Minister for Energy and Clean Economy Jobs
Leader of the House

Queensland Government

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Our Ref: MN04117-2024

09 April 2024

Ms Clare Savage
Chair
Australian Energy Regulator
Email: clare.savage@aer.gov.au

Dear Ms Savage

Default Market Offer for 2024-25

I write to you regarding the Australian Energy Regulator's (AER) upcoming final determination for the 2024–25 Default Market Offer (DMO 6) in the South East Queensland (SEQ) electricity market.

On 19 March 2024 and on behalf of Queensland households and small businesses experiencing a range of cost of living pressures, the Queensland Government expressed its disappointment that reductions in power prices in the draft DMO 6 determination, released on 19 March 2024, were not more favourable towards consumers.

The Miles Government is committed to reducing cost of living pressures, public ownership of energy assets and ensuring affordable electricity pricing decisions for consumers, and as such has committed that Queenslanders will not bear the impacts of any draft or final DMO decision that increases costs, by administering yet to be announced cost of living relief measures.

We also note the positive achievements of the AER in supporting consumers to make better informed choices of retailer, including the requirement for retailers to publish advice of better offers on bills, and the provision of bill comparison data. We will continue to support consumers to access these resources, particularly given recent advice from the Australian Competition and Consumer Commission that large numbers of consumers continue to enter into plans where they often pay substantially more than necessary - effectively paying a "loyalty tax" to their retailer.

The DMO was established as an electricity price safety net to protect consumers from unjustifiably high prices.

Wholesale electricity prices across Australia are moderating following Russia's invasion of Ukraine and other market events in 2022. The Australian Energy Market Operator's latest Quarterly Energy Dynamics report shows average wholesale electricity prices across the National Electricity Market have fallen by 48 per cent since Quarter 4 2022. The Miles Government remains focused on ensuring affordable and reliable energy for Queenslanders.

We understand pricing decisions are complex and the AER weighs various factors in its assessment. However, we submit that the AER should give further consideration to balancing the objectives of the DMO price towards consumer interests. Achieving this balance is challenging in ordinary times, let alone during this period of changing market dynamics and national cost of living pressures. Further, this balance should be struck in the most transparent manner, using publicly available data wherever available.

To support a final decision that ensures Queenslanders accessing the DMO pay less, our government has obtained independent technical advice from Frontier Economics and identified several areas that warrant further review and amendment by the AER for the final DMO 6 determination, including:

- Reinstating the non-adjusted **net system load profile** (NSLP) dataset as the assumed input into forecasting annual wholesale costs, noting the AER's own assessment that this data is 'transparent and publicly available…likely to have driven retailers hedging strategies.' The Department of Energy and Climate conveyed the same view as part of the AER's consultation on the NSLP approach in February 2024. It is unusual that the AER would adopt an approach that raises rather than lowers prices.

- Lowering the use of the 75th **percentile of distributed wholesale cost estimates** to the median. Noting standing offer prices for small customers are not to exceed the DMO (with around 9.4 per cent of residential SEQ customers on the DMO), we encourage the AER to reconsider this parameter and whether the approach of Victoria's Essential Services Commission to measure wholesale costs in that jurisdiction would strike a better balance between retailers and consumers.

- Shortening the **length of the book build period** from three years to be more reflective of actual hedging practices of retailers, noting the Australian Competition and Consumer Commission publicly observes the average contract time horizon for large and small retailers is consistently less than two years and often less than one year.

Further information is enclosed.

Separately, we urge the AER to consider options to further enhance transparency in its wholesale energy cost methodology, including publication of its data and methodology to facilitate replicability and even greater accountability to stakeholders for pricing decisions made.

Yours sincerely

Mick de Brenni MP
Minister for Energy and Clean Economy Jobs
Leader of the House

Encl.

Review of retail wholesale energy cost methodology

A note for Queensland Government| 8 April 2024

Introduction

Frontier Economics has been engaged by the Queensland Government to help inform the Queensland Government's consideration of regulated pricing decisions for 2024-25, as they apply to Queensland.

This note discusses 3 specific issues relating to the calculation of wholesale energy cost (WEC) from the Australian Energy Regulator's (AER) recent draft determination for the 2024-25 DMO (DMO 6).

Choice of percentile of simulated WEC

The WEC for the DMO was originally based on the 95th percentile from the distribution of WECs produced by ACIL Allen. This was consistent with ACIL Allen's advice:[1]

> *ACIL Allen adopts the 95th percentile WEC from the distribution of WECs as the final estimate. In practice, the distribution of WECs from the simulations exhibits a relatively narrow spread when compared to estimates based on the load being 100 per cent exposed to the spot market, which is to be expected since they are hedged values. Choosing the 95th percentile reduces the risk of understating the true WEC, since only five per cent of WEC estimates exceed this value.*

However, from DMO 4, the AER moved to using the 75th percentile from the distribution of WECs produced by ACIL Allen. This was supported by Frontier Economics' review of the DMO methodology. The AER noted:[2]

> *Findings from Frontier's review, which supports the decision to move to the 75th percentile, was that a number of elements within the current methodology can lead to an overestimation of the WEC. These include:*
>
> - *The approach only estimates the cost of supplying small customer load in each region on a standalone basis, which means portfolio benefits available to some retailers supplying a diversity of customers, such as variable loads, are not accounted for.*
> - *The approach estimates the cost of hedging small customer load only, based on a subset of hedging products actually available to retailers that can be used to manage their risks. This results in lower cost risk management products, such as*

[1] ACIL Allen, Default Market Offer 2021-22, *Wholesale energy and environment cost estimates for DMO 3 Final Determination*, 19 April 2021, page 17.

[2] AER, *Default market offer prices 2022-23*, Final determination, May 2022, pages 24-25.

Power Purchase Agreements or load following hedges, not being accounted for within the modelling.

- *A retailer takes a risk-averse approach when hedging their small customer load.*
- *The most efficient retailer could expect to achieve costs lower than the 75th percentile modelled outcome and the 95th percentile allows for an almost worst-case scenario each year.*

When reviewing these elements together, we consider that this highlights numerous layers of conservatism built into the methodology.

For DMO 6, the AER proposes to maintain the approach of using the 75th percentile. The AER notes that during DMO 4 and DMO 5, despite the wholesale market experiencing higher levels of volatility, retailers were able to recover their efficient costs of providing their services due to a number of risk-averse assumptions embodied in the DMO methodology.[3] The AER concluded:

… the 75th percentile strikes the right balance between retailers recovering their efficient costs of providing their services and the allocation of risks to consumers. In our view, the 95th percentile provides a significant margin of error against underestimation and is likely to result in a wholesale cost estimate that is significantly higher than what a typical retailer would incur, other than in the most extreme circumstances.

Even with the 75th percentile of WEC, the WEC incorporated in the DMO rates will exceed the 'true' WEC in 3 out of 4 years. The 50th percentile of WEC would result in the WEC incorporated in the DMO rates exceeding the 'true' WEC half the time, and being lower than the 'true' WEC half the time.

There is an argument that the WEC should be set based on the 50th percentile, rather than the 75th percentile or 95th percentile. Putting aside estimation errors, this approach would mean that over the long-term, retailers would be expected to recover their efficient costs, rather than an amount higher than their efficient costs (as they would with the WEC based on the 75th or 95th percentile).

A shift to using the 50th percentile might provide a better balance between retailers recovering their efficient costs and the allocation of risks to consumers.

Certainly there are risks to retailers of setting the WEC based on the 50th percentile, because, putting aside estimation error, this would entail an expectation that the true WEC exceeds the WEC allowance 50 per cent of the time.

However, it is worth bearing in mind that there are other aspects of the methodology that mean that there is "conservatism built into the methodology". We note that DMO 4 and DMO 5 coincided with periods of very high spot and contract prices – presumably the kind of circumstances that might be expected to result in risk that retailers' true wholesale costs would exceed the allowance in the DMO. However, it appears that the AER's analysis found that this was not the case and that retailers were able to recover their efficient costs.[4] This raises the question of whether even using the 75th percentile results in a wholesale cost estimate that is significantly higher than what a typical retailer would incur, given the numerous layers of conservatism built into the methodology.

It is also worth bearing in mind that there are other ways of managing the risk to retailers that the 'true' WEC exceeds the WEC allowance. Indeed, the AER also noted that the dollar value of the difference between the 50th and 75th percentiles of the DMO is greater than that of a VDO-

[3] AER, *Default market offer prices 2024-25*, Draft determination, March 2024, page 32.

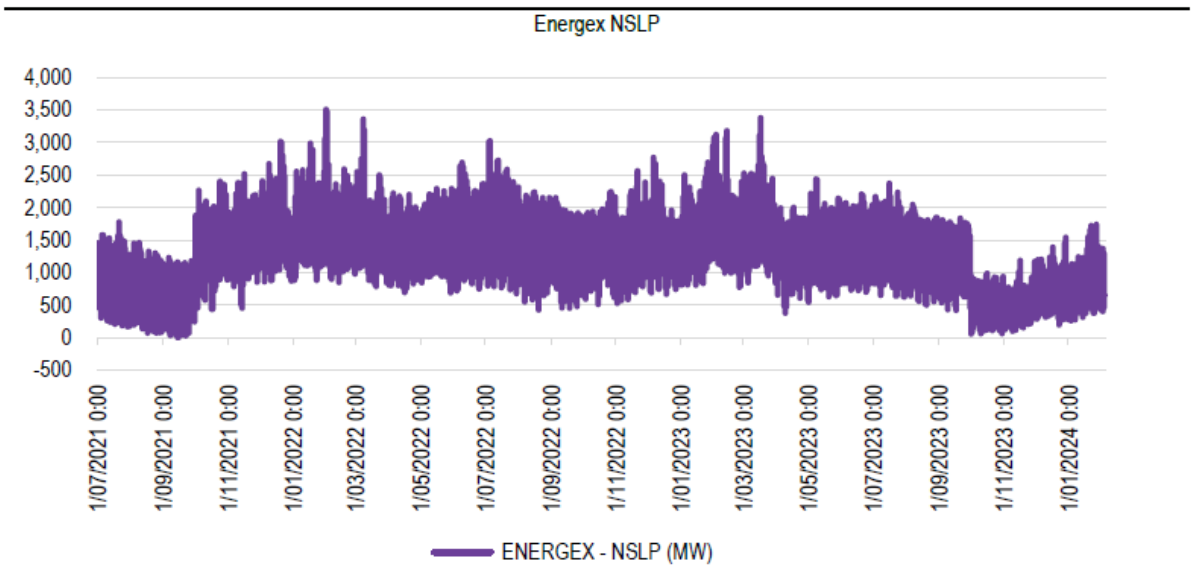
[4] AER, *Default market offer prices 2024-25*, Draft determination, March 2024, page 32.

style volatility allowance, which is an alternative path for compensating retailers for the risk that their costs could be higher than the median estimate of costs.[5]

Load profiles

As part of the AER's DMO 5 and DMO 6 reviews, an issue was identified with the net system load profile (NSLP) for Energex and SAPN. The NSLP is the profile that is used as the basis for determining WEC for the DMO. The issue with the NSLP resulted in an 'artificial uplift' in the NSLP between 1 October 2021 and 30 September 2023. This artificial uplift ceased from 1 October 2023. This issue is illustrated in Figure 4, which reproduces part of Figure 2.3 from ACIL Allen's report.

Figure 1: Issue with Energex NSLP between 1 October 2021 and 30 September 2023



Source: ACIL Allen, Default Market Offer 2024-25, Wholesale energy and environment cost estimates for DMO 6 Draft Determination, 13 March 2024, page 16.

The AER released a consultation paper in February on the treatment of the Energex and SAPN NSLP. The options considered were:[6]

- Continue to use the NSLP data as published by AEMO.
- Undertake a manual adjustment to the NSLP data.
- Continue to use the NSLP from DMO 4 and DMO 5 (which used data that predated the commencement of the 'artificial uplift' in the NSLP in 1 October 2021). However, the AER noted that this option would not be reflective of a retailer's load shape given the age of the data.

In response, all retailers supported a manual adjustment to the NSLP, on the basis that this would result in a more accurate retailer load profile. DCCEEW, the Queensland Department of Energy and Climate, PIAC and SACOSS supported the use of the non-adjusted NSLP, because this is more transparent and a reasonable reflection of the costs retailers have faced.

5 AER, *Default market offer prices 2022-23*, Final determination, May 2022, page 25.

6 AER, *Default market offer prices 2024-25*, Draft determination, March 2024, page 18.

The AER ultimately decided to model WEC using both approaches and take an average of the results. The AER considers:[7]

> *the two options to be evenly balanced in their inherent merits and disadvantages, while noting they produce materially different results (Table 5.1). A non-adjusted NSLP would be more transparent, allow for greater continuity in methodologies between DMO determinations, and reflect the basis of settlement used for most of our book build period. However, it does not reflect the underlying load shape, nor the settlement approach that is likely to be used in the future.*

The AER's view that the two options – using a non-adjusted NSLP and using an adjusted NSLP – are evenly balance in their advantages and disadvantages is a reasonable view.

Thinking about the way that retailers are assumed to hedge under the DMO methodology, and how retailers' cost are calculated, there are arguments that both load shapes are relevant:

- Retailers are assumed to hedge over a period of 2 to 3 years in advance. If retailers are hedging over this period, it would be reasonable to assume that they would be hedging based on the non-adjusted NSLP, since they did not have access to the adjusted NSLP.
- Retailer's settlement payments to AEMO are based on AEMO's determination of the NSLP over 2024/25, which means that settlement payments will be based on the NSLP after the artificial uplift ceased (on 1 October 2023).

However, there is an argument that there is an inconsistency between determining a hedging position based on the adjusted NSLP – which has not been available to retailers until the release of the AER's draft determination – and the assumption that retailers use a book build period of 2-3 years. To the extent that retailers require more hedging contracts as a result of the peakier shape of the adjusted NSLP, there is an argument that retailers will only make that adjustment to their hedging position now that they are aware that the adjusted NSLP will be used to set the DMO. This adjustment in their hedge position will not be made over the past 2-3 years, but will be made after the release of the AER's draft determination, and so it would seem consistent to price these additional contracts at the contract price since the release of the AER's draft determination.

Length of book build period

When determining the contract prices used as an input into determining retailers' costs, ACIL Allen use a book build period that is equal to the full period over which contracts trade on ASX Energy (generally around 3 years). The price over this period is averaged by weighting the prices according to trade volumes.

This approach to the book build period means that high contract prices at any point during the period over which contracts trade will continue to influence the estimated WEC. For instance, for 2024/25, the high prices that occurred for 2024/25 contracts during 2022 continue to feed into the WEC.

Responding to submissions from a number of retailers suggesting that a shorter book build period would better reflect the hedging behaviour of retailers, ACIL Allen commented that:[8]

> *ACIL Allen acknowledges that different retailers adopt different strategies to build up a hedge book. However, ACIL Allen remains of the view that using all available trade data from ASX Energy to estimate contract prices is appropriate.*

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7 AER, *Default market offer prices 2024-25*, Draft determination, March 2024, page 26.

8 ACIL Allen, *Default Market Offer 2024-25, Wholesale energy and environment cost estimates for DMO 6 Draft Determination*, 13 March 2024, page 41.

> *As we have noted in previous determinations, about two thirds of the contract trade volume on ASX Energy typically occurs within the 12 months prior to the final determination date – demonstrating that a small portion of trades occur greater than 12 months prior to the determination – reflecting to some extent the approach adopted by smaller retailers.*

The AER's explanation for the length of the book build up period is:[9]

> *In our issues paper we indicated our intention to retain the use of all ASX trades across the most recent 2 to 3-year period in assessing our simulated book build. We consider this approach most accurately reflects the average costs of a prudent retailer over time, and results in a more stable DMO from year to year.*

Whether it is prudent for a retailer to purchase contracts over a 2 to 3 year period, or a different period, is a matter of judgement. What is clear, is that it is common practice for retailers to contract over shorter periods, particularly smaller retailers. The ACCC has observed that:[10]

> *Over the period from January 2021 through to July 2023, small retailers purchased contracts between 4 and 13 months in advance of their delivery start dates on average, with a typical contract length of 4 months. Large retailers purchased contracts between 9 and 16 months in advance of delivery start dates on average, with a similar typical contract length.*

Retailers have provided some explanations for why a shorter book build period might be prudent, including uncertainty about their future customer base.

It is likely that a longer book build period results in more stable prices over time, but the corollary of this is that it is likely that a longer book build period results in prices that are less reflective of current wholesale market prices. For instance, a shorter book build period would result in retail prices increasing more quickly as a result of higher wholesale prices (for instance during 2022), but prices would also fall more quickly as those prices moderated – with this shorter book build period customers would face retail prices that tend to be more aligned with what is going on in the wholesale market at the time.

However, there are reasons to think that even if the AER were minded to shorten the book build period, it should only do so after signalling the change in approach in advance. The reason is that retailers may respond to the AER's current approach by deliberately purchasing contracts over the full 2 to 3 year period that contracts trade, so that they can better match their costs to the DMO allowance. Changing the assumed book build period at short notice will mean that retailers that have sought to match their contracting behaviour to the approach adopted by the AER will have their investment in contracts early in the period stranded.

[9] AER, *Default market offer prices 2024-25*, Draft determination, March 2024, page 20.

[10] ACCC, *Inquiry into the National Electricity Market*, December 2023 Report, 1 December 2023, page 91.

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