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AEC Submission to 2026–27 Default market offer Draft determination

The Australian Energy Council (AEC) welcomes the opportunity to make a submission in response to the 2026–27 Default market offer Draft determination (the Draft determination).

The Australian Energy Council is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. AEC members generate and sell energy to over 10 million homes and businesses and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 per cent emissions reduction target by 2035 and is committed to delivering the energy transition for the benefit of consumers.

Allowing efficient cost recovery

The AEC recognises that the regulatory reforms to the Default Market Offer (DMO) were likely to result in some methodological changes. However, the cumulative impact of the changes proposed in the Draft determination are highly material and have the potential to impact retailer viability and reduce the scope for retailers to develop attractive market offers. This could in turn undermine the competitive dynamic of the retail market, to the detriment of those consumers who actively participate in the market.

Accordingly we urge the AER to consider its decision holistically and to ensure that retailer viability is maintained, noting that the DMO is largely an *estimate* of efficient future costs and actual costs may turn out to be different. If they turn out to be lower, that will be reflected in competitive market offers that emerge through the period, and so many customers will still get the benefit. But if they are higher, then retailers are at risk of being unable to recover their efficient costs and at worst exit the market. So the outcomes are highly asymmetric.

In any case there are several individual components of the cost stack which we consider are not consistent with the requirement of the DMO to allow a retailer to recover their efficient costs.

Network costs

Retailers do not control network costs and currently have a limited set of tools to manage risks associated with network tariffs. Many of the tools that are available are dependent on customer take-up, which is unlikely to occur for DMO customers, who are by definition, disengaged customers. Accordingly we consider it is essential that:

- Retailers are able to recover the actual network costs they face, i.e. they must be built into the DMO cost stack.

- Retailers are able to pass through the network tariff structure. This is especially important for regulated tariffs. Retailers can and do make market offers that don't pass through, but that is only when they are confident that they can manage the mismatch appropriately, and they have the option to reprice the offer¹ if the risk exposure turns out to be higher than anticipated.

The Draft determination fails to meet these conditions in several ways:

- the “lowest network tariff” approach to the DMO cost stack;
- controlled load fixed charges are treated as if variable, and;
- the solar sharer tariff by definition doesn't include network charges for the free period.

We recognise that part of the issue with the solar sharer is inherent in the policy design and so we discuss the broader issues with the solar sharer separately.

The “lowest network tariff” is a material issue in the DMO Draft determination. Worryingly from a process perspective, this approach was not canvassed in the issues paper, which instead considered a “blended tariff” option. The AER asserts that it is appropriate for them to “apply the lowest applicable network tariff for the flat rate tariff because retailers can use either a flat rate or time of use tariff for flat rate tariffs”. This glosses over a number of practical challenges.

Retailers would not typically seek to assign a flat rate customer to a time of use network tariff. This would create a mismatch between costs and revenues, and thus a load profile risk that they have limited opportunity to mitigate, especially with the type of disengaged customer that the DMO is created for. This risk cannot simply be diversified away either, especially for smaller retailers. If next summer is hotter than average, then most or all customers will have higher load than usual during peak periods. Under the AER's proposal, retailers will be unable to recover their efficient costs of serving this additional load, because of the mismatch between their costs (determined by time of use network rates) and revenues (flat rates).

Aside from the mismatch risk, retailers also face an absolute loss on flat rate customers in some network zones under this approach. The difference between flat and time of use network tariffs could be up to \$125pa for some customers in some zones. Mitigating this risk through tariff reassignment as suggested by the AER is not straightforward. Flat rate customers will currently largely be on flat rate network tariffs. Tariff reassignment is not an instant “flick the switch” process, especially when it needs to occur *en masse*. Many flat rate customers will still be on accumulation meters, and so the retailer will need to incur the cost of meter replacement which takes time. And then in any case, the retailer is stuck with the mismatch risk as described above.

Conversely, in the Ausgrid/Endeavour zones, the problem retailers face is mandatory reassignment to time of use network tariffs once a smart meter is installed even if the customer wishes to remain on a flat tariff (noting that there is a 12 months lag to the switch in Endeavour's network).

The AER's view that the 12 month lag in Endeavour will lead to over recovery in the case where the customer chooses a time of use tariff reveals a lack of understanding of the mismatch risk. It's unlikely that a retailer would want to take on the mismatch risk for the possibility of saving a few dollars on sticking with a flat network tariff when the customer is on a time of use tariff. If a customer has chosen a time of use tariff, they are highly likely to either be already consuming proportionally more than average in off-peak times or intending to shift load into those times. But the retailer will under recover against off-peak consumption if it remains on a flat network tariff for those 12 months.

¹ i.e. change the offer for new customers, or change once annually for existing customers.

Given that discounted market offers are benchmarked off the DMO, the under recovery issues identified above are in practice not confined to customers on the DMO, but will impact retailers' costs and margins more broadly.

The AEC observes that these challenges arise because of the combination of a range of policies and regulations relating to smart meter installation, network tariff design, mandatory network tariff reassignments, prohibitions on retail tariff reassignments without customer consent, and regulated tariff setting, none of which are the fault of the retailer. This arises from the failure of policymakers to take a holistic approach to policy settings or adequate consideration of the flow on consequences of individual reforms. While the costs and risks emerging from this failure would be best avoided, given they exist, fairness demands that they are shared more widely than putting them entirely on retailers.

While our first best approach is to use the network tariff that corresponds to the shape of the relevant DMO (Flat -> flat, ToU -> ToU), we recognise the AER's concern that some customers may be "missing out" on lower costs in this case. Accordingly we consider that second-best approaches could include a combination of:

- A blending approach to network costs, along the lines of the approach consulted on in the Issues Paper
- A transitional approach that allows retailers time to process tariff reassignment and install meters where necessary. This could start with either a blended approach or the corresponding tariff approach and move to the "lowest cost" tariff approach by, say 2030, when full smart meter penetration is expected.
- Progressive equalisation of the flat and ToU networks tariffs through the annual network tariff setting process. It's unclear to the AEC why networks and the AER can justify a large cost differential for the *average* consumer between flat and ToU tariffs.

Additionally, we have identified that the AER's calculation of the controlled load cost stack includes fixed network charges treated as if they were variable. For customers using less than average, a retailer will under recover its efficient costs. This should be remedied for the final determination.

Wholesale energy costs

The AEC and its members have previously argued against the reduction in wholesale energy costs (WEC) arising from choosing the 50th percentile of the expected costs of hedging customer load. There is always a material uncertainty about what retailers' actual costs will be and the AER's requirement to make its calculations in time to include in its final determination means that it has to cut-off its data earlier than a retailer would in practice cease its bookbuild. This is well explained by the AER's consultant in its wholesale energy analysis. "In practice, retailers will continue with their bookbuild well after the determination date – with ASX Energy closing trades on the preceding day of the last day of any given quarter²". Taking this into account, the back casting exercise to compare "actual" WEC – noting this is still a construct – with the allowance indicates that the 75th percentile estimate is very close to actual – the difference being only 1.5 per cent across NEM regions. Notably in two of the five regions actual WEC is higher than the 75th percentile. By contrast, the 50th percentile estimate is lower than the actual WEC, indicating its unsuitability as the benchmark in the DMO.

If retailers were systematically beating the WEC benchmark by procuring energy at a materially lower cost than assumed in previous DMOs, this would presumably show up in actual margins. Yet, as the ACCC has documented, average margins are typically below regulatory assumptions in the DMO and elsewhere. While

² Wholesale energy and environment cost estimates for DMO 8 Draft Determination, ACIL Allen,

this is partly explicable by retailers competing for customers through discounted offers, that is unlikely to be the whole story.

As the AEC and its members explained in submissions to the issues paper, retailers are facing a wide range of risks, and wholesale price outcomes are likely to skew to the high side. Since those submissions, it has emerged that the NEM is facing an elevated risk level due to the global fuel crisis as a result of war in the Middle East. It is of course too soon to tell what the longer term impact will be, but the situation presents as an inopportune time to aggressively reduce the WEC.

Finally, the AER should account for the asymmetry of impacts if their benchmark is too high or too low. If the benchmark is set too high, then the minority of customers on the DMO will pay slightly more than otherwise. Other customers may not, because retailers will be able to make offers at a higher discount to the DMO. Conversely, if the benchmark is set too low, retailers will be unable to recover their costs and at the margins, some risk going under.

Accordingly we consider that it is entirely consistent with an efficient cost benchmark to retain the 75th percentile approach. Should the AER decide to stick with the 50th percentile, then the inclusion of the volatility allowance is essential to give retailers a realistic chance of achieving the WEC benchmark.

Retailer operating costs

A key concern with the retailer operating costs (ROC) methodology is the lack of transparency of how the AER arrives at its figures. We appreciate the stated methodology is simply a weighted average with outliers removed, but in some cases our members cannot reconcile their experience of their own costs with the movements in the ROC benchmark. This is especially the case where these members are tier 1 and thus should make up a significant portion of the weighted average. In particular the Energex reduction of \$51 pa in the Energex zone is not consistent with members' experience of their own costs.

One specific component of the ROC that risks being underestimated where it is based on historic cost is bad debt costs. The period from which the data is drawn includes a period when bill subsidies for households were made available by state and commonwealth governments. This would have led to lower bad debt outcomes than normal. Energex zone is the most impacted due to the Queensland government's large bill credit. We consider that this issue could best be avoided by reverting to the previous approach of using retailer provisions for bad debt, which can be more reflective of long-term trends than historical data when that has been impacted by government subsidies. Alternatively, if the AER is committed to using historical data, it may be possible to use older data from periods preceding the bill subsidies, adjusted for price escalation.

Solar sharer

We recognise that the AER is constrained by the requirements of government policy in setting a solar sharer DMO tariff. This requires the AER to address the allow recovery of the efficient level of actual costs retailers still face during the free period, by reallocating them to the other 21 hours. In order to do this, AER has to estimate how effective the policy will be, i.e. how much customers on the solar sharer will load-shift in response to the price signal of free electricity. Remarkably, and inappropriately, AER assumes that solar sharer customers will have the same load profile as other TOU customers. In other words, AER is acting as if the policy will be a failure. This is unlikely. Even apart from any actual load shifting, it is reasonable to suppose that customers who take up the solar sharer are likely to be those that already have a load profile oriented towards the free period and who will benefit without taking any additional action. This is after all how the better offer requirements are intended to work. While we recognise the challenges of making a reasonable initial estimate of a solar sharer load profile, it must be based on the assumption that solar sharer customers

will consume more in the free period than an average customer. To assume otherwise is to deny retailers the opportunity to recover efficient costs.

To illustrate the extent of this issue, we attach some analysis carried out for the AEC by Endgame analysis, quantifying how a retailer will under recover its variable costs if solar sharer customers have a different load during the free period than the typical customer. As this analysis is based on a retailer's actual costs, we request that the AER treat the analysis as confidential.

We note that in assuming no load shifting, the AER is only delaying the inevitable. It will be even more inconsistent with the requirement to allow recovery of efficient costs if the AER continues with this assumption once there is evidence of the actual load shifting SSO customers engage in. It will have to set future SSOs on the actual load profiles of SSO customers. This means that the only customers better off on the SSO are those who load shift more than the average. Either low shifting customers will defect back to an offer that better suits them and the average will keep rising year on year or (because only low engagement customers are going to be on a default offer) they won't notice (even if retailers send them comparison notices) and will be worse off than if they'd stayed on a flat default offer. Fundamentally this issue will not be addressed unless policymakers address the underlying costs in the free period. Primarily this relates to network tariffs, but retailers also incur modest levels of other costs, including market fees and environmental/efficiency scheme costs on a per kWh basis. To make the solar sharer fully effective, all these costs would ideally be removed from the three "free" hours.

In the meantime the best that the AER can do to minimise this issue is to ensure it bases the solar sharer on the lowest network tariff for those three hours for each network, which is typically a time of use tariff, and make a realistic estimate of the level of load shifting that will occur.

Additionally the existence of other costs, especially network costs, mean that retailers will face a significant loss on customers who max out the "fair use" levels of consumption during the free period. We estimate this could be as high as \$1800 pa in the Ausgrid area. Accordingly, in order to allow retailers to partially recover these losses, the tariffs for consumption above fair use should be set above marginal costs. For example, and for simplicity, they could be set at the same level as tariffs for the peak period.

Retail margins

The regulated retail margin in the DMO acts as a ceiling on margins. ACCC data illustrates that retailers on average actually attain lower margins than the regulated benchmark. Frankly such margins are unlikely to be sustainable, and do not represent a reasonable benchmark but are evidence that the competitive dynamic benefits customers overall by compressing costs and margins.

We recognise that the regulated margin of 6 per cent is comparable with other regulators' benchmarks. Nonetheless it is salient to recall that margins are based on risk. Key elements of the Draft determination, such as the "lowest network tariff" issue explained above, and the unrealistic assumptions of no load shifting in the solar sharer DMO, expose retailers to risks not present in other regulatory decisions. While we consider it essential that such issues are directly addressed, if they are not, then 6 per cent is an inadequate margin for the risks faced by retailers under the AER's decision.

We further recognise that the gap in previous years between margins between residential and small business customers was to some degree an artefact of the way the DMO was set. Nonetheless, in the light of the significant changes to other components of the cost stack, to reduce the margin on small business tariffs from 11 per cent to 6 per cent in one go represents a very significant shift. We urge the AER to consider a glidepath approach to step down margins over multiple DMO periods to allow retailers to adjust.

Compliance issues

The growth in the number of DMO tariffs, the overall cap and related regulations such as the better offer notification requirements all interact to make it onerous and resource-intensive for retailers to update their systems in order to ensure their tariffs, overall bills, and customer communications are all fully compliant. We expect that the tariffs arising from the Final determination will only be published on 26 May, allowing less than five weeks to be fully compliant in time for 1 July. Accordingly, we expect retailers to face substantial compliance challenges. As we do not expect the AER to issue any industry-wide relaxation of compliance requirements, we will leave it to our individual members to liaise with the AER on their specific challenges.

Any questions about this submission should be addressed to Jo De Silva, General Manager Retail Policy by email to jo.desilva@energycouncil.com.au or by telephone on 03 9205 3100.

Yours sincerely,

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