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Default Market Offer prices 2022-23 - Draft determination

AGL welcomes this opportunity to provide comments on the Australian Energy Regulator's (AER) *Default Market Offer prices 2022-23 – Draft determination* (Draft determination) published on 18 February 2022.

AGL understands that the AER has elected to change from the indexed approach to a cost stack approach for determining the default market offer (DMO) prices in order to address the inconsistent retail margins currently applying across the network regions. AGL believes this is appropriate, however, the application of a cost build-up approach requires each component of the cost stack to be determined more carefully than the indexed approach.

While we accept that some judgement is required, it is important that any margin for error is applied to ensure the AER does not underestimate any components of the cost stack and fails to meet its policy objectives. The DMO prices are not intended to be the best offer in the market.

However, the AER notes in its Draft determination that the prices determined under its new methodology are lower than they would have been under the previous methodology. This suggests and AGL believes that the AER has understated several cost elements, namely by:

- setting wholesale energy costs at the 75th percentile of modelled price outcomes; and
- relying only on ACCC data to assess retail operating cost and therefore not accounting for depreciation and amortisation costs in the allowance.

Detailed comments in response to the Draft determination are included in Attachment A. If you have any questions in relation to this submission, please contact Patrick Whish-Wilson on (02) 9921 2207 or Meng Goh on (02) 9921 2221.

Yours sincerely

Elizabeth Molyneux
GM of Policy and Market Regulation

Attachment A: AGL responses to draft determination

Wholesale costs

AGL has generally supported ACIL Allen's consistent approach to forecasting wholesale energy costs for the purposes of the DMO prices. This is unchanged. However, AGL does not support the AER's decision to select the 75th percentile of ACIL Allen's modelled price outcomes which appears highly subjective, short-sighted and without sufficient justification and transparency for the change.

The forecast of wholesale energy costs in previous DMO determinations was based on the 95th percentile of modelled outcomes, which assumed retailers were risk averse and minimised the annual variance under the index methodology.

The move to the 75th percentile significantly increases the risk that retailers' actual wholesale energy cost will exceed the AER's forecast allowance in 2022-23. Furthermore, this approach under a new cost stack methodology is likely to see increased and unwelcome variability in the AER's wholesale energy forecast in future years given the current and expected volatility in energy markets.

The AER has indicated that the shift to the 75th percentile provides a more balanced outcome and as ACIL Allen's modelling uses a risk averse hedging strategy, it does not materially reduce its forecast of wholesale energy cost. If this is the case, AGL questions why the AER would introduce such price variability into its new methodology when there is little direct benefit to current DMO prices. We expect the variance between these approaches to be even more significant in regions with highly variable peak loads such as South Australia. Given the lower liquidity and availability of contracts in South Australia the variance to retailers is likely to be even larger with the change in percentile.

The AER has not justified this notable change in methodology and AGL strongly recommends that the AER continue to use the 95th percentile of the ACIL Allen outcomes for estimating the wholesale energy for the DMO prices.

It is appropriate that the AER has recognised AEMO direction costs in the wholesale energy cost allowance under its cost stack approach. However, again AGL would note that this significant cost, particularly for South Australia, has largely been offset by the move to using the 75th percentile.

AGL does remain concerned that forward contract prices, specifically cap prices, in South Australia do not reflect the realistic market costs given the low liquidity. The AER has indicated in its Draft determination that it had no readily available data sources to inform any change to methodology and AGL has confidentially included in Attachment B some potential contract prices and proxies for cap prices that highlights our position.

Environmental costs

For the Draft determination, ACIL Allen has assessed the trade weighted forward price of LGCs to be $26.47/MWh for calendar 2022 and $22.36/MWh for 2023. To be clear, these average forward prices are significantly lower than current spot prices of over $40/MWh.

In relation to SRES, the binding 2022 STP need to be updated to 27.26% while the latest non-binding estimate for the 2023 STP is 22.34%. However, we note that in the Final Determination for the 2021-22 DMO, ACIL Allen did not use the CER's non-binding estimate and but assumed a similar level of rooftop PV

installations as the previous year. ACIL Allen noted that the binding STP has been greater than the CER's non-binding STP for eight of the past 10 years which supported this approach.

AGL believes that applying a consistent approach to the 2021-22 DMO is appropriate.

Retail operating costs

In the Draft determination, the AER has estimated retail operating costs by using:

- ACCC 'retail and other costs' in the ACCC's November 2021 Report,
- Advanced metering costs, weighted by the proportion of customers with advanced meters,
- Bad and doubtful debts, and
- CPI adjustment.

While the ACCC data appear to be an objective source, it does not address the nature of the representative retailer. It is useful as a starting point and the adjustments for metering costs and bad debt are appropriate.

However, importantly, the retail costs in the ACCC Report do not include depreciation and amortisation expenses (D&A). D&A are not insignificant. In AGL's FY21 Annual Report, D&A attributable to the retail business totalling $134 million exceeded bad and doubtful debts ($127 million). In addition, there are additional D&A reported under centrally managed expense ($62 million) which could be partially allocated to the retail business.

In recent years, retailers including AGL have invested significantly in billing systems and programs to digitalise and transform customer experience and business operations, and to comply with industry and regulatory requirements. According to accounting standards, these IT costs are amortised over a number of years. This will mean system development costs relating to regulatory requirements like five-minute settlement and consumer data rights (CDR) are not included.

The improvement in efficiency and productivity from the expenditure on technology has resulted in lower operating costs. The displacement of operating costs by D&A can be seen in the downward trend in retail costs in the ACCC's November Report. This can be illustrated by looking at the ACCC data and AGL's financial accounts. While the ACCC data shows the average retail cost for the NEM declining from $170 per customer in 2018-19 to $138 in 2020-21, AGL's D&A attributable directly to the retail business increased by over 30% from $101 million in 2018-19 to $134 million in 2020-21.

Without investing in technology, retail operating costs would be considerably higher, and it would not be possible to operate a compliant retail business. Alternatively, if these technology solutions are outsourced, operating costs will also be higher. Therefore, by ignoring D&A, the AER (and other regulators) has underestimated the total cost of operating a business.

In the Draft determination, the AER has also assumed that increases in retailers' costs will be adequately reflected in future ACCC data for future DMO determinations. As discussed above, this is not a reasonable assumption. For instance, AGL has several current projects to implement CDR and the Better Bills requirements that are estimated to cost around $30 million, mostly in IT development costs. These costs will result in amortisation expenses which will not be included as retail operating costs under the current approach.

Retail allowance

Under the cost build up approach, the AER has proposed a retail allowance which importantly will establish a more consistent margin across the regions. This retail allowance is intended to recover retail margin and an allowance to meet the DMO objectives. This presumes that all components of the cost stack have been set at reasonable levels.

In the Draft determination, the AER has set a retail allowance of 10% for residential customers and 15% for small business customers after examining the range of retail allowances in DMO1 to DMO3. We note that the residential retail allowance set in the Draft determination was within the range of the average allowances over the previous DMOs. However, the retail allowance for small business was set below the range of the average allowance over the previous DMOs and is close to allowance for SAPN for DMO3, which has the lowest retail allowance. We accept that the AER has exercised some judgement in setting the retail allowance, but it is important that this allowance achieves the key objectives of the DMO including maintaining incentives for competition.

Another consideration, as noted in the section above, is that the retail operating costs assessed by the AER do not include D&A. If there is no adjustment for D&A in the allowance for retail operating cost, the D&A will need to be recovered through the retail allowance. Therefore, the retail allowance proposed in the Draft Determination should be set higher by 2-3% to account for the cost of investment in technology which have not been included in retail operating costs. As D&A increases over time, this additional allowance should also be increased.

The AER has proposed a transition from the current level of retail allowance over a three-year period to minimise price shock, in particular in the SAPN region. It is worth considering if a shorter period of two years will be sufficient.

We also note that while the retail allowance has generally been set at the target level for DMO4 (except for SAPN in particular), the level of retail allowance for residential customers without controlled load in the Energex region has remained unchanged below the target level of 10%.