AUSTRALIAN **ENERGY** COUNCIL

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**Default Market Offer 2023-24 Issues Paper**

The Australian Energy Council ('AEC') welcomes the opportunity to make a submission to the Australian Energy Regulator's ('AER') *Default Market Offer 2023-24 Issues Paper* ('Issues Paper').

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.

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 Issues Paper. 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 has, to date, sought to engage constructively with the AER and stakeholders to minimise the risks of price regulation and ensure the DMO methodology aligns with its objectives. Part of this process involved having a transparent and predictable methodology that gave market participants confidence in the prices set. Unfortunately, this confidence is increasingly hard to maintain as recent changes to the methodology are opaque, hard to follow, and appear to indicate growing politicisation of the price setting process.

In the AEC's view, this is going to become a recurring problem for the AER as price regulation has meant the Federal Government has effectively taken ownership of prices. While this might not matter during periods of flat or low prices, price spikes – like we are experiencing now – are leading to contrived methodologies being put forward to artificially supress prices.

The dangers of this recently played out in the United Kingdom, where artificial price caps eventually placed too much pressure on the market and contributed to a domino effect of retailers falling over. The collapse of the retail market was then exacerbated by Russia's invasion of Ukraine, which saw wholesale prices skyrocket, and eventually forced the UK Government to announce a $AU233 billion support package for customers to manage their electricity bills.

There have been some tentative warnings about Australia repeating the UK's experience. While the AER has shown awareness about this, the Issues Paper seems to downplay the risks to the Australian retail electricity market: 'while there has been a significant increase in the number of ROLRs in 2022 compared to previous years, we estimate that this has affected around 0.3% of the total market'.  The challenge for

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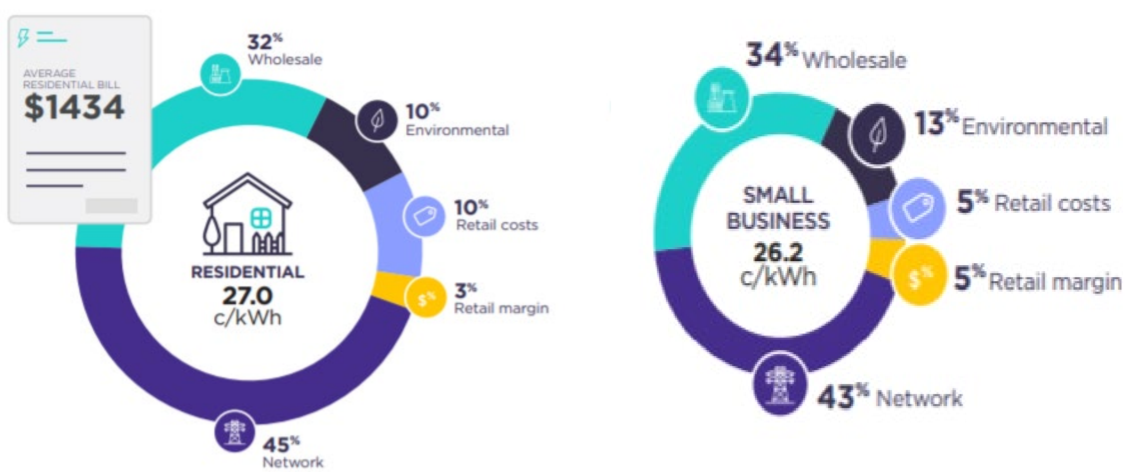
the AER is that it cannot afford to be reactive. It is inconsequential that only 0.3% of the total market has been affected now if an artificially capped price triggers a larger market crisis later.

**Retail allowance**

DMO 4 provided a "transition pathway" or "glidepath" for how the retail allowance would be allocated over time in each distribution area. This glidepath was intended to give certainty to market participants going forward given the level of scrutiny the retail allowance element in any cost stack receives. The AEC raised concern during the previous consultation that the glidepath will probably have the opposite effect: 'since there is no public formula to determine a 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'.

These concerns appear to hold true, as the Issues Paper is essentially asking stakeholders to consider how the retail allowance might be revised down to control increasing electricity prices. The problem with this approach, which the AEC has stated many times, is that the retail allowance is not a major contributor to electricity prices and treating this aspect of the price stack as effectively optional creates stability risk in the retail market, to the potential detriment of customers in the longer term. The images below, sourced from the ACCC's November 2021 report, illustrate this clearly.




This cost breakdown was compiled before the surge in wholesale and network costs, so it is probable the retail margin represents an even smaller percentage under today's market conditions. The AER has stated in its Issues Paper that large increases in wholesale and network costs are what is driving higher electricity bills. The tightening then of the retail allowance will only handicap the ability of retailers to price competitively into the market, while providing little bill relief to customers.

This does not align with the DMO objectives to enable competition and retain incentives for customers to engage in the market. It also does not go any way to meeting the DMO's other key objectives of ensuring customers are not charged unjustifiably high standing offer prices and that customers are protected from unreasonable prices. It seems a challenging case to make that the AER's own decision made less than 6 months ago represents an 'unreasonable' outcome – further illustrating the AEC's concerns that the question being asked in the Issues Paper is less about concerns regarding the dollar increase in the retail component, and more about a political need to ensure the DMO is perceived as being as low as possible.

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Notwithstanding the above concerns, what is clear in the current electricity market is that retailers are playing a much greater role in protecting customers than what was previously expected. Throughout the Covid-19 pandemic, retailers upheld the protections in the AER's Statement of Expectations, even though it invited considerable debt risks. At the time, the limited ability to recover debts was partially offset through government subsidies that provided customers with greater income – ultimately, allowing some customers to pay their electricity bills quicker than otherwise. With the conclusion of direct financial support to customers, incomes are once again lower and those who were paying their bills are now less able to do so.

This is worsened by the rising cost of living, driven by inflation, which is placing further challenges on customers, and in turn the ability of retailers to recover debt. As the sole debt managers in the NEM, retailers are being asked to carry vastly higher debts, at a time when their costs of procuring electricity are also vastly higher. The retail allowance is intended to cover the cash flow challenges these types of situations create.

Furthermore, and as has been well publicised, smaller retailers may currently be less able to access adequate working capital and clearing house services to make the forward market purchases they need to hedge their customers loads. The retail allowance is currently being used by the AER to mitigate these increases. If reduced, the AEC's expectation is that a similar allowance is introduced into the methodology to de-risk a retailer's exposure to higher costs of debt and contracting compared to previous years.

Finally, at the AER's recent public forum on the Issues Paper, the AEC's presentation highlighted that the risk of a poor regulatory decision is much higher for retailers than customers. Energy prices are a significant concern right now for households and businesses, but the DMO is not the right tool to provide direct support. The experiences overseas illustrate the type of market outcomes that can occur from poor regulatory decisions, and customer support must be kept separate to what should be mechanical price setting decisions. In the UK context, while bills are being reduced through several Government-led policy decisions, they are doing so alongside, not through the price capping mechanisms. The price cap itself is unaltered, with Government subsidies discounted off the final regulated price.

**Wholesale methodology**

The AEC welcomes efforts from the AER to continue to stress test its methodology for setting the wholesale electricity cost (WEC). However, we do not consider there to be sufficient evidence at this time that a materially different methodology would deliver better outcomes for retailers or customers. While the Frontier paper highlights some changes that could be made, it does not provide clear guidance on whether such changes would lead to a more reflective WEC. In the current market environment of dramatically heightened risk for retailers, making changes in the hope that they might end up being more reflective of retailer costs seems fraught.

That said, the AEC continues to see merit in making incremental amendments to the AER's WEC approach to provide greater confidence to retailers that the methodology is broadly aligned to what they can achieve in practice. At a minimum this includes continuing to move away from "black box" proprietary models towards publicly replicable approaches and reconsidering the volatility allowance where a change in market volatility is evident.

In DMO 4, the AER opted to change its previous approach from factoring in the 95$^{th}$ percentile outcome in its consultant's WEC model, to instead factor in the 75$^{th}$ outcome. This decision in effect meant that the DMO – which had provided retailers with confidence that in almost all modelled outcomes, they would be able to recover their WEC – now only allowed such an outcome in three out of every four years. In the current market, even a 95th percentile approach would have likely been below the actual costs; using the 75th has made it almost certain that the WEC in DMO 4 was materially lower than actual costs. The AER should consider undertaking a post-review of its modelled outcomes to determine the level of risk a retailer that did hedge at the 75th percentile would have faced, including whether they would have been exposed to a RoLR event.

Given the current market conditions, it would be prudent for the AER to revert to the 95th percentile to provide retailers greater certainty in what will clearly be a volatile period for electricity prices. This additional certainty would benefit customers by "unlocking" more value than would otherwise be the case from engaging with the competitive market to seek out a cheaper energy deal. The challenge that has been illustrated since 1 July 2022 is that when the DMO does not allow retailers to recover the costs of a new customer, competition is materially affected, and customers are much less able to reduce their energy costs through engagement. In effect, it results in more customers paying more, to ensure the declining percentage of customers on the DMO pay marginally less than is efficient.

Finally, the AEC has concerns with respect to the potential expansion of the AER's methodology to include more exotic trading tools, such as options. While not clear in the Issues Paper, it is assumed this refers to Asian Options as traded on the ASX futures market. It is the AEC's view that the use of exotic instruments is not fit for purpose for a prudent regulatory model. While some retailers may utilise options (if they are available to them) to minimise their exposure to wholesale risk, there are many who will not. There are also likely many financial traders with no NEM exposure purchasing these instruments speculatively, impacting the reliability of their price for the purpose of costing in physical hedging. Including Power Purchase Agreements ('PPA') seems equally inappropriate as these contracts are about negotiations between two specific counterparties and their sharing of risk. PPA information then is not relevant to the price setting methodology, which changes year on year.

For these reasons, the AEC encourages the AER to continue to rely on those instruments with greater certainty of cost, benefit, and outcome as is the case with the baseload, peak, and cap futures markets.

Any questions about this submission should be addressed to Rhys Thomas, by email Rhys.Thomas@energycouncil.com.au or mobile on 0450 150 794.

Yours sincerely,

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