



EnergyAustralia

LIGHT THE WAY

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AER Default market offer prices 2024-25 Issues paper - Public version

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 more than 5,000MW of generation capacity.

EnergyAustralia welcomes the opportunity to make this submission to the AER's Issues Paper on the Default Market Offer for 2024-25 (DMO6). Overall, we encourage the AER to maintain regulatory consistency on the DMO retail allowance. To preserve incentives for retail competition - which the AER seeks to better achieve in DMO6, the retail allowance should not be set at a lower level than the current approach. Our view holds even if the AER splits the retail allowance to an efficient margin percentage plus a fixed competition allowance amount. Regulatory consistency around the DMO and having sufficient retail allowance headroom remains paramount in providing the stability and environment for retailers to invest in customer solutions now and throughout the clean energy transition.

We outline our views on the retail allowance and other DMO6 cost and considerations in our full submission below.

If you have any questions in relation to this submission, please contact me (maria.ducusin@energyaustralia.com.au or 03 9060 0934).

Yours sincerely,

Maria Ducusin

Regulatory Affairs Lead

EnergyAustralia submission

1. Retail allowance

Maintaining competition requires consistency in the retail allowance at minimum

The AER has identified several reasons that reflect the need for, and importance of enabling competition, innovation and investment by retailers and incentives for consumers to engage in the market. These observations include:

- The unprecedented number of retailer exits in recent period. There are 11 retailers that exited the market through the Retailer of Last Resort Scheme between 1 May 2022 and 31 July 2023 and the lack of new market entrants due to current market conditions could weaken competition in retail markets.¹
- The slower rate at which smaller retailers continue to improve market share (away from the Tier 1 retailers).²
- The decline in the spread of market offer prices, which suggests that there's less value for consumers to shop around.³

Given the above, it follows that to maintain incentives for retail competition - which the AER is seeking to do, the DMO price and retail allowance should not be set at a lower level than the current approach. Doing so could discourage new entrants from entering the market and retailer investment in innovative products and services. This is critical for the clean energy transition.

As the AER is aware, the current DMO residential retail allowance of 10%, does not translate to retailers' margins (EBITDA) being close to 10%. The ACCC reported the electricity retailer NEM-wide margin for residential customers was 2.5% for FY22.⁴ This is lower than the annual yields on 10-year Commonwealth Government Securities (CGS) over 2023 (to mid-July) which averaged around 3.6%.⁵

Figure 1 below shows EnergyAustralia's residential EBITDA for DMO regions as a percentage of its cost stack and compares this with non-financial corporate 10-year bond yields. Comparing retailer EBITDA to non-financial corporate bond yields can be used to gauge the relative profitability of retailer's operations compared to conservative and market grade investment options that reflect prevailing interest rates and broader economic conditions. [



¹ AER, *State of the Energy Market 2023*, 5 October 2023, p. 246.

² AER, *State of the Energy Market 2023*, 5 October 2023, p. 244.

³ AER, *State of the Energy Market 2023*, 5 October 2023, p. 19.

⁴ ACCC, *Appendix D – Supplementary Excel spreadsheet with cost stack data and charts – November 2022 report*, D14.7, D 14.10, D 14.13.

⁵ RBA, *Capital Market Yields – Government Bonds- Daily -F2*, Reserve bank of Australia; AER, *State of the Energy Market 2023*, 5 October 2023, p. 110.

Figure 1



Figure 2 below shows EnergyAustralia's EBITDA for small business customers for DMO regions as a percentage of its cost stack and compares this with Victoria. [

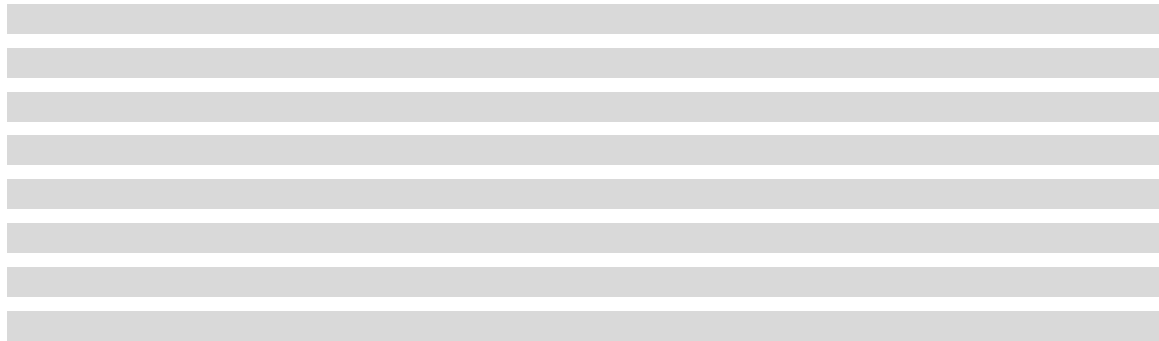
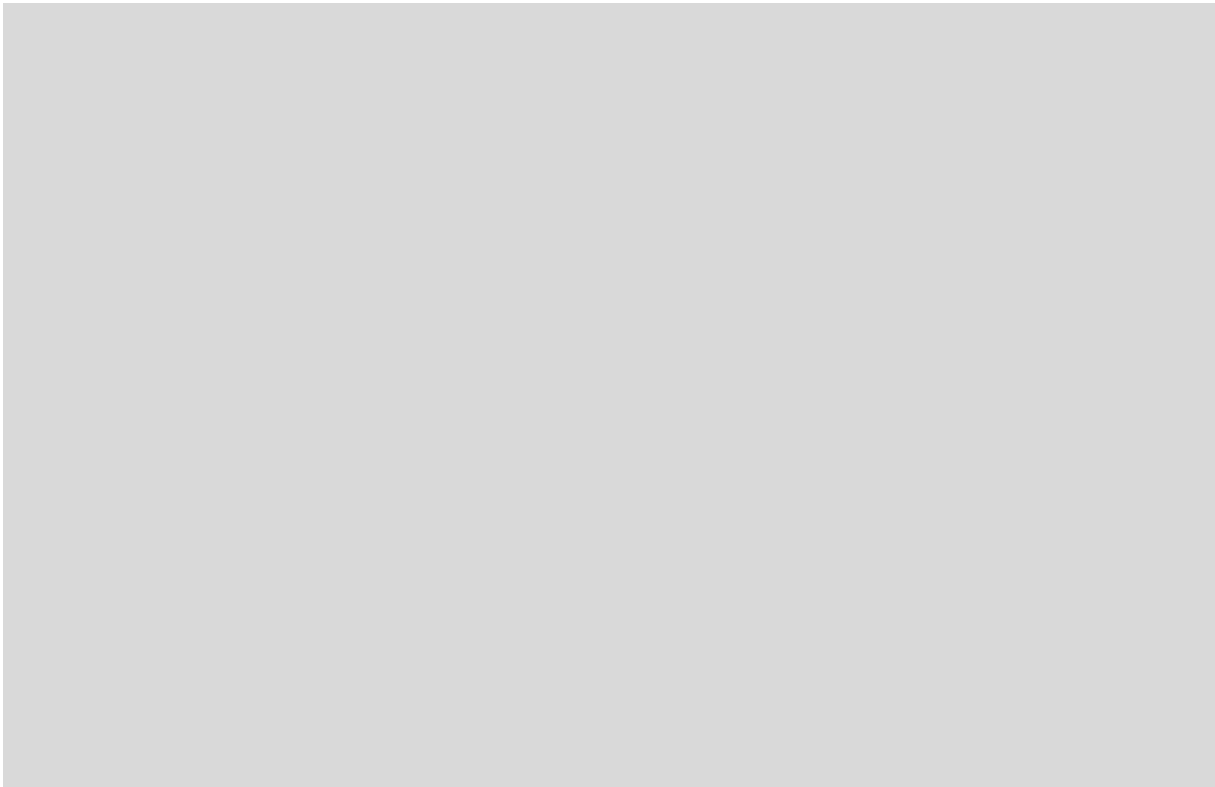


Figure 2

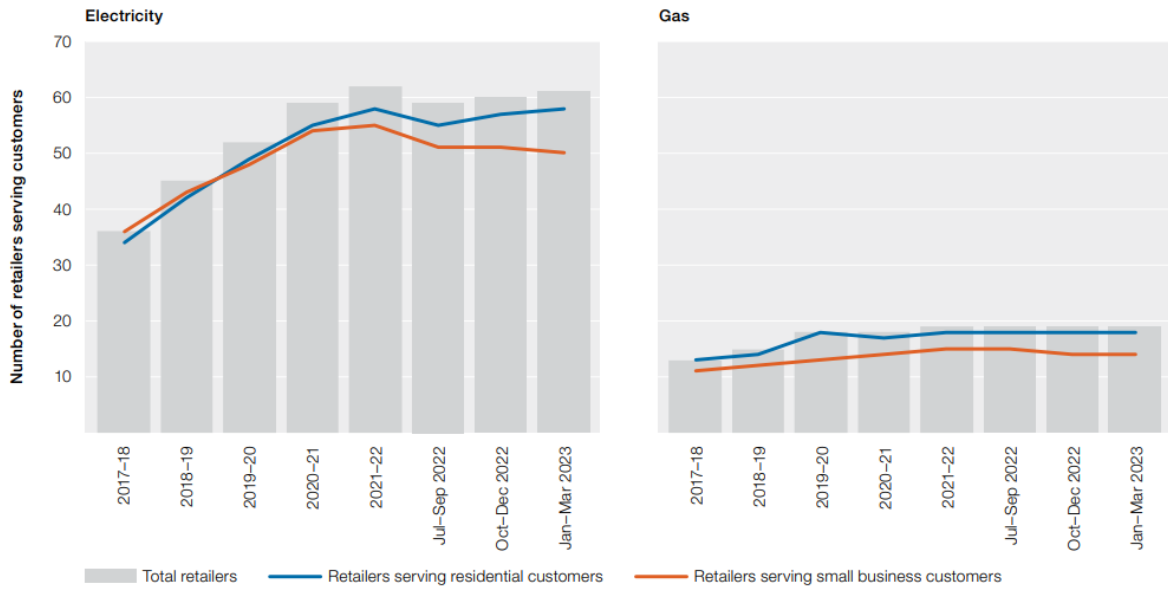


We do not support moving away from the current retail allowance approach that maintains small business and residential customer as separate. Small business and residential customers reflect different cost risks. For example, small businesses customers have higher bad debts on average than residential customers. Maintaining separate categories enables retailers to reflect the different risks associated with each group of customers.

Given the above, we consider that at minimum the AER should maintain the small business allowance of 15% if the AER seeks to maintain incentives for competition.

The AER has identified in its figure 7.16 below that the number of retailers servicing small business customers has remained lower from its peak in 2021-22. In an environment of low margins, this may be a basis to increase the small business retail allowance to encourage more retailers to enter and create incentives for retailers to invest in customer solutions critical for the clean energy transition.

Figure 7.16 Energy market – number of retail brands



Source: AER, Quarterly retail performance report, Q3 2022-23, June 2023; ESC, Victorian energy market dashboard, accessed 30 June 2023.

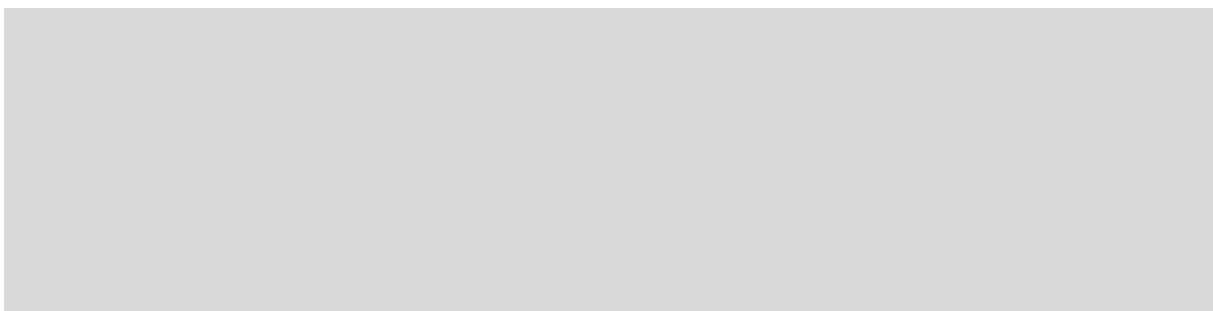
Low retailer margins reflect the level of risk and degree of competition

The AER’s internal analysis on market offers at or below the DMO may help assess the competitiveness of the electricity retail market but it can be misleading as it provides limited perspective on its own. It primarily focuses on consumer-facing aspects of the market such as pricing and discounts and does not consider the broader financial health and sustainability of retailers.

It is important to balance consumer-centric metrics with other considerations such as the impact of external market conditions and financial metrics like EBITDA. On these other considerations, the AER has already identified that:

- 11 retailers exited the market in the past 18 months.
- retailer’s NEM retail margins (EBITDA) for residential customers have gradually declined from a peak of 8.9% in 2016-17 to 2.5% of total costs in 2021-22 as reported by the ACCC to be the lowest retail margin on record.⁶

Electricity retailer margins can reflect both the level of risk in the energy markets and the degree of competition. [



⁶ ACCC, November 2022 report, Figure 4.5; Figure D14.1, Appendix D.



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In the final determination for DMO5 the AER noted that higher retailer costs do not appear to have prevented Tier 2 and Tier 3 retailers from competing aggressively on price.⁷ Consequently, to maintain these incentives for competition, the AER should maintain the level of the retail allowance. A reduction in retail allowance could lead to diminished profitability for retailers and ultimately less favourable outcomes for consumers. If anything, the above provides a basis to increase the retail allowance particularly given market conditions are likely to be more challenging and volatile with the clean energy transition.

As the retail allowance is currently set at as a percentage of the DMO price, any increase in the riskiness of providing retail services should lead to an increase in the retail margin, and reductions in the riskiness of electricity retailing should lead to a fall in the retail margin. DMO 5 saw a trade-off in short term over longer term objectives which we believe should be adjusted for in DMO6 if the AER seeks to maintain incentives for competition.

Given the above and that the AER also considers 'a lack of new entrants due to current market conditions could weaken competition in retail markets', EnergyAustralia firmly believes the level of retail allowance at 10% and 15% for residential and small business customers respectively is the minimum level required to maintain incentives for retail competition and consumer engagement. Accordingly, we suggest the following for DMO6:

- Returning the NSW residential retail allowance to 10%
- Returning the SEQ residential retail allowance to 10%
- Reinstating the SA residential retail allowance to 12% to recover the lost 2% from DMO5 then revert to 10% for DMO7.
- Maintaining the small business retail allowance at 15%.

1.1. Options proposed for a potential retail allowance

Our view that the current retail allowance for residential and small business customers is the minimum level required to maintain incentives for retail competition holds even if the AER seeks to separate the retail allowance to an efficient margin percentage plus a fixed competition allowance amount. The fixed competition allowance should be sufficient to cover a competition allowance plus

⁷ AER, Default Market Offer prices 2023-24: Final determination, p 47.

retailer depreciation and amortisation costs. This is critical for sufficient headroom to maintain incentives for competition and retailer investment in clean energy solutions.

If the AER changes the retail allowance to a split approach – noting our view that the overall allowance should not be lower than the current approach if it seeks to support competition and retailer investment, the AER should:

- Provide clarity and certainty on how long it intends to uphold this methodology approach.
- Provide clarity and certainty around the circumstances in which it will consider changing the approach.

We do not support setting the retail allowance as a fixed dollar amount because it would not achieve the DMO objectives better than the current approach. For one, this approach would be less responsive to changes in market conditions, which can fluctuate significantly (the volatility of the market in 2022 is a prime example). We consider that a retail allowance that is a percentage of the DMO price is appropriate provided it is set at a suitable level.

1.2. Advanced meter costs and accelerated rollout

Our project costs for the accelerated advanced meter rollout are substantial. [REDACTED]. The ongoing advanced metering costs and the extent to which the acceleration has ramped up should be reflected in the current DMO approach. That said, maintaining the retail allowance at an appropriate level with sufficient headroom remains critical for retailers who are investing in these solutions for the clean energy transition.

The retail allowance is a critical buffer for under-recovery in other parts of the cost stack. This is particularly the case for smaller retailers who typically have higher retail operating costs and for retailers with significant amounts of depreciation and amortisation. We encourage the AER to continue testing the DMO retail allowance against retailer depreciation and amortisation costs as it did for DMO5. We would appreciate the AER make this analysis more transparent by publishing the presentation of the calculations and analysis in an excel spreadsheet for DMO6.

2. Wholesale cost methodology issues

2.1 Load profiles

We support the AER blending basic meter and interval meter data and suggest blending profiles based on a weighted volume approach. To improve transparency we would like to see as much detail as possible around the output of the mixed load profile used by ACIL Allen published in the AER's DMO6 draft determination.

We support the use of a single load profile for NSW region for comparison purposes and is reflective of our approach in practice. We consider the profile should exclude exports to the grid.

We do not have strong views on separating load profiles for residential and small business customers, as it will mean a 'once off' change in one year, with future years adjusted for the change. Our preference for regulatory consistency would be to maintain the current approach.

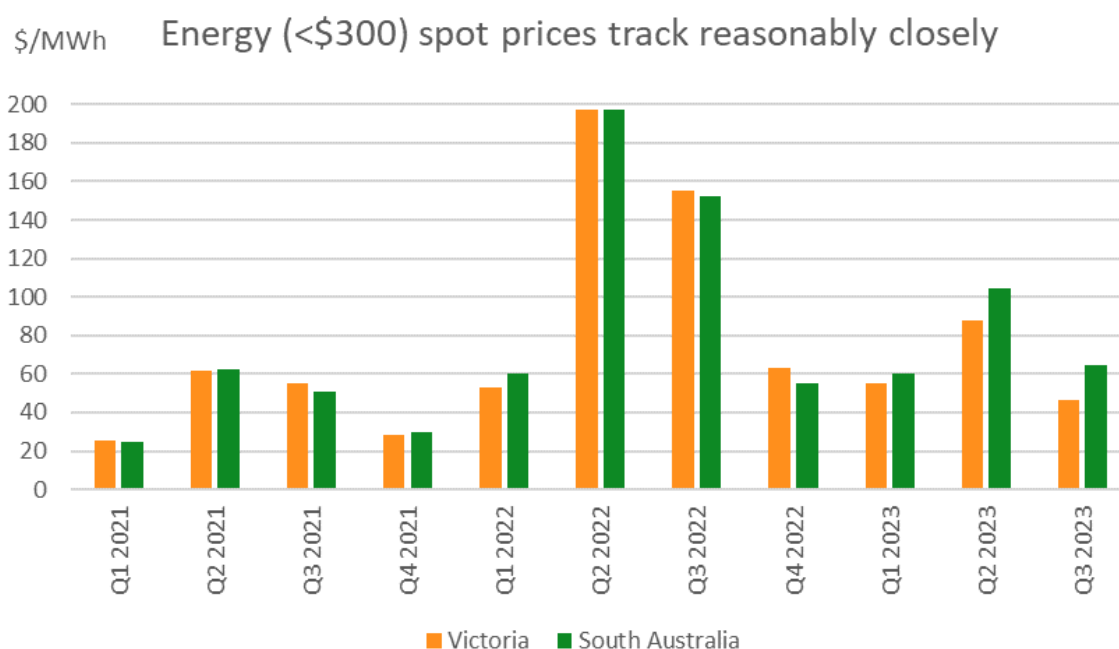
2.2 South Australia low contract liquidity and proposed option

While we acknowledge that contract liquidity in South Australia is low, we believe that the continued use of the ASX is preferred over the proposed option in the issues paper. Overall, the proposed option in the issues paper does not appear to be a reasonable approach. Further, we consider it undesirable and wish to avoid a mismatch of wholesale cost approaches in the DMO where wholesale forecasting for South Australia includes PPA costs while other states do not.

Using Settlements Residue Auctions (SRAs) can be a useful tool, but we consider them to carry fairly high risk and, importantly they are not a firm hedge especially given they are subject to transmission network outage risks where transmission networks show low regard to maintaining interconnecting capacity outside of Lack of Reserve (LOR) events.

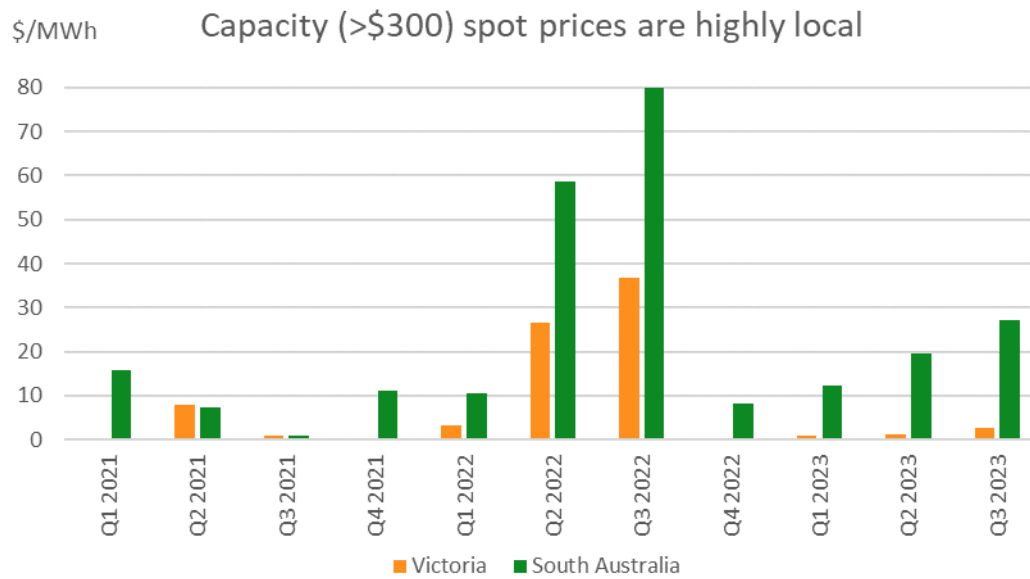
On the relationship between Victoria and South Australia in the proposed option, we consider that the energy price in Victoria and South Australia (prices below \$300/MWh) track fairly closely (Figure 3).

Figure 3:



However, the capacity component (price above \$300/MWh) is highly local and Victorian contracts are not a good hedge (Figure 4).

Figure 4



Caps are arguably the more important instrument (than base or peak contracts) for managing South Australia mass market price exposures. Accordingly we do not consider using a mix of Victorian and South Australian hedge contracts to be a sensible approach. Additionally, SRAs are a poor hedge for capacity component as South Australia volatility often coincides with transmission network planned and forced outages limiting flow into South Australia.

The AER may want to consider the use of broker curves, which could be an improvement for the AER if not already used. Broker curves often take into account over-the counter (OTC) activity and inter-regionals and can be a higher integrity mark for illiquid products.

3. Other DMO costs and considerations

- **Bad and doubtful debts** - we estimate a material increase in bad and doubtful debts which should be reflected in the DMO6 provision. We support the AER’s continued use of the ACCC’s data for bad and doubtful debt. [REDACTED].
- **Network costs** - we support maintaining the current approach of using flat rate tariffs for regulatory consistency.