



Government
of South Australia

Department for
Energy and Mining

Our Ref: 2022D037672

Ms Stephanie Jolly
General Manager, Market Performance
Australian Energy Regulator
GPO Box 3131
CANBERRA ACT 2601

Dear Ms Jolly

Default Market Offer prices – 2022/23 Draft Determination

The Energy and Technical Regulation Division (the Division) of the South Australian Department for Energy and Mining thanks you for the opportunity to comment on the Default Market Offer (DMO) prices – 2022/23 Draft Determination.

This submission does not represent the views of the South Australian Government, which has entered a caretaker period. The views and opinions expressed in this submission may be amended in the future to reflect the priorities and positions of the incoming government.

The Division thanks the Australian Energy Regulator (the regulator) for its work on the DMO Draft Determination, and in considering the appropriate methodology for adopting in the 2022/23 determination and beyond. While supportive of a number of elements of the regulator's draft determination, we wish to comment on changes proposed to the retail and wholesale cost components.

Retail costs – proposed methodology change

As mentioned in our submission to the regulator's options paper, the Division was supportive of a continuation of the indexation approach in determining the retailer component of the DMO. Given the policy objectives appear to have been largely met under this approach we considered continuing with this general approach provided a level of predictability. While open to the idea of obtaining new data sources (Option 3) we were concerned that adopting a bottom-up approach (Option 1) may result in marked price changes for customers. As there is no accurate methodology for determining retail margins under the cost-build up approach, and as this results in higher costs for consumers in some jurisdictions, we do not support this proposed change in approach.



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Importantly, the regulator's role specified under the regulations continually refers to consideration of prices, costs and profits *in that region*. These appears inconsistent with the proposed approach to applying a retailer margin consistent across all regions.

The Division agrees with the view, submitted by some retailers to the regulator's Options Paper, that it would be an undesirable outcome for a universal margin that resulted in a higher DMO. They stated that retailer margins can vary by region for many reasons including risk, marketing strategy, and customer longevity and attempting to set a consistent margin can have adverse consequences for customers in some regions with little reference to the actual cost of serving standard offer customers. Others noted that given the retail energy market is effectively competitive, the appropriate DMO margin would ideally reflect competitive market outcomes.

While we agree with the important objectives that retailers are to be allowed to recover their efficient costs, and that incentives for competition are to be maintained, we do note that allowing further margin within the DMO for competition to occur should be very carefully considered if competition in the market is already healthy. Any decision to increase margins in an already competitive market risks the important objective of the DMO which is to reduce unjustifiably high standing offer prices and to protect consumers from unreasonable prices.

The Division suggests that levels of competition in the South Australian retail market appear strong, despite the reportedly lower levels of retailer margins. The regulator's *Annual retail markets report 2020/21* shows the number of active retailers in the South Australian market consistently trending upwards, from 17 retailers in 2016/17 up to 32 retailers in 2020/21. Performance monitoring data shows that, of the jurisdictions monitored, South Australia has the highest proportion of customers on market contracts - 91.9 per cent for residential and 84.7 per cent for small business. Further, residential and small business customers switching retailers are consistent with other jurisdictions, with these quarterly switching rates not showing any significant change since September 2017.

The draft determination notes that retailer margins for residential customers in South Australia are around 1 per cent. We consider a jump to a consistent 10 per cent retail margin a significant increase for residential customers in South Australia, even if a transitional pathway is adopted. It is highly likely that the resultant increase in the DMO will lead to an increase in market offers for many consumers. We query whether the retailer allowance cost component should be a reflection of the market that the retailer is in, and its level of competitiveness, just as all other cost components are.

It is also noted that the step-change framework in the current methodology, which allows stakeholders to seek recognition of any material changes in retail costs, has not been used in DMO determinations to date. If the methodology, and therefore the determination of the retail component of the DMO determinations, was inadequate it is assumed that additional allowances in this cost component would have been approved.





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Finally on this matter, setting the retailer allowance as a proportion of the overall bill will result in larger retailer allowances if other cost components increase, effectively allowing retailers to recover greater costs via standing offer customers for no justifiable reason, if other, non-retail related costs increase.

Wholesale costs

The regulator's consultant has provided an indicative estimate of the impact of including the AEMO directions cost component on the DMO 4 price. These AEMO directions cost estimates have been achieved by taking the sum of the quarterly direction costs by region for the most recent past four quarters. We note that the regulator will update this amount in the final determination, to ensure the estimate continues to reflect costs over the previous 12 months.

The AER should be cognisant that AEMO's approach to system strength has changed markedly over the past 12 months with the recent full operation of four synchronous condensers in South Australia in November 2021. This will have a significant impact on direction costs for the future.

The successful commissioning of the new synchronous condensers means that AEMO is now able to operate South Australia securely with a reduced number of synchronous generators. Given this, AEMO has updated its system strength limit advice to reduce the minimum number of gas generation units required to ensure power system security from the equivalent of four large units to two, under most operating conditions.

The AEMO *Quarterly Energy Dynamics Q4* report suggests that since the updated advice, in most circumstances only two gas generation units have been required to be online for system security purposes in South Australia, resulting in a notable reduction in average gas generation output under direction and therefore a reduction in directions costs. Based on their preliminary data, directions costs incurred after the change in AEMO advice reduced to \$3 million compared to \$31 million prior to the change, although these estimates may change as directions costs and additional claims are finalised.

Given this marked change, the Division suggests the regulator determines an alternative approach to the forecasting of AEMO directions costs. Future market conditions and costs from directions are highly unlikely to resemble outcomes over the last 12 months.

Finally, given the changes being experienced in the electricity market, the Division supports the regulator's draft decision to seek a peer review of the wholesale forecasting modelling to ensure it remains able to capture changes in wholesale market outcomes in the coming years.





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Conclusion

Noting that the draft DMO prices are to be adjusted in the regulator's final determination to incorporate updated data between February and April, we are concerned that the final DMO will not meet the objectives of the DMO. We therefore encourage the regulator to consider proposed changes in their methodology.

The Division thanks the regulator for the work on this review. Should you have any questions in relation to this submission, please contact Mr Chris Leverington, Senior Policy Officer, Energy and Technical Regulation Division, on (08) 8429 3298.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Vince Duffy'.

Vince Duffy
**EXECUTIVE DIRECTOR
ENERGY AND TECHNICAL REGULATION**

18 / 3 / 2022