Stephanie Jolly
General Manager, Market Performance
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

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Default Market Offer 2022-23 Draft Determination

The Australian Energy Council ('AEC') welcomes the opportunity to make a submission to the Australian Energy Regulator's ('AER') *Default Market Offer 2022-23 Draft Determination* ('Draft Determination).

The Energy Council is the industry body representing 20 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia, sell gas and electricity to over ten million homes and businesses, and are major investors in renewable energy generation.

Given the position of the AEC as a representative of competitor businesses, we operate in strict compliance with the Competition and Consumer Act (the 'CCA'). The CCA prohibits the AEC discussing with members confidential information relating to costs and how they set their prices. This submission has been drafted in line with our CCA obligations and will focus on the methodology considerations raised in this Draft Determination. It does not consider the preferred methodologies of individual members. Our members will provide more detailed views on the issues raised in their own submissions.

The AEC does not agree with the decision in the Draft Determination to adopt a cost build-up approach for future DMOs, including DMO 4. We do not believe a reasonable case has been made for changing methodologies and it contradicts previous statements that the AER has made about the effectiveness of the DMO. Only in its most recent Final Determination for the 2021-22 DMO, the AER stated that indexation 'remains the approach best suited to achieving the DMO policy objectives, while also providing consistency and stability for stakeholders'.

We do nonetheless acknowledge that this is the direction the AER has taken and it is unlikely to reverse its position. It is critical that whatever methodology is used remains faithful to the objectives of the DMO, which is to act as a safety net that protects customers from unjustifiably high standing offer prices. It is *not* intended to be a competitive price that customers actively choose to be on. The AEC has concerns that some of the messaging used to justify this Draft Determination appears to reposition the DMO as an efficiently priced offer that customers benefit from being on. This type of outcome would be bad for disengaged customers, as they will be paying too much, and for engaged customers, as the AEMC has warned a low DMO will reduce competition and innovation.

Level 14, 50 Market Street
Melbourne 3000
GPO Box 1823 Melbourne Victoria 3001

P +61 3 9205 3100
E info@energycouncil.com.au
W energycouncil.com.au

ABN 92 608 495 307

Perceived precision of a cost-build approach
In trying to explain the shift to a cost build-up methodology, the Draft Determination states that it will provide 'greater transparency on the cost drivers in a market' and this is important given the pace of change of the energy transition. This type of argument reflects the claims of stakeholders who supported a cost build-up approach in submissions to the Options Paper. For example, Energy Consumers Australia said it will lead to 'transparency of retail costs and an amendment to information asymmetry'.

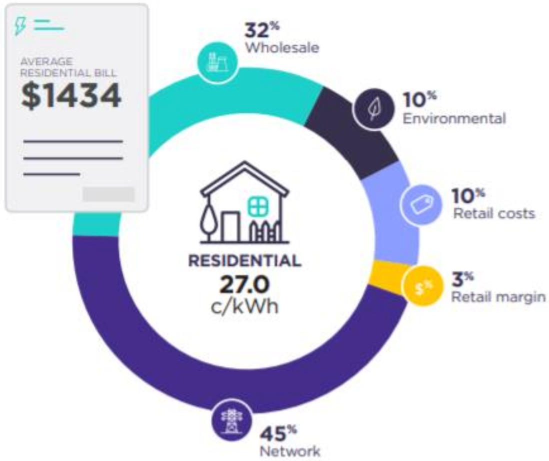
In other words, it is believed transparency will enable greater precision of retail data and this will, in turn, lead to a more efficient price setting. While a bottom-up methodology does give the impression of precision, the AEC is doubtful it will result in a more scientific calculation of retail costs. In submissions to the Options Paper consultation, retailers raised various concerns that the AER's intended approach for calculating retail operating costs – relying on ACCC data – is flawed and unsuitable for price setting. This is because the ACCC collects this data for market monitoring purposes, which does not require the same level of robustness as is needed for price setting. Some of the discrepancies include:

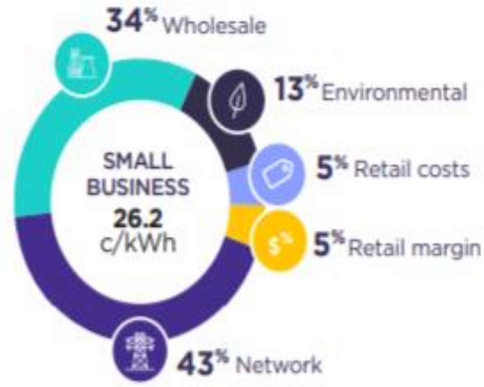
- Does not account for depreciation (we note the AER discusses this in its Draft Determination).
- Does not capture the full regulatory costs that retailers face to implement reforms (for example, the data being relied on does not consider Consumer Data Right or Better Bills implementation costs).
- There is no working capital provision in the Draft Determination, meaning there will be an undervaluing of holding costs given there is over a two-year lag from when these costs were reported by retailers (being in 2019).
- While this may be the result of unfortunate circumstance, the lag period is especially significant here because it means the retail data reflects the operating costs of retailers before the coronavirus pandemic began. It would not be reasonable to imply that pre-covid retail operating costs are the same as today.

The AEC does not raise these discrepancies to derail the use of ACCC data, but rather to encourage the AER to accept that the data is still imprecise. This is not a setback *per se* so long as the DMO maintains its original intent of being a safety net, rather than an efficiently regulated price. In line with this view, the AEC believes retail operating costs should be set with a degree of conservatism to avoid squeezing the ability of retailers to innovate and compete.

The AEC has considered alternative approaches to determining retail operating costs, noting that relying on a third party for data is not the approach taken when it comes to network costs. Some retailers have tentatively indicated interest in working with the AER to develop a cost template for retailers to complete to help determine their costs under the DMO. This may be practical given the ACCC will cease collecting retail data after 2025, however we also acknowledge it will impose a considerable regulatory burden on both the AER and retailers, and strain resources.

Whichever way retail operating costs are calculated, a bottom-up approach opens the door to politicisation. Arguments about greater 'precision' tend to be based on the premise that the DMO is too high, and the AER will now face sustained pressure to squeeze retail costs and margins regardless of how the data is collected. The AEC is confused by this intense focus on squeezing retailers that some stakeholders have, as retailer costs and margins are not a primary cost driver. The graphs below, sourced from the ACCC's November 2021 report, illustrate this clearly.





We encourage the AER to keep this in mind because a tightened margin of error will only hamper the capacity of retailers to price competitively into the market, leading to poorer outcomes for customers.

Shift to 75th percentile

The Draft Determination has proposed shifting from the previous 95th percentile estimate to a 75th percentile estimate. No evidence is given for this shift other than to say that the previous percentile was 'overly risk averse' and that a 75th percentile estimate 'manages wholesale forecasting risks appropriately'. The AER's consultant for designing the forecasting approach for wholesale and environmental costs, ACIL Allen, also appears to disagree with this shift, stating that it 'remains of the view that adopting a risk averse strategy is appropriate' and that 'choosing the 95th percentile reduces the risk of understating the true WEC [wholesale electricity costs]'. However, since the AER has determined and requested a 75th percentile be adopted, it has followed this approach. No reason is provided in ACIL Allen's report for why the AER has given the consultant this direction.

In terms of stakeholder views, only one submission to the Options Paper consultation (by Enova Energy) supported moving to a 75th percentile estimate, and this support was tentative and qualified by the strategy remaining risk averse. Their argument about the customer perspective is also disputable, since almost no customer would have a view on what percentile should be taken, and if they did, may prefer their retailer taking a risk averse approach if it insulates them from high wholesale prices.

The opaqueness over why the Draft Determination has proposed a 75th percentile does not align with the principles of best regulation that regulators are expected to meet. The Federal Government's [Statement of Expectations] states the AER should act with transparency and 'have an open and consultative relationship' with the entities it regulates. While the AER is being consultative, the reasons behind the decision it has made here are not open or transparent. This makes it difficult for stakeholders to provide views in return, leading to sub-optimal consultation. The AEC encourages the AER to provide stakeholders with clarity as to the reasons why it made this instruction.

Outside of these concerns about maintaining best practice, the AEC struggles to understand why the AER would now opt to lower the percentile, given the current and forecasted volatility of the wholesale price. Since the publication of the Draft Determination, two major events have sparked further fears about wholesale price fluctuations:

- Origin Energy announcing its intent to bring forward the closure of Eraring Power Station. This announcement led to Minister Taylor expressing his concern that the earlier closure of Eraring Power Station would lead to volatility in the wholesale market that risks higher prices.
- The geopolitical tensions in Europe have significantly and negatively impacted global energy supply chains. Fluctuations in international oil and gas prices are already being felt in Australia, and will lead to greater volatility in the wholesale market, as coal and gas prices soar.

The effects of both these events are ongoing and increase the risk retailers face when purchasing wholesale energy. In this context, the AEC does not agree with the shift to a 75th percentile and encourages the AER to revert to the original 95th percentile. If the AER does maintain that a 75th percentile is the way forward, then it should provide retailers with a volatility allowance to compensate for fluctuations.

Changes in retail allowances

The Draft Determination proposes new retail allowance caps for DMO 4, being a 10 percent retail allowance for residential customers and a 15 percent retail allowance for small business customers. These allowances will be uniform across jurisdictions. Repeating the concerns expressed elsewhere in this submission, the analysis to explain how the AER settled on these figures is not comprehensive. In fact, the AER acknowledged at its DMO Online Forum on 9 March that the proposed allowances were somewhat of a judgment call.

While we are not necessarily opposed to the allowance caps proposed, this element of subjectivity concerns the AEC because it does not provide any certainty about the future trajectory of these caps. ECA already foreshadowed its intent at the Online Forum to challenge the retail allowances as too high, both in terms of comparing it to other jurisdictions, and to each other (i.e. small business should be the same as residential). Consumer groups will inevitably do the same based on their previous submissions.

Since there is no public formula to determine retail allowance that stakeholders can debate, this means it is somewhat of a lottery which future direction the AER takes, and again opens the door to politicisation. It was mentioned earlier that retail margins are often put under the spotlight – despite being the smallest cost component of the bill – and this is now going to intensify.

These concerns about future tightening of the retail margin are exacerbated by the transition pathway the AER has taken. Essentially, where retail margins have dropped, the effect is immediate (i.e. part of DMO 4), while where retail margins have increased, the effect is gradual and scaled over time (i.e. up until DMO 6). The AEC accepts the need to protect customers from bill shock, but it does pose a dilemma if the AER elects to tighten retail margins further in DMO 5 or 6 – especially in Energex or SAPN regions – where retailers have planned for an increase.

Peer review of wholesale methodology

The AER has stated its intent to seek a peer review of the wholesale forecasting modelling. It was further explained at the DMO Online Forum that Frontier Economics will be engaged to perform this review. The AER would be aware that Frontier Economics are the consultant responsible for forecasting wholesale electricity costs under the Victorian Default Offer and that their methodological approach differs largely to that of ACIL Allen. The AEC has previously commissioned work, by ACIL Allen, that analysed the methodological approach of Frontier Economics and found it underestimated wholesale costs.

Level 14, 50 Market Street
Melbourne 3000
GPO Box 1823 Melbourne Victoria 3001

P +61 3 9205 3100
E info@energycouncil.com.au
W energycouncil.com.au

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Given it is a matter of interpretation over what elements will be material in a future price setting process, there needs to be full public transparency about the scope and intent of this peer review. This is so stakeholders are aware of what it is trying to achieve and what weight the AER will place on its findings.

Noting that the AER encouraged stakeholders to comment on the wholesale methodology in submissions, the AEC reiterates support for the ACIL Allen model and believes it more accurately captures costs than the model used in the VDO. Our reasons for this are explained in the commissioned work linked above.

Any questions about this submission should be addressed to Rhys Thomas, by email to Rhys.Thomas@energycouncil.com.au or by telephone on (03) 9205 3111.

Yours sincerely,

Ben Barnes
General Manager, Retail Policy