



EnergyAustralia

LIGHT THE WAY

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Dear Mr Feather

Default Market Offer to apply from 1 July 2021 – Draft determination – February 2021

EnergyAustralia is one of Australia's largest energy companies with around 2.5 million electricity and gas accounts across eastern Australia. We also own, operate and contract a diversified 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 appreciate the opportunity to engage with the AER in setting the Default Market Offer (DMO) from 1 July 2021.

We have consistently supported the need for a price safety net for customers that cannot genuinely engage and who therefore do not derive benefits from the competitive market. We also support the overall policy intent of the DMO to not be the cheapest offer and for the price cap to retain a competitive allocation above costs to encourage customers to move and remain off standing offers, thereby promoting dynamic efficiencies in the market.

The AER's top-down approach that gives effect to these objectives has evolved over several determinations. We support the AER using its judgement to determine DMO price caps and reference pricing in the long-term interests of consumers. The AER's approaches should continue to be improved, and while we welcome the AER signalling an intent to review its methods in future determinations, some further work can and should be undertaken for this 2021-22 determination.

We have the following suggestions to help the AER improve upon the analysis contained in its draft determination:

- The AER's assumption that the median market offer is a fair representation of retailers' efficient costs should be substantiated with available data on retailers' costs and billing revenue. The AER should also be careful of referring to 'margins' in its analysis of price differences. Presenting specific values on the amount of

'headroom' also implies a false sense of precision when inferring retailer profitability.

- The AER should be transparent and present quantitative data that substantiates the statements it makes throughout its determination that the DMO's 'headroom' is sufficient to accommodate various costs items. The AER's approach to recognising 'step changes' should also be more transparent in its treatment of materiality.
- We consider the AER is erroneously overstating the liquidity of the market for large-scale renewable generation certificates (LGCs) and it should address evidence we have presented previously on the representativeness of traded LGC prices.
- We also have some further observations on the data referred to by the AER regarding the prevalence of advanced metering and customers on time-of-use (TOU) tariffs, as well as the need to provide guidance on how the retailer reliability obligation (RRO) will affect wholesale cost estimation in the future.

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

Regards

Lawrence Irlam

Regulatory Affairs Leader (acting)

The assumption that median market offers reflect efficient costs should be validated with further analysis

We support the AER's light-handed approach to setting the DMO. Alternative methods which set efficient costs through a bottom-up approach (e.g. the Victorian Default Offer) involve wasteful debate with minimal additional benefit to consumers. Such approaches tend to overstate the degree of precision that is possible in setting regulatory parameters in the face of uncertainty on underlying costs and forecast market conditions, and some degree of judgement is also necessary in balancing the interests of different stakeholders.

The use of judgement must, however, be transparent and based on rigorous analysis, and we caution the AER in being complacent in following a top-down approach.

The AER's latest draft determination does not recognise any of the cost changes identified by retailers. In almost all cases the AER's justification is that the 'headroom' or "margin" between the DMO price cap and median market offers is sufficiently large to accommodate these cost changes. These statements should be supported by an examination of available evidence. Specifically, the AER should ensure appropriate rigour is applied when satisfying clause 16(4)(b), which requires the AER to have regard to the principle that an electricity retailer should be able to make a reasonable profit.

The AER's draft determination states that it has satisfied this requirement by:

- noting that observed standing and market offers (on a portfolio basis) reflect a typical market participant's expectations about the efficient costs of providing retail services in particular distribution regions, including a reasonable profit margin
- setting prices for the first DMO determination above median market offers, in order to exclude potential loss-leading offers that may not reflect a reasonable profit margin
- adjusting the first DMO in line with forecasts of network, wholesale and environmental costs, and indexing the remainder ("retail component") by CPI
- repeating this approach for setting the third DMO.¹

There are various issues in having regard to pricing data as a proxy for retailer profits under clause 16(4)(b):

- The AER noted it was mindful of the possibility of retailers pricing below cost, and alluded to the need to consider standing and market offers on a portfolio basis, when setting the first DMO. However, these factors do not appear to have been considered by the AER in presenting amounts of 'headroom' over time
- Acquisition offers in the market at any time will not be a reliable indicator of the average revenue received per customer across the retailer's customer base. Moreover, profits in relation to prices will fluctuate in line with costs, and the AER has explicitly avoided any 'bottom-up' cost calculations.

¹ AER, *Draft Determination Default Market Offer Prices 2021-22*, 17 February 2021, p. 106.

- Related to this, taking snapshots of prices and implied headroom under the DMO at any point in time needs to account for when different retailers undertake repricing activity. Due to administrative burden and contractual terms (e.g. fixed price periods) retailers will not make frequent price changes in line with costs. By contrast, the AER's approach implicitly assumes costs, revenues and (all) prices are in 'equilibrium' at all points in time.
- The DMO Code refers to profit of "an electricity retailer" however this is undefined. The AER should explore the likelihood of significant divergences in costs across retailers, particularly wholesale costs, given retailers will have different contracting approaches and corresponding risk exposure.

The issues in relying solely on market pricing should already be apparent given the large and unexplained differences in the amount of 'headroom' (and implicitly, profits) the AER calculates across distribution zones. For the current DMO, these amounts range between \$227 (Energex) and \$352 (Essential Energy) for residential flat rate customers.²

Given these factors we believe that the AER's analysis of market offer pricing should be cross-checked with information on customer billing and of retailers' costs. We note the AER does not have access to detailed cost or billing data. It may also be tempting to place a heavy reliance on pricing data given the richness and currency of information that is available from Energy Made Easy. However, other relevant published information is available that could be used to conduct cross-checks.

The AER has already interrogated the ACCC's electricity market monitoring reports in attempting to determine trends in retailers' productivity³ and exploring the impacts of the DMO on prices.⁴ A further review of the ACCC's most recent report suggests that there are only small variations between what market offer customers actually pay in terms of billed amounts relative to those paid by standing offer customers. Importantly, these observations provide a view on the revenues earned by retailers across the entire market and, along with costs, must be considered when having regard to retailer profits.

The ACCC's billing data for 2018 and 2019 suggests median bills for residential customers were roughly equal for market and standing offer contracts.⁵ Data for July to September 2019 show, as expected, the reduction to bills with the introduction of the DMO from 1 July. However, these data also show that customers on market offers were, on average, paying amounts that were very close to the DMO (or even above the DMO in the SAPN region). That is, the initial DMO was set roughly in line with (or below) the median bill for residential customers across the entire market. The AER's narrower consideration of acquisition offers suggests essentially the opposite – that the DMO was, and remains well above, the price paid by median residential customers in each distribution zone, with the difference increasing to above \$300 in more recent observations.⁶ In essence, this comparison suggests the DMO actually provided no headroom, and also that average revenues (or prices) from acquisition offers in 2018 and 2019 were materially below those for the entire customer base.

² *ibid.*, p. 21.

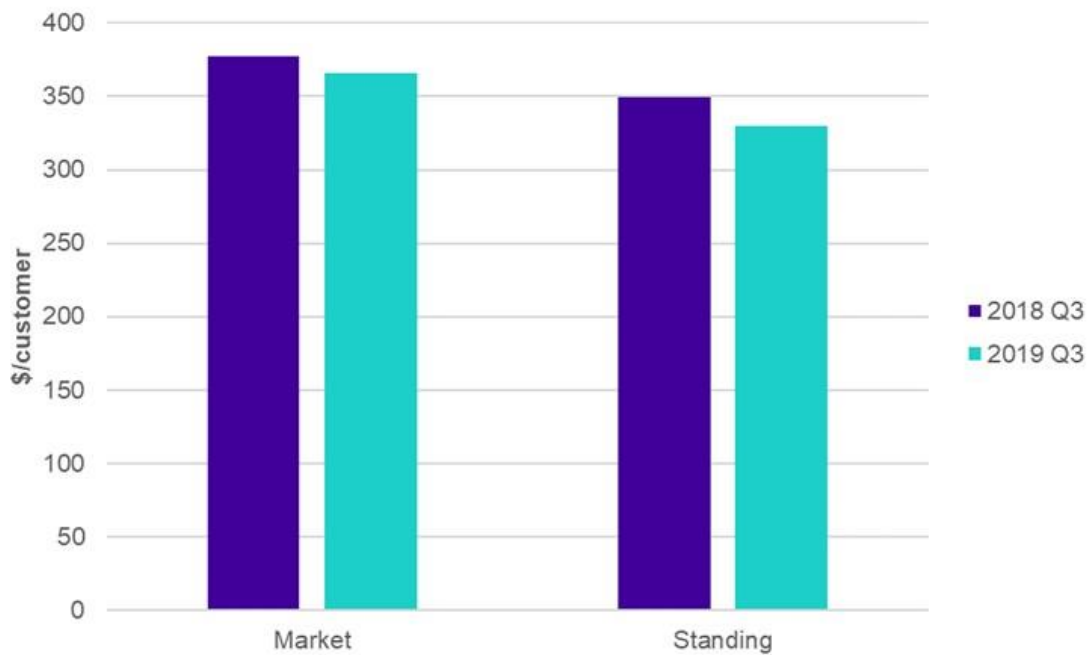
³ *ibid.*, p. 69.

⁴ *ibid.*, pp. 22-3

⁵ <https://www.accc.gov.au/system/files/Appendix%20E%20-%20Billing%20data%20and%20charts%20-%20Inquiry%20into%20the%20National%20Electricity%20Market%20-%20September%202020%20report.xlsx>

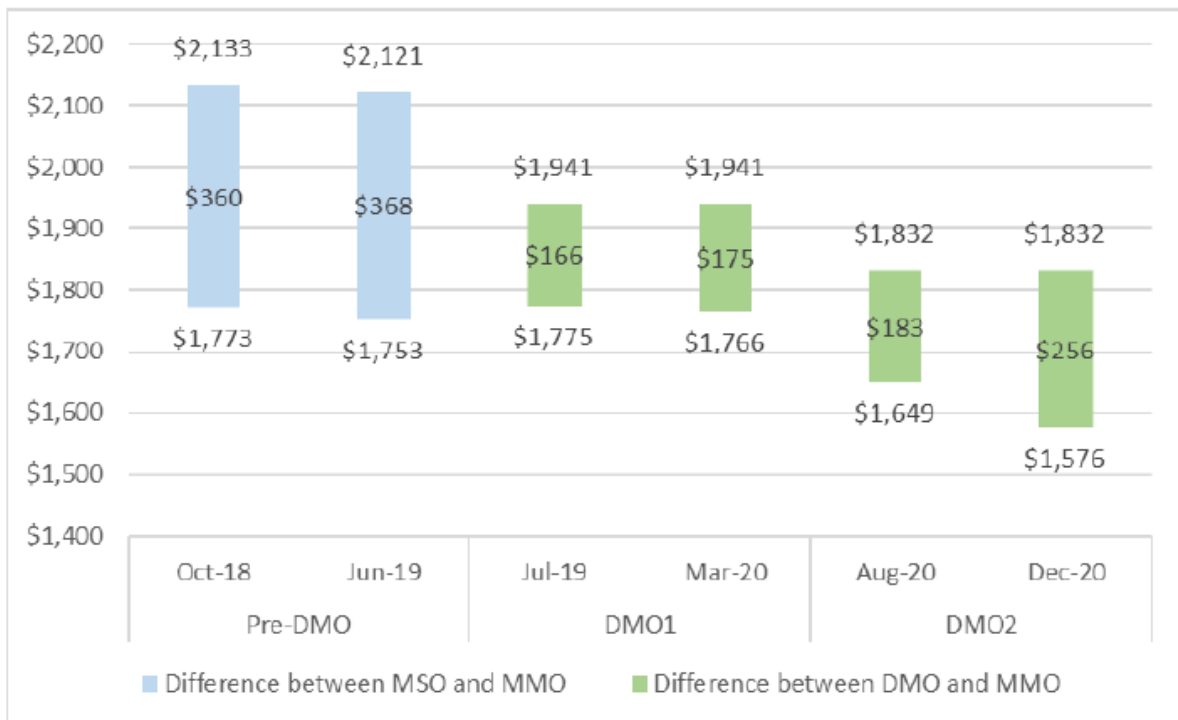
⁶ AER, Appendix C.

Figure A3.4: Median bill for residential market and standing offer customers in SA



Source: ACCC, *Inquiry into the National Electricity Market - September 2020 report*, Appendix E.

Figure C9: Residential flat rate tariff

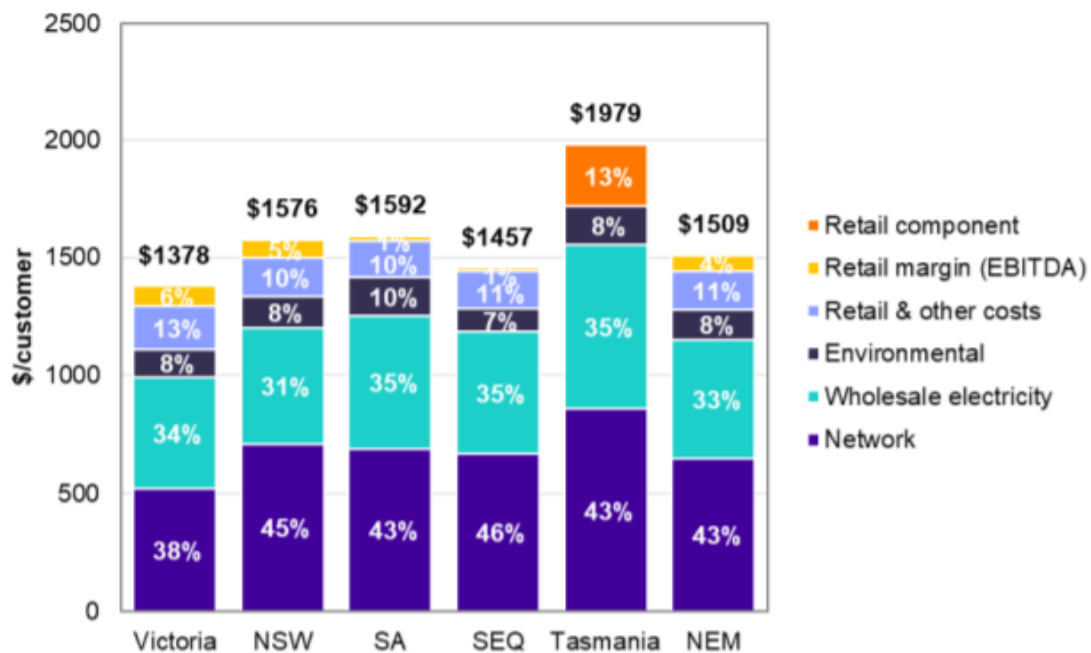


Source: AER

The AER’s approach in setting the first DMO for 1 July 2019 above median market offers may have suggested an element of conservatism that favoured retailers in terms of cost recovery. That market offer customers have faced bills in line with standing offer customers, when taken on face value, might also suggest retailers were earning above-normal profits around this time.

This is not, however, reflected in the ACCC’s cost stack analysis. The ACCC’s reporting of retailers’ costs for 2018-19 suggests average EBITDA margins per residential customer were around 4 per cent across the NEM (and as low as 1 per cent in SAPN and Energex regions). This is below the ESC’s benchmark EBITDA of 5.7 per cent, suggesting that prices across this entire customer segment for 2018-19 were likely below reasonable costs. Note this was prior to the introduction of the DMO on 1 July 2019, which saw in significant reductions in customer bills, as per the charts above.

Figure 1: Average residential customer bills by NEM regions, 2018–19, real \$2018–19, excluding GST



Source: ACCC

There are obviously challenges in relying on data in the ACCC’s published reports to validate the use of current market offers to approximate retailer profitability, including the use of averages, median bills and offers, and a time series with no recent observations. Further analysis could be conducted with updated ACCC billing and cost stack data, although the next ACCC report will be published after the AER’s final DMO determination.

Nevertheless, we consider that our findings with the data currently available raise important questions around the AER’s sole reliance on pricing data when having regard to whether the DMO price cap allows an electricity retailer to make a reasonable profit under clause 16(4)(b) of the Code.

Notwithstanding the AER's ability to successfully validate the relationships between pricing, bills, retailers' costs and profitability, we have two final related points on this topic:

- Given the limitations outlined above, the AER should not place heavy weight on specific calculated values or charts of 'headroom' as its methods may give a false sense of precision in the calculation of retailer "margins". This has implications for how the AER applies its judgement on what may, or may not, be material cost changes, discussed below.
- We also recommend the AER do not refer to differences between the DMO price cap and market offers as a "margin". This term, as it is used generically and by the ACCC, implies the entire observed price difference is attributable to retailer profit. A more appropriate term fitting the AER's analysis would be 'price spread'.

The measurement and assessment of step changes should be more transparent

The AER's draft determination explores submissions from retailers on a range of cost adjustments however does not factor any of them into the draft DMO allowances for 2021-22. While various reasons are given, in many cases the AER refers to the sufficiency of headroom and a corresponding high materiality threshold for passing them through or immateriality of costs generally. These potential costs adjustments are for:

- true ups for forecast errors in NSW network tariffs in the current DMO⁷
- COVID-19 bad debt impacts⁸
- Consumer data right
- 5 minute settlement⁹
- Advanced meter costs.¹⁰

While individually the AER considers various retailer costs to be immaterial, it has not explored whether they together materially alter retailers' cost components under clause 16(4)(c).

We accept that retailers may not have been forthcoming with sufficient data, or in the AER's view, credible data, to quantify some cost adjustments. However, we consider that stakeholders would benefit from some understanding of the total amount of costs that retailers are expected to absorb for each distribution zone in 2021-22.

We consider that once this is properly done by the AER, and in combination with the uncertainty on the 'true' value of headroom as outlined previously, it could reveal that adjustments to the DMO in some distribution zones are warranted.

For illustrative purposes, the table in the attachment to this submission lists the potential range of adjustments as proposed by stakeholders or listed by the AER, or otherwise our own rough estimate of such values, including in reflection of confidential data we

⁷ AER, p. 30.

⁸ *ibid.*, p. 61

⁹ *ibid.*, p. 66.

¹⁰ *ibid.*, p. 88.

submitted previously. The total of these amounts is expressed as a percentage of the 'headroom' values calculated in Appendix C of the AER's draft determination, giving a range of 8 to 13 per cent. The mechanistic application of CPI to increase residual costs by much smaller amounts (\$4 to \$5 per customer) is a further contrast to the AER's application of judgement to disallow potential step increases that are far larger.

The AER's positions regarding costs relating to COVID-19 and implementation of 5-minute settlement are also worth briefly exploring, namely its justification that the DMO is forward-looking and it is now only seeking to assess costs incurred over 2021-22. Although the AER has judged these items as being immaterial, these costs are important and represent legitimate step changes, yet were never compensated for under the 2020-21 DMO. Similarly, although the AER's approach to dealing with network cost changes will 'wash out' previous forecast errors, retailers were still undercompensated for significant uncontrollable costs in 2020-21.

As we noted in our prior submission, it is not necessarily critical that the AER's DMO tracks cost changes with precision in order to preserve retailers' financial viability. The percentage changes in the DMO, as set by a national independent energy regulator, are taken by some stakeholders as a reflection of efficient cost trends and therefore how prices should change across the market. The AER appears to be cognisant of such stakeholder expectations by explaining key differences in its calculations and those underlying the AEMC's most recent residential price trends report.¹¹ By extension, the AER should be explicit where it knows certain costs are changing, and attempt to quantify them, even though it has chosen not to reflect these in its DMO determination. It should also be mindful of communicating 'headline' DMO changes, and how these are based on costs for particular customer segments and tariff types i.e. flat tariffs, customers without solar etc.

The AER's approach to assessing materiality could be refined

The AER outlines the following considerations under its 'step change' framework:

- A cost must:
 - be due to an exogenous change in a retailer's operating environment that is mandatory and would be incurred by an efficient and prudent retailer within the relevant DMO determination period
 - not be compensated in other parts of our forecast or other DMO cost elements
 - lead to a material overall change in the retail costs of an efficient and prudent retailer.
- The AER does not define 'materiality', however its view is that incremental cost changes due to new regulatory requirements, for instance, would generally be compensated by the residual CPI indexation.

¹¹ *ibid.*, p. 9.

- the DMO price is sufficiently high that minor cost increases can be accommodated without impacting retailers' abilities to recover their costs to service standing offer customers.
- Adjustments or allowances made under the step change framework are separate to the residual cost component, and not subject to indexation. Any step change adjustment or allowance would apply for one DMO period only.
- Where a step change spans multiple DMO periods, retailers would need to demonstrate the cost changes remain material for the subsequent period.¹²

As noted above, we generally support the AER applying judgement when balancing the objectives of setting the DMO in line with cost trends without being drawn into wasteful debates over the accuracy of the DMO prices. In assisting the AER in forming its judgement when setting the final DMO from 1 July 2021, as well as assessing costs via step changes or trends into the future, further analysis should be undertaken to substantiate that the DMO is "sufficiently high" or above retailers' efficient costs¹³ to absorb minor cost increases.

The AER should also quantify the cost of new regulatory requirements relative to CPI indexation if such costs are not being recognised as step changes. For example, the draft determination effectively presumes that the cost of recent and very large interventions like 5-minute settlement and the consumer data right, are compensated for by the \$4 to \$5 per residential customer increase associated with indexing residual costs by CPI.¹⁴ As per data presented in the attachment to this submission, we consider this to be inadequate.

Regarding its step change framework, the AER's considerations largely mirror what is in place for regulated energy networks in terms of administering cost pass throughs, including that that costs must arise from events that are outside of the entity's control, material and not already compensated for elsewhere. For networks, the National Electricity Rules prescribe a materiality threshold of 1 per cent of annual regulated revenue requirements.¹⁵ The AER may not wish to be as explicit in setting a threshold for retailers, and there is nothing binding the AER to maintaining a consistent approach between different regulated sectors. However, the following considerations seem relevant for the AER in applying its judgement when considering cost changes and retailer profitability:

- Network determinations are based on (effectively) a bottom-up assessment of efficient costs. Hence a cost change in the order of 1 per cent of revenue requirements would basically reflect a one-for-one change in uncontrollable current expenses (i.e. opex).
- Assuming the AER's calculation of DMO 'headroom' is a fair representation of revenues in excess of costs (which, in our view, has not been substantiated), the revenue equivalent of a 1 per cent network cost pass through would roughly be a 1.2 per cent materiality threshold for retailers, all else being equal. Based on the flat rate residential DMO, this would be in the order of \$20 per customer.

¹² *ibid.*, p. 54.

¹³ *ibid.*, pp. 30, 54, 61

¹⁴ *ibid.*, p. 10.

¹⁵ National Electricity Rules, Chapter 10, definition of "materially".

- Retailers operate on margins that are much smaller than capital-intensive network businesses. For example, networks are effectively expected to absorb opex increases up to 1 per cent of revenue, which would translate into a reduction in a network's return on capital (roughly speaking, its EBIT margin) of around 3 per cent.¹⁶ If retailers were expected to absorb a 1 per cent increase in costs, this would reduce an efficient retailer's margin (i.e. EBITDA of 5.7 per cent of revenues) by around 17 per cent. Conversely, our conceptual 3 per cent "margin threshold" for networks would translate to around 0.2 per cent of retailer revenue,¹⁷ or around \$3 per customer based on a \$1600 per year residential flat rate DMO.

Our further observations on the AER's LGC cost estimation approach

One of the justifications put forth by the AER in affirming its approach to LGC cost estimation is that the ESC's most recent final decision found that its benchmark of LGC and wholesale costs sits comfortably within the range of retailers' submitted actual costs.¹⁸ While this is perhaps not a critical point for the AER, the ESC acknowledged drawbacks in its approach.¹⁹ Specifically, the ESC compared costs incurred by retailers in 2017-18 to its first VDO allowance from 1 January 2019. As we outlined to the ESC, this comparison is flawed because:

- LGC prices reflected in first VDO were above \$60 per certificate, however the ESC was attempting to validate an approach (similar to the AER's) that would now compensate retailers for prices that are around half of this amount.
- prices for LGCs traded in the market around 2017-18 were likely reflective of long run costs of LGCs sourced from power purchasing agreements, hence this validation approach could also be used to confirm that a long run LGC price of \$60 per certificate would have appropriately compensated retailers.
- the VDO's benchmark wholesale energy costs were around \$100 per MWh. Retailers' actual wholesale costs would easily vary by several dollars around this amount. When combined with environmental costs, this wholesale cost variance would more than offset the under-compensation arising from the ESC's LGC cost estimation approach (i.e. around \$2 per MWh).

The AER has not adequately addressed our earlier points about the appropriateness of relying on traded LGCs as a fair price for all LGCs to be surrendered, and hence their use when determining retailers' costs of compliance. The AER stated:

As we noted in our DMO 2 Final Determination, LGCs trade reasonably well in the market. For example, LGC market trades during calendar year 2019 amounted to over 69 million LGCs, or over two times the mandated LRET target for 2019.²⁰

The data quoted by the AER from the Clean Energy Regulator is for all certificate registry transactions, not unique certificates, and moreover is for certificates of all vintages, not

¹⁶ Calculated on the basis of AusNet's recent transmission pass-through application, namely a materiality threshold of \$5.6 million, compared to its return on capital for 2020-21 of \$194 million. <https://www.aer.gov.au/system/files/AusNet%20%28T%29%20-%20Final%20Decision%20-%20PTRM%20-%202021-22%20RoD%20update%20-%20Tower%20collapse%20pass%20through%20-%20September%202020.xlsm>

¹⁷ That is, 3% of 5.7%.

¹⁸ AER, p. 48.

¹⁹ Essential Services Commission, *Victorian Default Offer 2021: Final Decision*, 25 November 2020, p. 23.

²⁰ AER, p. 48.

just those to be surrendered for 2019. We sourced the following information directly from TFS to explain these different concepts:

- LGCs for calendar year 2019 — 4,121,165 certificates were traded over 2019
- LGCs of all vintages traded in 2019 — 20,361,455 certificates
- LGCs for calendar year 2019 traded at any time — 13,672,056 certificates.

In the AER's terms, the measure of relevant trades against the 2019 LRET target of 31 million certificates is only 13 per cent (i.e. 4.1 million 2019 certificates) and not over 200 per cent as suggested by the AER.

Further points on advanced metering and time of use tariffs

We have further observations on the AER's analysis of advanced metering and customers on TOU tariffs, in addition to the points raised above on material cost changes for 2021-22.

The AER notes that around 80 per cent of residential customers with smart meters are currently on flat tariffs.²¹ This will change under the tariff structure statements of Energex and SAPN, whose policy is to shift all smart meter customers from legacy tariffs (mostly flat) to demand (Energex) and TOU (SAPN). Our understanding is that approximately 100,000 customers in each distribution zone will be affected by these changes from July 2021. As it relates to network tariff reassignments, 100 per cent of SAPN type 4 customers will be TOU from July 2021. The extent to which this is reflected in retail tariffs will obviously depend on each retailer, however we assume these network price signals are generally passed through to the consumer. We note that reassignments in the case of Energex are not directly relevant to the AER given they involve demand tariffs, however these points illustrate the need to consider future reassignments across the distribution zones.

The AER's finding for Ausgrid, that over two-thirds of TOU customers do not have advanced meters²², is correct to the extent advanced meters are specifically defined as type 4 meters. As the AER may be aware, Ausgrid rolled out its own interval metering many years ago to facilitate TOU tariffs. Hence the cost to serve in Ausgrid's region may be higher than suggested by the AER's analysis.

We also reiterate the comments we made in previous submissions regarding the comparability of market offers to the DMO which excludes advanced metering costs. The AER's view is that including any such allowance would result in an inequitable allocation of costs to 80 to 90 per cent of standing offer customers who do not contribute to such costs.²³ As mentioned earlier in this submission, the AER's use of median offers as a proxy for underlying costs²⁴ requires further validation, and this point applies equally to examining the cost of serving TOU customers.

²¹ *ibid.*, p. 84.

²² *ibid.*

²³ *ibid.*, p. 87.

²⁴ *ibid.*, p. 89.

Wholesale costs and the retailer reliability obligation

The impact of the Retailer Reliability Obligation is not an immediate issue for the AER in assessing wholesale cost trends for 2021-22. However, the AER should set out some guidance on how a binding RRO will affect benchmark retailer practices and its cost estimation methodology. This is important given the lead times involved, and the fact that retailers seeking to manage price risk against the DMO may be emulating the AER's wholesale estimate method.