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**Mr Mark Feather**
**General Manager, Policy and Performance**
**Australian Energy Regulator**
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By email: DMO@aer.gov.au

**18 March 2021**

Dear Mr Feather

***Draft Decision – Default Market Offer Price 2021-22***

AGL welcomes this opportunity to provide comments on the Australian Energy Regulator's (AER) *Draft Determination - Default Market Offer Prices 2021-22* (Draft Decision) published on 17 February 2021.

AGL is a leading energy retailer with around 4 million electricity and gas customers in New South Wales, Queensland, South Australia, Victoria and Western Australia as of 31 December 2020, following the acquisition of Click Energy during 2020.

AGL is generally supportive of the Draft Decision given the AER has broadly maintained the methodology used for the 2020-21 DMO and has made some necessary adjustments by:

- allocating ancillary service charges at a jurisdiction level;
- using proposed or approved network prices rather than indicative estimates from network determinations; and
- ensuring the indexation method uses the cost estimates of the previous year's DMO (with no updating) to determine the appropriate change in cost for this year determination.

However, we are concerned with the AER's initial decision to exclude COVID-19 related costs and other incremental retail costs because of questions on materiality.

The DMO is not intended to be an accurate reflection of retailers' efficient costs nor the lowest offer in the market. Instead, the objectives of the DMO are to prevent unjustifiable high prices for disengaged customers, allow retailers to recover their efficient costs but not reduce incentives for competition, innovation and investment by retailers.

The AER's decision not to specifically allow for retail cost impacts due to regulatory changes is because each change is not considered material on an individual basis. However, AGL considers the cumulative impact of these incremental costs, when combined with the escalation in bad debts due to COVID-19, is material and ignoring all these changes may potentially threaten the objectives of the DMO. More detail on these and other concerns follow.

## Wholesale costs

AGL supports ACIL Allen's largely unchanged approach to forecasting wholesale energy costs for the derivation of the 2021-22 DMO.

Consistency of methodology is important and considering the DMO is not intended to be an accurate reflection of a retailers' efficient costs, AGL agrees with the continued use of the index approach, the 95$^{th}$ percentile and the net system load profile (NSLP).

## AEMO Directions

In 2020, the costs associated with directing South Australian generators to maintain the security of the power system increased by around 90 per cent to $49 million (around $4/MWh) and in Q4, time on directions hit a record quarterly high of 64 per cent.

ACIL Allen has acknowledged that these AEMO Direction costs represent a real cost incurred by retailers[1].

**Figure 1: Time and cost of AEMO directions, South Australia**


**Source: AEMO Quarterly Dynamics Report Q4 2020**

However, the AER have chosen not to include AEMO Directions costs in its Draft Decision because:

- it has not previously included AEMO directions costs in the DMO price and to do so now would be complex because of its indexing approach;
- the Essential Services Commission (ESC) in its determination of the 2021 Victorian Default Offer (VDO) excluded the costs of AEMO directions; and
- the installation of four synchronous condensers by ElectraNet will reduce the need for AEMO interventions going forward.

AGL does not believe that the reasoning for excluding these real costs is justified.

Firstly, the costs of AEMO Directions were immaterial prior to the calculation of the initial DMO for 2019-20. Therefore, the AER is not required to perform any complex re-indexing of previous DMO calculations to accurately reflect this cost. It simply requires the AER to include a forecast of the cost of AEMO Directions in 2021-22 in its DMO indexation model which will then reflect and allow for the rapid escalation of these costs over the last 3 years.

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1 ACIL Allen, *Default Market Offer 2021-22: Wholesale Energy and Environmental Costs, Estimates for DMO3 Draft Determination*, Feb 2021

Secondly, the ESC's reasoning for excluding the cost of AEMO Directions was due to its uncertainty on how retailers were being impacted and given the costs were much smaller in Victoria. The AER has confirmed that these costs are not covered by NEM fees and the costs in South Australia are material as shown above.

Thirdly, while the installation of four synchronous condensers by ElectraNet will decrease the need for AEMO Directions in South Australia, AGL believes the AER cannot rely on this justification as:

- although the synchronous condensers are under construction, they are not yet in operation and it is not certain that all four projects will be operating prior to 2021-22;
- even when they are operational, the costs arising from AEMO directions are still likely to be material, just reduced in frequency as ElectraNet stated "*once a full synchronous condenser solution is commissioned end 2020) we assume an ongoing cost of $12m per annum remains, based on the conservative assumption for 2 synchronous generation units to remain online thereafter*"[2]; and
- the AER's current approach for forecasting other energy costs which are uncertain (e.g., ancillary services costs, RERT) is to base its estimate on the most recent historic cost data, usually the last 12 months of data. If the AER was consistent in its approach, it should use this method to estimate the cost of AEMO Directions for the 2021-22 DMO.

AGL maintain that the AER include the impact of AEMO directions in its determination of DMO prices for 2021-22.

### Ancillary Service Charges

AGL supports the Draft Decision changing the calculation of ancillary service charges from a NEM-wide basis to a NEM regional basis. We also believe the way in which the AER has incorporated this change in its index methodology has resulted in the appropriate correction to the ancillary service charge allowances across the DMOs that apply in the different NEM jurisdictions.

### Large-scale Renewable Energy Target (LRET)

AGL recognises that the AER has considered the proposal of applying a minimum price to its LGC market approach in its Draft Decision. Given the current level of LGC prices for 2021 and 2022, the decision to not apply a LGC floor price has no impact on the 2021-22 DMO but AGL will look to explore this issue further during the proposed review into the *Competition and Consumer (Industry Code—Electricity Retail) Regulations 2019* and associated review of the DMO ,methodology by the AER.

### Network costs

AGL recognises the challenge that the AER faced in determining the network charges applied for DMO2 due to the five yearly reset of the networks' revenues. For the final determination of the DMO3 prices, AGL supports the use of the networks' proposed prices as these charges will not be approved before 30 April 2021. In AGL's experience, the approved charges are usually as proposed.

AGL also supports the AER modelling which uses the network price estimates of the previous year's DMO (with no updating) to calculate and determine the appropriate change for the 2021-22 DMO.

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[2] https://www.aer.gov.au/system/files/ElectraNet%20-%20System%20Strength%20Economic%20Evaluation%20Report%20-%2018%20February%202018.PDF, page 25

## Retail costs and step changes

The AER indexation methodology incorporates a step change framework that allows the DMO price to be adjusted to account for material increases or decreases in retailers' costs to serve. Although AGL support the framework, we have yet to see it fully utilised to allow for adjustments separate to the escalation of the residual cost component.

In the Draft Decision, the AER considered the following costs:

- Incremental bad debts related to COVID-19 and other COVID-19 related costs;
- Consumer Data Rights;
- 5-minute settlement;
- digital metering costs; and
- other regulatory changes

The AER has considered information available on additional bad debts related to COVID-19 including the information provided by AGL. The AER concluded that while the increases in bad debt costs may be higher than CPI, the DMO price is sufficiently above retailers' efficient costs that the DMO policy objectives can continue to be met without an adjustment for COVID-19. In AGL's Half-Year Results presentation for 2020-21, released on 11 February 2021, the provision for COVID-19 credit losses for 2020-21 remain significantly high, at around $35 million.  In our view, the level of bad debts for 2021-22 will remain higher than pre-COVID-19 levels.

The AER has not made a clear decision on other COVID-19 related costs, CDR, 5-minute settlement and regulatory changes. AGL is concerned that while these costs may not be individually material, when considered in total in conjunction with additional bad debts related to COVID-19, they are significant. The AER also made no allowance for the cost of digital metering. Again, this cost may be currently small but will require a cost allowance to be made in future year as advanced meters become more prevalent.

The AER cannot continue to rely on any headroom available when the DMO was initially set as this will be incrementally reduced when cost changes are not sufficiently recognised.

We note the AER also reviewed data on the productivity factor for the cost of serving, acquiring, and retaining customers. We agree with the AER's position that assessing any productivity adjustment will require a more detailed analysis into retail costs which is inconsistent with the top-down methodology. From AGL's perspective, the current operating environment is complicated due to COVID-19 and the integration of several business acquisitions (Perth Energy, Southern Phone and Click Energy). It is also important to ensure that all relevant costs are assessed including corporate costs and other shared costs.  In our view, any assessment of productivity adjustment will be inconsistent with the current framework.

If you have any questions in relation to this submission, please contact Patrick Whish-Wilson on (02) 9921 2207 or Meng Goh on (02) 9921 2221.

Yours sincerely

Elizabeth Molyneux
GM of Policy and Market Regulation