**AGL Energy Limited**
ABN: 74 115 061 375
Level 24, 200 George St
Sydney NSW 2000
Locked Bag 1837
St Leonards NSW 2065
**t:** 02 9921 2999
**f:** 02 9921 2552
agl.com.au

**Mark Feather**
**General Manager, Policy and Performance**
**Australian Energy Regulator**
**GPO box 520**
**Melbourne Vic 3001**

By email: DMO@aer.gov.au

**20 March 2019**

**AER Draft Determination: Default Market Offer Price**

AGL would like to take this opportunity to comment on the Australian Energy Regulator's (AER) Draft Determination on a Default Market Offer (DMO) Price. AGL has previously made a submission to the AER's Position Paper in December 2018.

In this submission, we will focus on the pricing methodology to set the DMO price for 2019/20 and future years. Our comments on the Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019 (the draft Code) will be provided separately to the Department of the Environment and Energy in the Australian Government. Whilst we understand that certain policy considerations and features of the DMO rest with the Government, we would like to re-state our position that, on principle, we do not support price regulation in a competitive market. In addition to the uncertainty of prices set by the regulator, the regulation of retail prices whilst wholesale energy costs are unregulated will create significant risks for retailers.

The imposition of the DMO is a fundamental shift in policy direction in the last 10 years. What is highly important is that the DMO price will be the common reference price which will make it easier for customers to compare market offers from various retailers. AGL supports the application of a reference bill, but not a regulated price cap.

In the draft determination released on 23 February 2019, the 2019/20 DMO price will be below nearly all retailers' current standing offer prices, including AGL's. We note the AER's expectation that standing offer customers who are currently benefitting from a voluntary retailer discount would continue to receive the equivalent discounted prices where they are lower than the DMO price, and not be disadvantaged in any way by the introduction of the DMO price. AGL's safety net discounts were offered to customers who have not signed a contract with AGL and these were offered at the time when it was unclear if a DMO will proceed. AGL would be very concerned if the DMO were to operate penalise retailers who invested money in such customer focussed initiatives, as it would risk removing any incentive for retailers to undertake such programs in the future.

The introduction of the DMO and the Industry Code will result in changes in retail competition. The consumer survey in the 2017 AEMC retail competition review showed that residential customers across the

NEM would require an average savings of 23% to seriously consider switching retailer or plan[1]. For businesses, the 2018 survey showed an average savings of 26% in their electricity bill to consider switching[2]. In December 2018, the AEMC advised the COAG Energy Council that the introduction of price caps will reduce price dispersion, resulting in a reduction in the price of high-priced offers and increases in the price of low-priced offers.[3]

Below are AGL's comments on key aspects of the pricing methodology in the draft determination on the DMO price.

**Top down approach**

AGL agrees that the top-down approach is appropriate due to time constraints. AGL notes the ACCC's support for this approach as well as the ACCC's view that "… inefficiencies in the supply of electricity are better tackled by facilitating effective competition between retailers that drives prices down toward efficient costs. In the recent dynamic of advertising large headline discounts, facilitating competition between retailers will involve giving retailers room to discount well below the DMO."[4]

The selection of the mid-point (50th percentile), i.e. the 'half-way point', of the median standing offer and median market offer is somewhat arbitrary. While it may seem to be a simple decision to take the 'half-way point', AGL notes the asymmetric risk associated with setting price caps: if the price cap is set too high, then competition will continue to operate to provide the lowest efficient rate, whereas if the cap is set too low, there is significant risk of harm to competition and the ongoing viability of retailers.

**Key cost components for 2019-20**

The DMO price is initially set using standing and market offers available in October 2018. In setting the 2019/20 DMO price, the AER also had regard to forecast changes in key cost inputs such as network charges and wholesale energy costs including green scheme costs.

AGL agrees with the AER's approach to not adjust the DMO price for these modelled expected changes between 2018/19 and 2019/20. AGL would have concerns if the AER were to seek to rely on the EY modelling conducted for the AEMC's 2018 Residential Price Trends Report for the reasons below.

*Wholesale energy costs*

The AEMC report specifically cautions that its report does not provide and should not be regarded as providing forecasts of future prices, and in AGL's view, particularly, with respect to a specific year.

The modelling done by EY is predicated on a very large number of assumptions and methodologies which can influence the outcome in a very significant manner. These assumptions and methodologies were not consulted on for the purpose of the AEMC report and have not been the subject of consultation here. These types of 'black box' models have been the subject of very intensive consultation and debate when used in

[1] AEMC, 2017 retail competition review, p 86

[2] AEMC, 2018 retail competition review, p 124

[3] AEMC, Advice to COAG Energy Council – Customer and Competition Impact of a Default Offer, 20 December 2018

[4] ACCC submission to AER's Position Paper on Default Market Offer, December 2018

jurisdictional price regulation processes. AGL notes in this context that on 28 February 2019, the QCA has released its draft determination for regulated prices in regional Queensland. To assess wholesale energy costs for 2019/20, the QCA engaged ACIL Allen. The wholesale energy costs ACIL Allen has estimated are significantly different from the results of the EY model. The key differences in modelling are noted in the QCA draft determination as well ACIL Allen's report.[5] ACIL has noted that the EY approach could yield very different results if the weighting of modelled spot prices is changed.

Models such as that employed in the EY Report cannot be considered a non-contentious means of forecasting a wholesale electricity cost, and it would not be appropriate for the AER to rely on the EY report in this process.

*LRET*

AGL notes that the EY approach to LRET assumes that large retailers' costs are based on the cost of the subsidy required for a new entrant renewable generator while small retailers' costs are based on the spot market. In some years, there are significant differences. AGL suggests this approach would need to be subject to further consultation before being adopted. AGL agrees that the costs being incurred by retailers in underwriting investment in renewable generation by way of PPAs is not always reflected in the market costs.

*SRES*

Similarly, the methodology adopted in the EY Report in respect to SRES costs requires further consultation. The EY Report assumes that that retailers can purchase STCs on the market at around $35 or from the Clearing House at $40 per certificate, and that large retailers only purchase STCs on the market. This is an assumption that would require further discussion. AGL notes in this context that in the QCA determination of notified tariffs for regional Queensland, the QCA's consultants, ACIL Allen, has assumed STC price to be $40. AGL supports this approach.

*Other costs*

AGL also notes that any attempt to model future wholesale and retail energy costs would need to consult carefully with market participants on the range of additional costs that may to be incurred in current market circumstances. For example, AGL notes that there have been considerable costs associated with funding the Reliability and Emergency Reserve Trader (RERT) and the Power of Choice reforms in recent years.

AGL notes that in the recent half year results to 31 December 2018, AGL's net operating cost per customer increased by over 7%. In the full year to 30 June 2018, these costs had increased by 27.4%. A portion of this is attributable to AGL's decision to make a significant investment in affordability and customer experience initiatives. As noted above, it is important that the DMO does not operate to penalise retailers who have invested in such initiatives

Increases in retail cost allowance of 2.4% is insufficient.

---

[5] ACIL Allen, Estimated Energy Costs, 2019-20 Retail Tariffs, 19 February 2019.

### 2019/20 DMO price

While the forecast changes assessed in the draft determination would lead to a moderate decline in retail prices, the AER has proposed not to adjust the DMO price for these expected changes between 2018/19 and 2019/20. The DMO price is below nearly all retailers' current standing offers.

AGL supports this approach because:

- the selection of the mid-point is arbitrary,
- the modelled wholesale market costs and green costs are likely to be different from actual retailers' costs,
- energy market participants have incurred costs, which have not been taken into account fully in this draft determination, to manage significant market and regulatory change.
- the proposed DMO price does not account for any changes in underlying costs that have subsequently been incorporated in market offer pricing since October 2018.
- the proposed DMO price will result in the reduction in nearly all standing offers from 1 July 2019 anyway as intended by Government,
- if the price cap is set too low, competition will wane, resulting in poorer customer outcomes in the long run.

The ACCC has recognised the need to allow room for retailers to discount below the DMO to facilitate competition. Given that the DMO will introduce regulatory risk, this approach provides a reasonable outcome which is likely to have a lesser impact on retail competition.

### QCA regulated prices and the DMO

There is no price regulation in the south east Queensland (Energex distribution zone). The QCA currently sets retail electricity prices for customers in regional Queensland (Ergon Energy distribution zone). Due to the Uniform Tariff Policy, these prices are set using an annual 'bottom up' analysis, using a cost stack, based on the assessed cost of supply in the Energex distribution zone. Whilst these regulated prices apply only to customers in regional Queensland, they also provide a guide to the level of standing offer in SEQ.

The DMO will provide another set of prices for SEQ which could create confusion amongst customers. As the QCA's authority and approach to set prices have been in place for a number of years, in AGL's view, the DMO price for the Energex distribution zone should simply be the same as the regulated prices which the QCA has determined for residential and small business customers in regional Queensland. The Industry Code does not preclude the DMO price to be set in this way.

### DMO from July 2020

It is unclear how the DMO price will be set from 1 July 2020. It will not be appropriate to apply the 'top-down' approach as the DMO for 2019/20 will set the price cap for standing offers.

The electricity market is in a period of significant change and potential disruption. The wholesale market is in a period of unprecedented change and transition – the Finkel Review estimates that over $400b will need to be invested in generation over the next 30 years. The introduction of the Retailer Reliability Obligation, challenges in the gas market, changes in technology, increasing renewable penetration and the role of demand response, the changing running pattern (and eventual retirement) of old thermal plant and changes in market design and frameworks will make the task of forecasting wholesale energy costs an extremely difficult one, and there are no models or methodologies that can be assumed to be capable of reasonably capturing these factors for the purpose of forecasting a wholesale energy cost.

Network businesses are undergoing price determinations and there are proposals to introduce cost reflective tariffs such as demand tariffs for small customers, and different operational models are being considered such as distribution system operators. In the retail energy market, there has been continually changes in regulatory framework, rule changes as well as regulated retail pricing.

AGL notes the experience of jurisdictional regulators in seeking to determine regulated retail prices, and the range of different methodologies that were considered and applied at various times. AGL believes it is reasonable to say that jurisdictional regulators struggled to identify any single approach that could be applied with confidence in all circumstances. Whether the AER considers a traditional ‘bottom-up’ approach using a cost stack, an index-based approach (such as that adopted by ESCOSA in the later period of price regulation in South Australia) or other methods, it will be essential that the AER to provide participants with proper opportunity for adequate consultation on the methodology, assumptions and approaches being contemplated.

If you have any questions, please contact Meng Goh, Senior Manager Regulatory Strategy on (02) 9921 2221 or mgoh@agl.com.au.

Yours sincerely,

Elizabeth Molyneux
General Manager Energy Markets Regulation