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Mr Mark Feather
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Dear Mr Feather

AER Position Paper — Default Market Offer Price 2020-21 — September 2019

EnergyAustralia is one of Australia's largest energy companies with around 2.6 million electricity and gas accounts across eastern Australia. We also own, operate and contract an energy generation portfolio across Australia, including coal, gas, battery storage, demand response, wind and solar assets, with control of over 4,500MW of generation capacity.

We support the AER's proposed approach in taking the current default market offer (DMO) annual prices as an acceptable starting point and adjusting these by cost factors to set values for 2020-21. In doing so, the AER could make some refinements to its proposed cost calculation methods. We would also support the same DMO being extended to customers with solar PV and to residential time-of-use customers, subject to any further examination of differences in underlying costs or consumption profiles.

The AER should continue to monitor market offers under its top-down approach

We agree with the AER that the level of the current DMO prices appears to have appropriately reduced unreasonably high standing offer prices while also retaining incentives for retailers to compete and develop innovative market offers.

We would not support alternative methods for setting the DMO including bottom-up calculations or as a synthesis of retailer offers. The former would be disproportionately burdensome, while the latter would involve significant uncertainties in how prices are determined, and likely require a cross-check against cost trends in any case.

We support the AER's intention to cross-check its determined DMO prices against market offers, as well as an indicative cost stack. Public information on historic costs and estimates of future costs will be useful in this regard. The AER, including as part of its retail performance reporting, should seek to understand forward-looking pricing and marketing strategies as partly revealed in observed pricing, and we encourage the AER to discuss market developments with us and other retailers. For example, we have observed some increasing prevalence of non-price benefits and product diversification since the DMO was introduced. Understanding these changes will be important in accurately interpreting price and cost data, including the extent to which the DMO is effectively functioning as a safeguard and a reference price.

Some cost estimation methods could be refined and tested

We note the AER has engaged ACIL Allen to prepare wholesale and environmental cost estimates, whereas previously it had relied on cost trend calculations for a range of factors published by the AEMC. Aside from costs associated with large-scale generation certificates (LGCs), we do not have specific concerns with either those produced by ACIL or the AEMC. We question the need for the AER to develop its own estimates when others are already published for the sector (and were relied on by the AER in making its current DMO determination).

As has been raised with ACIL Allen previously[1], approaches that rely heavily or entirely on the market price of LGCs as an estimate of costs under the large-scale renewable energy target (LRET) do not reflect the prudent practice of retailers and will give a poor estimate of retail cost trends. This inaccuracy would grow over time as the market price of LGCs continues to decline, whereas the cost of LGCs procured by retailers under long term power purchasing agreements (PPAs) is comparably stable. By our estimates, around 80 percent of LGCs surrendered against mass market load are from the largest five retailers[2], who all have significant PPA commitments and would not be procuring LGCs from the market. We consider these retailers better fit the AER's definition of a "representative retailer", particularly one with an established customer load[3] and not a new or recent entrant that would more likely procure LGCs from the market.

These issues have been identified previously for the AEMC in its cost trends reporting[4], with the AEMC estimating significantly different costs for small and large retailers[5] which should illustrate the materiality of this issue.

The AER should investigate this further. It should challenge ACIL Allen's view that the only approaches to estimating LGC prices are either from market data or a theoretical marginal cost approach.[6] For example, the AER could request and examine a sample of PPA contracts from retailers or investigate LRET costs periodically reported by retailers to the ACCC under its electricity inquiry.[7]

Wholesale cost methods and data sources should be examined to ensure cost trends and more recent market developments are accurately captured. Load and price volatility is increasing, particularly in QLD and SA due to the influx of solar PV, bringing associated changes in shaping costs incurred by retailers. Some of this may be captured in ACIL's data and methods.[8] The outputs of ACIL Allen's modelling should also be compared to actual price and cost outcomes to gauge the size of errors and what impact this might have on retailers under the DMO's price constraints.

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[1] ACIL Allen, *Estimated Energy Costs – 2019-20 retail tariffs*, 19 February 2019, p. 9.

[2] EnergyAustralia analysis, using data on retailer market shares from AER, *Retail energy market performance report*, December 2018.

[3] AER, *Position Paper - Default Market Offer Price 2020-21*, September 2019, p. 25.

[4] EY, *Residential Electricity Price Trends – Wholesale Market Costs Modelling 2018 - Australian Energy Market Commission*, 18 December 2018, pp. 31-33.

[5] AEMC, *Final report – 2018 Residential Electricity Price Trends Methodology Report*, 21 December 2019, p. 43.

[6] ACIL Allen, *Estimate wholesale energy and environmental costs – Phase 1: initial scoping and assessment of forecasting options*, 10 September 2019, pp. 18-19.

[7] For example, as illustrated in ACCC, *Inquiry into the National Electricity Market*, August 2019, pp. 100-1.

[8] ACIL Allen, 10 September 2019, pp. 30-2.

Coverage of solar customers and residential TOU customers

The AER indicates it does not have primary data to determine whether customers with and without solar PV have different consumption profiles and costs to serve.[9] It also considers there are unlikely to be significant revenue impacts in using a flat tariff DMO for residential customers on time-of-use tariffs.[10] Subject to there not being material differences across these customer types, we would support having the same DMO and reference prices apply as this would add simplicity and transparency for retailers and customers.

In the case of time-of-use tariffs, we note the AER's responses to concerns we have raised verbally about misalignment of retailers' time-of-use periods with those in the AER's reference price calculations.[11] In many cases retailers apply the price signals contained in the underlying network tariff, which the AER has approved in accordance with the National Electricity Rules' pricing principles and have been developed in consultation with consumer representatives. The AER acknowledges that this makes some retail tariffs appear to be better or worse relative to the DMO reference price, but retailers are free in how they design tariffs. The solution for us, where our pricing appears worse off, would be to design tariffs that mirror the AER's reference price calculation, which may appear more competitive but potentially dilute price signals and leave customers worse off over the longer term.

If you would like to discuss this submission, please contact Lawrence Irlam on 03 8628 1655 or Lawrence.irlam@energyaustralia.com.au.

Regards

Sarah Ogilvie
Industry Regulation Leader

[9] AER, *Position Paper - Default Market Offer Price 2020-21*, September 2019, pp. 53-54.
[10] ibid, p. 49.
[11] ibid, p. 52.