seriously detrimental impacts on competition and investment. The less risky approach would be to remove the glide path, which avoids permanent changes to the Retail Allowance. We note this would still have serious ramifications on Tier 1 Retailers. [

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2. Wholesale cost methodology issues

We agree with the AER's general approach to not adopt large scale changes to the DMO wholesale cost methodology, with the exception of gradually exploring potential changes for the South Australian market with multiple rounds of consultation aiming for a DMO 6 determination at the earliest.

2.1. Option issue for DMO 5

We wish to draw an issue to the AER's attention which was not canvassed in-depth in the Issues Paper. This issue is separate to using Options to calculate the DMO, which is discussed at 4.2 of the Issues Paper (which we do not support). Rather, our issue is about the expiry of call options for CAL23 swap contracts which would impact the DMO much more than in previous years. This would incorrectly deflate the wholesale cost calculation for the DMO, resulting in a Wholesale Electricity Cost component that is too low.

As the AER is aware, the DMO wholesale cost methodology assumes hedging contracts are bought for a Retailer's customer base in line with a conservative hedging strategy. It uses a trade weighted price for ASX contracts to estimate the cost of those hedging contracts.

On 20 November 2022 and 17 May 2022, a very significant volume of call options for swaps expired/will expire. For 20 November, this included a very large volume of call options which were in the money (3,000 MW) – i.e. gave the buyer a right to purchase the swap at a lower price than the prevailing market price for a swap. 2,000 MW of these options had a strike price of \$150 or below, compared to the market price at 20 November of \$205. Those call options were traded at the lower strike price, which will deflate the trade weighted contract price used in the DMO.

The crux of the issue is that the majority of the call options traded are not being traded from generators to Retailers for the purposes of building a hedge book for their customer load. Rather, the large volume of the option trades are most likely performed for financial purposes, by Retailers, financial intermediaries and speculators like investment banks.

This option expiry issue is material this year because of the higher volumes of options being traded and the escalation in contract prices in the market (i.e. the widening gap between the strike price and the prevailing market price). We will seek to provide the AER some data on the materiality of this issue.

One solution is to incorporate these volumes traded under call options, not at their strike price, but using the market ASX traded price on 20 November. Given the materiality of the issue, the AER should quantify its impact on the DMO. This issue should be fleshed out in the Draft determination on DMO 5.

2.2. Load profiles

We would like to see more detail around the AER’s proposal to change its use of Net System Load Profiles to alternative data either completely or on a mixed basis.

2.3. 75th percentile of modelled wholesale electricity cost outcomes

We question whether the 75th percentile decision in DMO 4 reflects the real world spot market volatility experienced in winter 2022, which culminated in the first market suspension by AEMO. We suggest that the AER should ask ACIL Allen to test whether the 75th percentile margin of error would cover the events of winter 2022, and if it does not, there is a strong case to revert back to the 95th percentile. Even after geopolitical events subside, the closure of thermal generation will likely continue to see volatility in future years throughout the clean energy transition.

3. Embedded networks

EnergyAustralia has an embedded network business which operates as an Authorised Retailer in NECF states. We fully support the extension of the DMO price cap to embedded network customers which are supplied by Authorised Retailers to close the regulatory gap for these embedded network customers. We also agree with the AER’s position to not extend the reference pricing requirements to embedded network customers as it would make complex billing arrangement even more onerous for little benefit.

From a practical perspective, we note the AER should adopt the simplest approach to extending the DMO as price cap to authorised Retailers selling to embedded network customers, to minimise the ongoing administration cost of the DMO. The DMO should be extended “as is”, with the current customer types and same customer usage profiles. This consistent approach will also be aligned with how the DMO currently applies to exempt sellers in embedded networks.

The AER validly identifies the issue around unbundled embedded network pricing. Where a customer within an embedded network moves “on-market” to a Retailer that sells to standard customers (on-market Retailer). In this situation, the customer buys their electricity from the on-market Retailer but then still ultimately pays the embedded network the network charges for the physical delivery of the electricity to the customer’s home. Shadow pricing regulation applies to the network charges to cap them at what a standard customer would pay in that distribution zone for network charges. There are two types of billing structures, which raise different issues as to how the DMO should apply.

	Pricing and billing	Implications for DMO
1	Pricing is unbundled so that the embedded network customer receives two bills , one from the on-market Retailer and one from the embedded network service provider.	<p>The DMO and this pricing construct is not “like for like”. The DMO covers both electricity usage and network charges, while this is separated and billed by two providers.</p> <p>As the DMO is a bundled price, inclusive of electricity usage and network charges, the on-market Retailer (charging the usage component only) will need to know what is being charged for the network charges to be able to deduct it from the DMO to determine what it can charge for usage. The issue is that the on-market Retailer will not know this. While shadow pricing regulation is a cap on network charges, the embedded network service providers can charge below it and the on-market Retailer will not know this charge.</p> <p>The simplest way to resolve this is to calculate a DMO for the usage component only so that the on-market Retailer can</p>

		comply with the relevant part of the DMO. The DMO does not need to specify a cap for the network charges, because the existing shadow pricing regulation covers this adequately.
2	Pricing is bundled by the on-market Retailer, which issues a single bill to the customer. In the back end, the on-market Retailer reimburses the embedded network service provider for network charges.	<p>DMO can apply "as is" because it is "like for like" with this pricing construct. i.e. a single bill with both electricity usage and network charges.</p> <p>The on-market Retailer has the information, i.e. they will know how much the embedded network service provider is charging for network charges (as they are sending the customer the bill), and will be able to calculate compliance with the DMO price cap.</p>

Attachment – Confidential