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Australian Energy Regulator  
Stephanie Jolly  
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Australian Energy Regulator  
By email: [DMO@aer.gov.au](mailto:DMO@aer.gov.au)

### Draft DMO decision 2023-24 – Public version

EnergyAustralia is one of Australia's largest energy companies with around 2.4 million electricity and gas accounts in NSW, Victoria, Queensland, South Australia, and the Australian Capital Territory. EnergyAustralia owns, contracts, and operates a diversified energy generation portfolio that includes coal, gas, battery storage, demand response, solar, and wind assets. Combined, these assets comprise more than 5,000MW of generation capacity.

EnergyAustralia appreciates the opportunity to make this submission to the AER's draft decision on DMO5. We commend the AER on generally maintaining a consistent approach to DMO5 and retaining the same percentage-based approach to the Retail allowance. This decision gives due weight to the DMO's longer-term objectives around promoting competition and innovation. It also provides much needed certainty and stability to support investment by Electricity Retailers in the context of a market which could see continued volatility and challenges for Retailers, as thermal generation exits the National Electricity Market.

Our main issue with draft DMO5 is around the proposed approach to explicitly incorporate options in the DMO's hedging strategy. Overall this methodology is reasonable but requires some changes to improve its accuracy before it can be adopted. We also raise some other issues regarding the proposed pause on the glide path for the retail allowance, and continued concerns as to whether the DMO allows for sufficient depreciation and amortisation given the AER has only been able to test this in a limited way.

Our full submission is below.

## 1. Wholesale electricity cost methodology

### 1.1. Use of Options in the DMO's hedging profile

The AER's draft decision is to include base futures that are traded as a result of exercising base options in the wholesale methodology for DMO5. This is to reflect the use of options in a risk averse retailer's hedging strategy. Specifically, the WEC will include the exercised options at the trade weighted average strike price plus the trade weighted average premium attached to the exercised and expired options.

To support its change in WEC methodology, the AER observes that “the volume of base options has increased significantly in the last 5 years. We anticipate the use of options as a hedging tool will continue to increase, as retailers revise their spot market risk management strategies”. ACIL Allen notes that exercised base options contribute about 15 per cent of the traded volume of base 2023-24 contracts, and the increase in use of options over the last 12-18 months.

We observe that some retailers have recently turned to using more options in their hedging strategy because of illiquidity issues in buying swap products. This illiquidity is due to sellers not selling because of generator reliability issues, increased ASX margin calls late last year, and other factors etc.

Although there has been some increase in use, the increases in the volume of base options observed by the AER and ACIL Allen might still be also due to higher levels of speculative trading incentivised by volatile prices, rather than increased Retailer use for hedging purposes. i.e. The 15% of traded volumes appears too high for hedging purposes.

Overall however, we generally accept the AER’s change in methodology but with adjustments. The AER’s proposed change is, on balance, more accurate than the status quo. The AER should implement the following adjustments however before it adopts its proposal for final DMO5:

- **Trade weighted vs open interest** - It is important that the AER attempts to exclude the volumes of options traded for speculative purposes only and in particular the AER should exclude the impact of spread option trades. For example, a trader might simultaneously buy a 10MW \$60 strike call for \$5 and at the same time sell a 10MW \$80 strike call for \$1.50. Assume those options are exercised. The AER’s trade-based approach would factor this 20 MW as weighting the strike price (by \$5 and \$1.50) which would be factored into the WEC. However, in reality, the trader has a net zero hedge position. Ultimately they have not acquired any incremental MW volume to hedge any customer load.

The more accurate approach would be for the AER to evaluate the change in open interest in the same underlying swap product for the days the swaptions expire (in May and November), instead of a trade weighted approach. Change in open interest could be applied for both contracts traded from call options and those traded independent of options. This approach should provide a better proxy of the “net” position.

If the AER fails to adjust for speculative trades, it could result in a significant under-recovery in WEC costs in a rising market. That is, it would overstate the impact of call options traded at a lower strike price compared to the settlement/market price. Note the reverse does not apply to average out the effect over time. i.e. it will not result in an over-recovery in a falling market, as a falling market will mean the options are “out of the money” (strike price above market price) and so the option will not be exercised in the first place i.e. no trades will occur to inflate the WEC.

- **Option premium** - We agree with the AER in including the cost premium attached to exercised and expired options.
- **Inclusion of financial year options that expire in mid-May** – ACIL Allen’s methodology on options will include the calendar year options that expire in mid-November. However, it is unclear if financial year options that expire in mid-May will be included as this depends on whether ACIL Allen draws their ASX data for their final WEC calculation in time. The AER must include both calendar year and financial year options for their WEC to be accurate. If it can only include calendar year, then the better approach would be to exclude both and revert back to the status quo approach taken in the WEC.

- **Put options** – We question whether the new methodology will cover both call and put options. Put options should have limited impact, given the majority of options bought by Retailers for hedging purposes are call options.
- **Continued assessment of whether the new approach is appropriate** – We accept that the AER’s changes are more accurate than the status quo and that current practice justifies the change. However it is still unclear how material the trend towards options is, how long it will last, and whether changing the methodology permanently is warranted in the longer term. The AER should continue to assess these matters after DMO5.

### 1.2. Error in AEMO fees

There appears to be an error in the DMO’s input for AEMO fees for Full Retail Contestability (FRC) and Energy Consumers Australia (ECA) items. This results in an under-recovery of \$1.30 per NMI. This error also appears to have occurred in all past DMOs. Given AEMO fees are a direct cost pass through in the DMO, we ask that this error be rectified going forward and be compensated for previous DMOs in final DMO5.

The correct figures from AEMO<sup>1</sup> are below:

**Table 6 FRC revenue requirement and fee**

	Budget 2021-22	Budget 2022-23	Variance	Variance
FRC Revenue Requirement (\$m)	14.2	13.9	-0.3	-1.8%
Connection Points (Million)	10.5	10.6	0.1	1.0%
FRC Fees (\$ per connection point per week)	0.02592	0.02519	-0.0007	-2.8%

**Table 29 ECA revenue requirement and fees**

	Budget 2021-22	Budget 2022-23	Variance	Variance
<b>Electricity</b>				
Revenue Requirement (\$m)	6.43	6.02	-0.41	-6.3%
Electricity FRC - Connection Points (Millions)	10.49	10.59	0.11	1.0%
Electricity Fee (\$/connection point for small customers per week)	0.01185	0.01104	-0.00081	-6.8%
<b>Gas</b>				
Revenue Requirement (\$m)	2.19	2.26	0.08	3.6%
MIRN’s Basic Meters - Total (Millions)	4.73	4.81	0.08	1.6%
Gas Fee (\$/customer supply point per month)	0.03861	0.03925	0.00064	1.7%

The DMO has seemed to apply an incorrect figure and incorrect metric, \$0.078/MWh and \$0.034/MWh for both FRC and ECA costs (Table 4.11, ACIL Allen Report to AER, 3 February 2023).

### 1.3. Net system load profile issue

We support the AER’s approach to explore this net system load profile issue in DMO6.

<sup>1</sup> [aemo-2022-23-budget-and-fees.pdf](#)

## 2. Retail margin

### 2.1. Glide path issue

We strongly disagree with the AER's decision to delay the glidepath for increases to the retail allowance in SAPN and Energex distribution areas, but to continue the glide path for all other distributor areas where the retail allowance is decreasing. This lack of consistency could be perceived as being aimed to produce lower price outcomes for customers, at the expense of allowing Retailers to recover their efficient cost or other DMO objectives around enabling competition and innovation. In terms of forgone revenue, the forgone retail allowance for 2024 for SAPN and Energex is not immaterial, amounting to between \$39 and \$55 per customer per year.<sup>2</sup>

The AER has not provided certainty as to when it will re-instate the glide path, stating it will reassess this in the context of movements in the DMO in DMO6. The implication is if DMO6 is increasing, the glide path may be paused again, with no indication of the materiality of that increase etc. The basis for this reasoning seems arbitrary and it extends any uncertainty for Retailers indefinitely which makes it difficult to predict standing offer revenues in those distributor areas in our forecasts. If the AER pauses the glidepath for DMO 5 (which we oppose), then it should at least confirm the circumstances it will pause or recommence the glide path in DMO 6 i.e. if there is a material increase of over X%.

### 2.2. Retail margin and depreciation & amortisation

The AER estimates the Retail Allowance which includes retail margin (EBITDA). As per our previous submissions, we ask the AER to continue to substantiate that the Retail Allowance is sufficient to cover larger Retailers with significant levels of capital investment and depreciation for their IT assets.

We recognise that the AER has done some analysis to substantiate its position using AGL's public data on depreciation and one other Retailer. This shows that depreciation would lower the Retail allowance below 10%; 5.5% to 9.6% depending on the distributor area. This means the full DMO allowance to enable competition and innovation is not provided which in itself means the DMO is not achieving its full policy intent.

We note that the AER's ability to test the amounts of depreciation and amortisation under the DMO is limited to the data it has. To undertake this assessment robustly, we recommend:

- The ACCC request a breakdown of EBITDA data from retailers in their cost stack requests, with D&A split out from EBIT. This will complement the ACCC's own analysis of cost stack data generally, and provide the ACCC with a greater understanding of costs across the cost stack – both the costs in the Retail Operating Cost (ROC) and the Retail margin (EBITDA) components. The ACCC's focus and analysis has been on Retail Operating Cost only, which excludes D&A, and therefore provides an incomplete view on retailer cost. A breakdown of EBITDA will also allow the ACCC to analyse the actual profit of Retailers.
- The AER can then either request the same data or obtain this data from the ACCC to undertake a wider analysis of whether the DMO's EBITDA is sufficient to cover actual D&A reported by Retailers (beyond two retailers).

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<sup>2</sup> - \$49 for residential without controlled load in SAPN; - \$55 for residential with controlled load in SAPN; and - \$39 residential without controlled load in Energex

### 3. Advanced meter cost – deduction of upfront fees from advanced meter cost allowance

The AER proposes to make an adjustment to subtract up-front, once off advanced meter fees from the advanced meter cost allowance. At a conceptual level this appears reasonable to ensure that Retailers do not over-recover on metering costs.

The AER requested data from Retailers to calculate this over-recovery. However we have some doubts over whether other Retailers understood the intent of what was being asked. The AER sought separate data on:

- smart meter costs (annual and per customer)
- up-front smart meter costs.

In the AER's first email, it's clear that these categories were meant to be mutually exclusive, but then subsequently, the AER stated the first could include the second category; and either way it would be accounted for in the DMO. Reviewing the template alone it is unclear whether the categories are meant to be mutually exclusive or not.

It is also unclear how Retailers responded in the past but comparing last year and this year's costs might point to an issue. The smart meter costs are higher this year: \$107 and \$120 vs \$106 and \$116 last year for residential and small business customers (differential of \$1 and \$4). This could suggest that last year Retailers were not including the upfront fee in their smart meter cost reporting so the AER should check that this was the general response from Retailers. However if this was the case, the differential seems to be on the small side given the upfront fee of \$5 and \$8. This discrepancy points to potential interpretation issues which the AER should check with Retailers. The AER could start by comparing meter cost data submitted by Retailers to see if that data broadly aligns.

If you have any questions in relation to our submission, please contact me (Selena.liu@energyaustralia.com.au or 03 9060 0761).

Regards,

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