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Australian Energy Regulator
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Submitted online via: DMO@aer.gov.au

Dear Ms. Jolly

Australian Energy Regulator (AER) Default Market Offer (DMO) 2023-24 Draft Decision

Thank-you for the opportunity to provide a submission in response to the Default Market Offer 2023 -24 Draft Decision (Draft Decision).

Momentum Energy Pty Ltd (Momentum) is an Australian operated energy retailer, owned by Hydro Tasmania, Australia's largest producer of renewable energy. We pride ourselves on providing competitive pricing, innovation and outstanding customer service to electricity consumers in Victoria, New South Wales, South Australia, Queensland, the ACT and on the Bass Strait Islands. We also retail natural gas to Victorian customers. We aim to offer competitive rates to both residential and business customers along with a range of innovative energy products and services.

1. Summary

Whilst we support the proposed increase in the DMO for 2023-24 (DMO 5) we note that the significant changes in wholesale electricity costs are largely responsible for the proposed increase. The extreme market volatility experienced during 2022 has highlighted a material inadequacy in an assumption used to determine the wholesale cost component which needs to be adjusted. We have provided details of this wholesale cost issue below, together with comments regarding several other components of the cost stack used to determine the Draft Decision.

2. Wholesale Costs

Momentum recommends that futures trades that result from exercising an option should be excluded from consideration in the DMO trade weighted pricing methodology. The current proposed methodology to include futures trades arising from option exercise, results in unrealistic hedge pricing outcomes for the following reasons:

- a) It assumes retailers know in advance, which option strikes will end up being in-the-money on the option expiry day, to enable them to buy all such options in advance (on a trade weighted basis) if they trade, to mirror the futures trade prices created on the option exercise date.

- b) It ignores the Australian Securities Exchange (ASX) option market tendency for up to 90% of ASX electricity options, to be traded simultaneously as a strategy with an offsetting ASX product. For example, call options overwhelmingly trade as “call-spreads” where to buy one call another call must be simultaneously sold. In such situations, a retailer is unable to benefit from unlimited hedge payoff from their bought call as would be provided by a futures contract. Similarly, a bought call option might trade with a simultaneous sold futures position (a delta hedge). The high proportion of options traded simultaneously with other offsetting futures or options can be quantified using ASXEnergy trade data, to identify option trades which traded with an identical time-of-trade as another ASX option or futures contract.
- c) Put options which expire in-the-money also give rise to ASX futures transactions on option expiry day. Presumably futures transactions resulting from exercised puts have also been included in the trade-weighted futures price calculation despite put buying not typically being a retailer hedging strategy.
- d) The financial impact of these methodology shortcomings can be very large. For example, consider the case of a call spread where a retailer buys a \$40-strike call and simultaneously sells a \$47-strike call, and pays \$2/MWh premium for the combined call spread. If the futures market at the option expiry date is \$205/MWh (or any price \$47/MWh or greater) the maximum hedge protection provided by the call spread is \$5/MWh (the difference between the option strike prices, less the \$2/MWh premium the retailer paid for the strategy). On option expiry day, given both calls would have ended up in-the-money and given rise to futures transactions, the proposed DMO methodology would capture the following trades:
- The \$40 priced futures resulting from the \$40 strike call would be included in the trade weighted price as a buying opportunity; and
 - The \$47 priced futures resulting from the \$47 strike call would not just be ignored (despite being a significant \$155/MWh loss for the retailer. i.e. \$205 - \$47) but would perversely be considered a futures “buying opportunity” at \$47 for the retailer – and included in the trade weighted price as such.
- e) Additionally, the proposed methodology dramatically increases the complexity and likelihood of error for participants attempting to estimate and manage DMO pricing risk in their portfolios. In effect, market participants would need to know up to years in advance whether a potential option trade was going to end up a “winner” (in-the-money) on option expiry day and therefore included in the DMO price-weighted sample.

Futures trades that resulted from option exercise, could be filtered out of the DMO methodology, by omitting ASXEnergy futures trades that meet the following conditions:

- Occur within 2 business days up to and including the option expiry day. For example, some options are exercised prior to the option expiry day (e.g., some CY2023 options with an ASX expiry date of Monday 21 Nov 2022, were early exercised on Friday 18 Nov 2022); and
- Denoted as “strip” trades in the ASXEnergy data i.e., strip option exercise only results in “strip” futures types as denoted in the ASXEnergy data; and
- Futures covering terms that align to the “underlying” futures year, covered by the option that has expired.

3. AEMO and AMEC Compensation for Wholesale Market Intervention

We refer to the Draft Decision’s proposal to only include known Australian Energy Market Operator (AEMO) and Australian Energy Market Commission (AEMC) market intervention compensation costs, flowing from the energy market crisis in 2022, in the DMO 5 final decision and the proposal to not include a working capital allowance for retailers to manage the compensation costs should they be determined, post the DMO 5 final decision. It is proposed that these costs will be recoverable in subsequent DMO determinations.

In our response to the issues paper, Momentum proposed a working capital allowance for retailers to manage any compensation costs issued post the DMO 5 decision, but this has not been adopted on the pretext of the following statement:

The issues paper provided our current approach, which involves including any known costs arising from compensation regimes in the wholesale energy component. In relation to the cash flow impacts from the timing of this lagged cost recovery, the issues paper noted that the current wholesale methodology accounts for these through the prudential costs that a retailer would incur in meeting the requirements of both AEMO and the ASX.

Momentum seeks clarity on how the wholesale methodology accounts for these working capital costs through the AEMO prudential costs. It is our understanding that the prudential costs are levied to retailers based on the amount and price of the wholesale electricity supplied to our customers. We are unaware of any off setting “discount” that may apply based on the lagged recovery of any market intervention costs.

4. Network Costs

We fully support the use of updated network tariff information provided by distributors to better align the DMO 5 draft decision to what is expected in the final decision where final network tariffs will be included. This provides a more accurate indicator of the final DMO decision.

5. Environmental Costs – NSW Peak Demand Reduction Scheme (PDRS)

Momentum appreciates the inclusion of the NSW PDRS into the environmental cost allowance for DMO 5 and subsequent DMO decisions. This is an additional cost that retailers will be incurring to comply with this new environmental program.

6. Retail Operating Cost

It is our view that the bad and doubtful debt allowance methodology used in the DMO 4 final decision and DMO 5 draft decision are inappropriate. The AER has collated bad and doubtful debts reported by the three largest retailers and determined an average debt cost per customer based on this data. This data includes the total expense related to bad and doubtful debts from all small customer types (gas, electricity, internet etc) of these three retail entities. It is our experience that electricity customer debt is greater than gas customer debt and that this allowance would be more accurately calculated using the ACCC annual reporting data provided by all retailers.

7. Retail Allowance Glidepath

Momentum is disappointed that the AER has chosen to not continue with the retail allowance glidepath proposed for DMO 5 and DMO 6 for residential customers. We fully supported the glidepath of (10% residential and 15% SME retail allowances) for all network areas when it was proposed for DMO 4. We acknowledged that this will occur for small medium enterprise (SME) customers in DMO 5. The rationale to pause this glidepath for residential customers is largely based on increases to the wholesale market component of the DMO. A consistent approach to calculating the DMO is paramount to maintaining market confidence and ensuring certainty. Commitments made in previous DMOs, should be delivered across all cost stack components of the DMO. This will support competition in all networks providing customers with choice and confidence in the market.

We are hopeful that our comments above will help shape DMO 5 as well as future DMO's and result in a fair and reasonable outcome for all market participants. Should you require any further information regarding this submission, please don't hesitate to contact me on 0478 401 097 or email randall.brown@momentum.com.au

Yours sincerely

[Signed]

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