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Default Market Offer ('DMO') 2024-25 Draft Determination

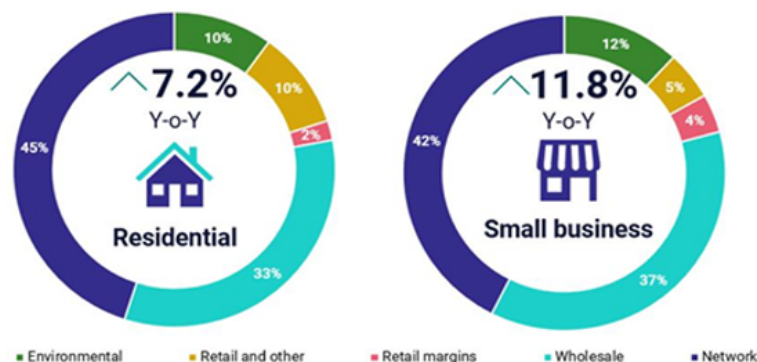
The Australian Energy Council ('AEC') welcomes the opportunity to make a submission on the Australian Energy Regulator's ('AER') *DMO 2024-25 ('DMO 6') Draft Determination ('Draft Determination')*.

The AEC 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.

Household energy bills are made up of several different components, with costs varying from state-to-state depending on things like the types of generation sources, the market size, the network area, and the state-based green schemes. Bills will also vary depending on the retailer and energy plan chosen. To understand energy power bills, it is important to understand what goes into them.

Broadly, energy bills cover four types of costs: Wholesale, Network, Retail (including the retail margin and retail costs) and Environmental (refer to figure below). Around 80 per cent of a customer's power bill is made up of the costs of generation and the costs of the poles and wires, which retailers then pass on to the customer, so these are major factors in determining final prices. Other costs include government environmental schemes, retail operating costs and retail operating margin.

Cost components of an average electricity bill 2022-23



Source: <https://www.aecc.gov.au/about-us/publications/serial-publications/inquiry-into-the-national-electricity-market-2018-25-reports/inquiry-into-the-national-electricity-market-report-december-2023>

The AER estimates the new DMO price changes will be less than the rate of inflation for all households and small businesses. Depending on the area a customer lives in, household price changes will range from a 2.7 per cent increase to a 7.1 per cent reduction. The latest decision reflects a moderation in the costs

of generating electricity (the wholesale costs), offset partly by increasing network costs for the poles and wires used to deliver electricity.

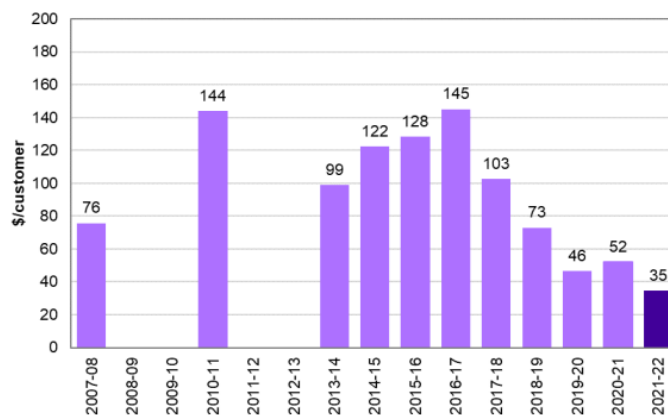
It is widely anticipated that network costs will continue to increase over the coming years to pay for the transmission investment that is planned and underway. In the 2024 Draft Integrated System Plan, projected transmission projects amount to \$16.4 billion.¹ The Commonwealth Government is offering \$20 billion to deliver new and upgraded energy infrastructure.² In addressing affordability issues, the AER has said it is turning its attention to how much of “the buffer” for retail competition can be reduced. But with network prices exponentially increasing, this can only ever be a short-term measure for keeping a lid on prices. The retail part of the bill is only around 10-12%, so it is a small part of the bill compared to the network component.

Squeezing retail to offset burgeoning network costs will only work for as long as there is something left to squeeze. Retail margins are currently at 2 per cent.³ To put this in context, the ‘risk-free rate’ (10-year Australian Government bond yield) is 4.3 per cent as at 26 March 2024.⁴ Since May 2022, 11 retailers have exited the market.

Retailers have been competing in a highly volatile and challenging environment as the below graph from the ACCC shows:⁵

Figure 4.5: Retail margins in 2021–22 declined to the lowest on record

Average retail margins (as earnings before interest, tax, depreciation and amortization or EBITDA) per residential customer across the NEM, 2007–08 to 2021–22, real \$2021–22, excluding GST



Source: ACCC analysis based on retailers' data.

The AEC understands the balance the AER needs to find when setting the DMO price, between protecting customers from unreasonably high prices, supporting reasonable and efficient margins and supporting competition. The AEC considers that in recent years the pendulum has swung well away from supporting

¹ AEMO (2024) Draft Integrated System Plan 2024 at <https://aemo.com.au/consultations/current-and-closed-consultations/draft-2024-isp-consultation>

² DCCEEW (2024) <https://www.dcceew.gov.au/energy/renewable/rewiring-the-nation>

³ ACCC (2023) Inquiry into the National Electricity Market – November 2022 Report at <https://www.accc.gov.au/about-us/publications/serial-publications/inquiry-into-the-national-electricity-market-2018-25-reports/inquiry-into-the-national-electricity-market-report-december-2023>

⁴ www.rba.gov.au

⁵ ACCC (2022) Inquiry into the National Electricity Market – November 2022 Report at <https://www.accc.gov.au/about-us/publications/serial-publications/inquiry-into-the-national-electricity-market-2018-25/inquiry-into-the-national-electricity-market-november-2022-report> p.73

reasonable and efficient margins and that the retail market is becoming increasingly unattractive as a site for equity investment.

The AEC has noted the record levels of Retailer of Last Resort events over the last year. As the Australian Energy Regulator (AER) said in its *State of the Energy Market Report 2023*, the market remains vulnerable to supply or demand shocks:

While wholesale prices have subsided since a peak in 2022, the market remains vulnerable to supply or demand shocks. Reliability issues with coal-fired generation assets and managing the increasingly peaky shape of customer demand could also put upward pressure on wholesale costs.⁶

The AEC believes that it is important for the AER to ensure that DMO6 adequately supports reasonable and efficient margins and competition.

In considering the DMO, it is good to remember the different roles of different players in the system. The role of the regulator is to set a determined price in line with the DMO objectives. Retailers have programs in place to support customers in payment difficulty. There are other community based government support mechanisms such as Energy Bill Relief. To the extent that support is required beyond those, it is the role of government to step in. It is not the role of the regulator to adjust its assessment based on a view of affordability.

Each actor playing their role in the system is, more than ever, important to maintain system stability



It is important to reflect on the purpose of the DMO – to protect customers from high standing offer prices. The objective of protecting customers from high prices in general is a broader objective which can be addressed through social policy such as concessions, bill relief and promotion of low cost generation and storage.

The AEC believes that the Australian Energy Regulator’s Draft Determination on regulated power prices for 2024-2025 should act as an important reminder for households and businesses to shop around for better electricity deals. Customers looking to save money should not wait for the new DMO which will come into effect on 1 July. They should check online or ring their retailer because there are more competitive deals available.

⁶ AER (2023) State of the Energy Market at <https://www.aer.gov.au/publications/state-of-the-energy-market-reports/state-of-the-energy-market-2023> p.230

It is quick and easy to find and switch to a cheaper market offer today using the government comparison website [Energy Made Easy](#). Retailers also inform customers every three months if they are on their best deal and how much they can save by switching, but because of the need for informed consent they cannot automatically move customers to a different deal. For that reason, it pays to check the competitive market.

The regulated prices are designed to be a safety net for the 8.6 per cent of Australian households who are on the DMO. While they are not the cheapest deals in the market, the risk with default prices is many people may think they are the best option. That is why we encourage people to shop around.

The AEC addresses key consultation questions below.

Net System Load Profile ('NSLP') Approach

The AEC acknowledges the issues recently identified in the SA Power Networks ('SAPN') and Energex NSLP datasets from October 2021 to October 2023, and welcomed the AER seeking further stakeholder feedback on alternative options to produce the load profiles based on NSLP data for DMO 6:

- Option 1 Use NSLP data as published by the Australian Energy Market Operator ('AEMO')
- Option 2 Undertake a manual adjustment to the NSLP data
- Option 3 Continue to use the NSLP data from DMO 4 and DMO 5.⁷

The AEC supported option 2 to address the issue resulting from AEMO's temporary adjustment of the NSLP data for SAPN and Energex, for DMO 6. In the DMO Net System Load Profile Approach Consultation Paper, the AER acknowledges that the option 1 data set is essentially a corrupted data set. The AEC does not think it is acceptable to use data which is known to be incorrect where other options are available.

In its Draft Determination, the AER decided to model separate Wholesale Energy Cost (WEC) estimates using AEMO's non-adjusted NSLP and ACIL Allen's adjusted NSLP and adopt the midpoint of the two results as the final WEC input for DMO 6. The AEC does not support this approach as AEMO's non-adjusted NSLP is known to be essentially a corrupted data set. The AEC also is aware that there is likely to be a step change in the load profile for DMO 7 and requests the AER provide notice of how it intends to deal with this.

Blended profile

In the lead up to the Draft Determination, the AER sought stakeholder views on whether the way it calculates the load profile for energy users should change to take into account smart meter data (also called interval or advanced meter data).

Each year, the AER commissions a consultant to undertake analysis and make recommendations as to how it should set the wholesale electricity cost element of the DMO. In its 2023 report, which was used as a basis for setting DMO 5, consulting firm ACIL Allen recommended a change to the AER's methodology which would see the regulator use smart meter data in tandem with the older accumulation meter data the regulator has used to date. The reason? To provide a more accurate picture of a customer's consumption profile a retailer will need to meet through their contracting arrangements. The consultants also noted doing this sooner rather than later and "when it represents a smaller proportion of customers will result in a modest change".⁸

⁷ AER (2023) NSLP Issues Paper at <https://www.aer.gov.au/industry/registers/resources/reviews/default-market-offer-net-system-load-profile-approach>

⁸ ACIL Allen (2023) DMO prices 2023-24 at <https://www.aer.gov.au/documents/acil-allen-draft-determination-default-market-offer-prices-2023-24-wholesale-and-environmental-costs> p.17

The dataset used to date is known as the net system load profile (NSLP) and controlled load profile (CLP). Given the increasing numbers of households with solar as well as smart meters, and the expectation this can only accelerate with factors like the Australian Energy Market Commission (AEMC) setting a target to have a full rollout of these meters to all households by 2030, it makes sense to use this data if the DMO is to more accurately reflect the actual costs incurred by a retailer. There is an expectation more solar will bring “peakier” loads which retailers will need to meet. To be able to offer customers stable retail prices, which will typically change once a year, retailers will contract with generators to supply electricity at a fixed price over the course of a year or several years. These are known as hedge contracts.

Impact on Hedging Strategies

As noted by the AER, the rollout of advanced meters “is expected to create a more accurate view of the consumption patterns of consumers. This combination of peakier load profiles and more accurate data may lead retailers to adapt their hedging strategy e.g. to change the mixture of hedge contracts they purchase and the extent to which they are exposed to the spot price”.⁹

By seeking to include smart meter data alongside the data from accumulation meters to establish customer usage (or load), the AER is attempting to develop a benchmark wholesale energy cost for a representative retailer.

ACIL Allen has pointed to the use of smart meter data improving “the estimation of the cost of supplying energy to small customers because the interval meter data in addition to the NSLP better reflects the shape of small customers’ load”.¹⁰

The consultant’s report also argued delaying use of the data would run the risk of a future “step change” (or shock) to the way wholesale costs are calculated in the regulated price. Given all meters are expected to be smart meters under the AEMC’s target, this would occur in the next six years.

In its DMO6 Issues paper, the AER sought stakeholder views on the question of whether the way it estimates load profiles should be changed, and noted “a blended load profile including advanced metering data would more accurately represent the load that a prudent retailer would hedge”.¹¹ The AEC agreed with this assessment and considered utilising such a blended approach would smooth out the change if undertaken in the near term. Deferring the change will ultimately see a greater impact in future years. The AEC strongly urges the AER to move forward in creating a blended profile using the accumulation meter and interval meter data for future DMO decisions. We believe this will assist in better reflecting the changing energy profile use of small customers especially as increased CER is installed and with the imminent accelerated roll out of smart metering in non-Victorian jurisdictions.

In its Draft Determination, the AER has said that it “consider[s] a blended approach suitable in that it allows the methodology to account for rising installation of interval meters among consumers and will more accurately reflect the load profile overall.”¹² The AEC welcomes this move.

The AEC does not support the AER’s decision to exclude solar exports. The AEC believes that the methodology should uphold the principles of incentive-based regulation and provide for the representative retailer, capturing the risk that retailer faces. Retailers may outperform that benchmark but that is inbuilt into the form of regulation.

⁹ AER (2023) DMO 2024-25 Issues Paper at <https://www.aer.gov.au/documents/aer-default-market-offer-price-determination-2024-25-issues-paper> p.7

¹⁰ ACIL Allen (2023) op.cit. p.16

¹¹ AER (2023) op.cit. p.11

¹² AER (2024) DMO 6 Draft Determination at <https://www.aer.gov.au/documents/aer-draft-determination-default-market-offer-prices-2024-25-19-march-2024> p.27

Smart metering costs

In general, the AEC favours a forecasting approach over the reliance on historical data for determining smart meter costs. Under the historical approach adopted by the AER in DMO 6, there is a potential risk that retailers could end up under-recovering some of their capital and financing costs for smart meters for the difference between historic and actual installs. To mitigate this risk, we note that the AER has proposed to include an estimate for the cost of capital to cover the shortfall between historical installs and actual installs. The financing costs for these estimates are likely to be inaccurate and the actual capital costs for the differences between historic and actuals are not included. As a result of this, the AEC considers retailers may be disincentivised to proactively deploy any smart meters above the historical costs adopted by the AER in DMO 6.

Of course, if the AER continues to apply the historical approach to cost recovery for smart meters over 2025, then retailers will be even more disincentivised to proactively roll out their smart meters. This is because the financial impact of the historical approach would be even more severe, especially because of the large capital costs associated with the accelerated deployment of smart meters. In a positive development, we note that the AER has argued that it would be better positioned to adopt a forecasting approach for 2025-30, especially in light of the distributor's legacy meter retirement plans. This is a welcome development, and we encourage the AER to further progress its thinking in this regard. If the AER continues to apply the historical approach to smart meter cost recovery, it could inadvertently end up delaying the pace at which smart meters are deployed.

Network decisions timing

The AEC is concerned about the timing of the NSW and ACT electricity network regulatory determinations and timing of the final DMO 6 decision. As retailers have strict obligations to prepare and deliver individualised customer communications at least five business days ahead of any price changes, we urge the AER to release its DMO 6 decision by 24 May 2024 at the latest.

Retail margin

The AEC supports the AER in its development of a methodology for determining the retail margin and urges the AER to remain consistent in the application of the methodology.

Competition allowance

In its issues paper, the AER sought stakeholder views on the appropriate form of the retail allowance. It considered whether the retail allowance should be cast as separate components, into an efficient margin and a competition allowance. In its Draft Determination, the AER decided to separate the retail allowance into a separate retail margin and competition allowance. The AER decided that the retail margin will be set as a percentage of the DMO price excluding the competition allowance, which would not be provided for DMO 6.

The AER's decision to not apply the competition allowance may see some of the cheaper market offers disappear, which in the future could negatively affect the more than 90 per cent of customers on market offers. We understand the desire to keep costs down, but this allowance serves an important function - to incentivise competition among retailers. Since May 2022 we have seen 11 smaller retailers leave the market. Regulators must ensure there is room for ongoing competition, so we do not lose more retailers from the market. The AEC is strongly opposed to the removal of the competition allowance.

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,

Jo De Silva

Jo De Silva
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