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Dear Chairperson and members

Default Market Offer 2022-2023 and proposed DMO pricing methodology – 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 4,500MW of generation capacity.

We welcome the opportunity to provide this submission to the Australian Energy Regulator's (AER) draft determination on the proposed pricing methodology and draft DMO 4 (Draft Determination).

The DMO is highly important for both Retailers and customers. The DMO sets the level of costs that Retailers will be able to pass through to customers. While Retailers can adopt different tariffs to the DMO in their market offer pricing, Retailers are under competitive pressure to price their market offers below the DMO and must use the DMO as a reference point for their market offer pricing.

In the broader context of the clean energy transition, a DMO that does not provide for realistic Retailer costs, will hinder the ability for Retailers to quickly adapt and innovate to changing environments. Due to climate change policy and competitive pressures, and separate to changes in generation mix, Retailers will increasingly need to ensure that electricity plans offered to customers support decarbonisation. These new de-carbonised retail products often apply across standing offer and market offer customers.[1] A price regulatory framework that impedes these changes, will lead to a transition that is more costly than necessary for consumers. The UK is a current example of how the mismatch of stringent price regulation, a lack of investment in a smooth transition, and resulting price hikes causes unnecessary costs and pain for customers.

In today's context for Tier 1 Retailers, the DMO is the price cap for a material proportion of standing offer customers (at least 1 in 20 customers). If Retailers cannot recover their costs under the DMO then it undermines their viability over the long term. The DMO also plays an important role under the Retailer of Last Resort (RoLR) regime where it is the price cap for customers transferring to a

[1] For example, EnergyAustralia's solar feed-in tariffs and carbon offset program are available to standing offer customers and we are providing or trialling other plans, products and pricing that facilitate the further decarbonisation of the electricity and gas usage for our customers (our scope 3 emissions).

RoLR. A DMO that does not allow the recovery of efficient costs heightens the risks for the RoLR and undermines the RoLR regime.[2]

The draft DMO price is significantly lower under the AER's proposed pricing methodology, compared to the current indexation approach.

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We submit that the DMO will not allow for the recovery of efficient costs. Our retail operating costs reported to the ACCC and the ACCC's figures do not include depreciated capital costs. The retail allowance via retail margin/EBITDA does not sufficiently reflect this depreciation either. This is also an increasingly important issue for the transition which will involve a large amount of regulatory reform. The AER and regulators must now take it into consideration. While there is variation in Retailers' funding approaches, capital expenditure is a real cost for Retailers, and not including these in the DMO suggests (incorrectly) that this expenditure is not necessary in serving customers.

The AER should also review the ACCC's methodology for determining Retail operating costs to ensure that it reflects all efficient costs of supplying electricity, before using it in the DMO. Our concern is the ACCC's cost figures were designed for information only and not for determining a regulatory tariff. The ACCC retail operating cost figures for residential customers are $22 or 14% lower than the VDO's[3], when we would expect a narrower gap.

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] Without knowing how the ACCC applied data received from Retailers it is difficult to extrapolate how the ACCC came to its Retail operating cost figures. A review is necessary to give the AER confidence in using the ACCC figures in the DMO.

Separately, a pricing methodology which produces a lower DMO price will inevitably reduce the spread of market offers and result in customers being disincentivised from 'shopping around' for the best deal.[4] While the AER provides extra retail allowance (above retail margin) or "headroom" to deliver the competition/innovation/customer engagement objective, it is the overall level of the DMO price that matters. Therefore, reductions in other parts of the cost stack such as retail operating cost effectively reduce the retail allowance.

Regarding wholesale electricity costs (WEC), the AER's draft decision to adopt the 75th percentile for the margin of forecast error in ACIL Allen's model does not have a strong basis. Given the inherent limitations of market models, the AER should retain the 95th percentile. Moving away from the 95th percentile would also not be appropriate in view of a wholesale market which will undergo significant

[2] Risks to a ROLR are already substantial as ROLR events are more likely to occur when wholesale prices are unexpectedly high, which can make it extremely challenging for a ROLR to hedge the incremental load when wholesale prices are high and market conditions may make it difficult to purchase the required hedges.

[3] DMO's Retail operating cost figures are calculated as: (Retail operating costs + costs of debt)*CPI forecast = ($132+$25.71)*1.025 = $161.65. VDO retail operating costs are $184 in its draft decision for the 2022-23 VDO.

[4] **Confidential:**

volatility in increasing fuel costs, geopolitical events, and in the clean energy transition where the cheapest generation will exit the market. It is incomprehensible that the AER believes that now is the time to be less risk averse when all indicators are pointing in the opposite direction.

Given the significant limitations identified above regarding the AER's proposed pricing methodology and the lack of evidence to suggest any shortfall with the current one, we consider it is prudent for the AER to provide regulatory certainty and continue the current approach.

If the AER continues with its proposed methodology, we provide detailed comments on that methodology below.

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

Yours sincerely,

Selena Liu
Regulatory Affairs Lead

EnergyAustralia's submission

1. ACCC Retail Operating Cost appears too low

EnergyAustralia has concerns around the ACCC's estimate of retail operating costs being used by the AER in the cost build up methodology. We question whether the ACCC's estimate will allow the recovery of efficient costs.

Notably, the ACCC's retail operating costs are below those used to determine the VDO when we would expect they should be similar as both estimate efficient costs, and jurisdictional differences are not sufficiently different to cause a material gap. For example, the ACCC's reported retail operating costs for the Ausgrid zone (residential) is 14% lower than that used for the VDO ($162[5] (including provision for bad/doubtful debt but excluding metering costs) versus $184).[6] We also have more confidence in the ESC figures as they draw on previous regulatory tariff determinations whereas the ACCC's retail operating cost figures were defined for market reporting purposes only.

We refer to our last submission which expressed reservations around using the ACCC's costs. We remain concerned about:

- A lack of transparency in how the ACCC has taken each line item of Retailer's data and used it to calculate the Retail operating cost figures. There is a risk that the ACCC has either excluded data or modified it, in a way that is inconsistent with Retailer's costs.
- Possible inconsistencies in how Retailers have interpreted different line items and allocated costs. The AER will obtain an idea of these differences, if it reviews Retailers' notes in their data submissions.

Our position is that the AER should defer using the ACCC's Retail operating costs until DMO 5 and retain the current residual cost approach. In the year to DMO 5, we ask that the AER and industry undertake a process of understanding the ACCC's calculation of Retail Operating cost to:

- ensure all relevant costs are included. Where they are not included, the AER could work to calculate those as extra items which would need to be added in e.g. similar to the extra provision for bad debt; and
- gain assurance that the ACCC's reported average of retail operating costs is a reasonable proxy of an efficient Retailer's costs. There are questions around what that efficient Retailer is e.g. the size of that Retailer, vertical/horizontal integration, operation across jurisdictions, and the extent it outsources its functions etc.

1.1 Depreciation and amortisation not adequately reflected in DMO

Separately, but related to retail operating costs, our key concern with the proposed cost build up methodology is that it does not adequately provide for depreciation and amortisation (D&A) in the retail allowance (EBITDA). D&A should be explicitly allowed for and calculated based on actual D&A data provided by Retailers. This is fundamental to ensure the AER considers all relevant matters to the DMO determination and to ensure Retailers recover their efficient costs of service.

The AER explains its decision to not include an explicit D&A allowance:

> We consider that including costs other than depreciation and amortisation is consistent with that adopted by other regulators and that the total DMO retail allowance discussed in section 8.4 will allow Retailers to recover depreciation and amortisation expenses.

In terms of the approach of other regulators, the Essential Services Commission of Victoria (ESC) does not include depreciation calculated from Retailers' data. It instead provides for it, nominally, in

[5] This is calculated as (Retail operating costs + costs of debt)*CPI forecast = ($132+$25.71)*1.025 = $161.65

[6] Victorian Default Offer to apply from 1 July 2019_0 (7).pdf , p 65

the VDO's EBITDA, which we consider is also a gap in the ESC's approach. However the ESC also acknowledged Retailer's concerns on D&A, and was open to considering the issue in November 2020:

> The VDO allows for the benchmark Retailer to undertake some level of capital expenditure. While cross-checking the retail margin using the expected returns approach, the capital expenditure less depreciation was assumed to be 0.52% of expected total costs in each year. Therefore we expect that the current level of retail margin compensates Retailers for cash outflows associated with efficient capital investments.
>
> In addition, the pricing order does not require us to determine tariffs based on the actual costs of a Retailer. **However, to consider the impact of any change in capital expenditure we need to identify long term trends in depreciation and amortisation reported by Retailers over a period. In order to do this we will explore whether Retailers will be required to provide information on the depreciation costs of their retail operations in future cost data requests.**[7]

(Note, it is unclear as to what the ESC's cross check (0.52%) purports to do. Capex and D&A differs from year to year depending on what IT projects and regulatory changes are implemented).

The AER's comment that the total DMO retail allowance would allow Retailers to recover D&A expenses is not supported by our data.

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It may be tempting to assume the proposed retail allowance which is based on the retail margins provided under the first three DMOs, includes EBITDA and therefore includes D&A i.e. the first three DMOs were set at the mid-point between the median market offer and median standing offer and therefore they should cover EBITDA. However, this is not firmly based because pricing for acquisition offers to new customers (which DMO 1 was based on) does not represent the pricing or average revenue received from a Retailer's entire customer base. Acquisition offers to new customers are generally lower, driven by aggressive pricing from new entrant Retailers which compete to gain market share. We therefore caution against the AER drawing assumptions around the first three DMOs providing sufficient EBITDA and sufficient D&A.

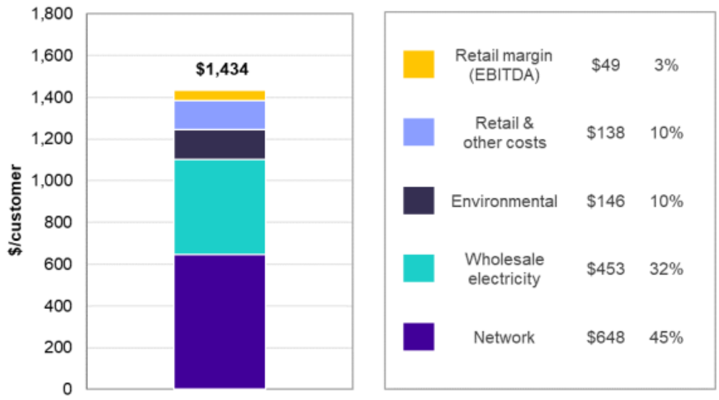
The AER will instead gain a better indication of revenue and costs across a Retailer's whole customer base by looking at the cost and billing data submitted by Retailers to the ACCC. The ACCC's graph below[8] shows that annual cost to supply an average residential customer for FY 2020-21 is close to the DMO price set for Ausgrid ($1,462). This shows that average costs of supply across a Retailer's whole customer base is much closer to the DMO, than the AER may have assumed (because of the way the DMO was originally set as the mid-point and because the DMO includes headroom).

[7] See Victorian Default Offer 2021 Final Decision 25 November 2020, p 41, available here: [Victorian Default Offer price review 2021 | Essential Services Commission]

8 [Inquiry into the National Electricity Market - November 2021 report - Copy.pdf (accc.gov.au), p 10]

Figure 1.1: Annual cost to supply an average residential customer is $1,434

Cost components for the average residential customer across the NEM in 2020–21, real $2020–21, excluding GST



The AER may also consider the extra retail allowance (above retail margin) will allow for D&A to be recovered. This would be analogous to some of its historical reasons to now allow for regulatory costs previously because the residual allowed for it.

We encourage the AER to move away from relying on the extra retail allowance above retail margin to provide for extra costs not explicitly accounted for (like D&A). This might have been appropriate under the indexation approach, which was less precise, but under a cost build up approach it is less justified. Further, if the AER were to point to this retail allowance above the retail margin to provide for D&A, it would only compromise the ability of that extra allowance to meet DMO objective 3 (incentivise competition/innovation/customer engagement).

EnergyAustralia, like other Retailers, continues to invest in technology assets to support its retail business. Examples include investment in billing, credit management, metering data management and finance systems. There have also been many regulatory changes recently with a heavy technology requirement, which require further investment in technology assets. For instance, the Consumer Data Right, five minute and global settlement and Power of Choice reforms. We expect these reforms will only continue and potentially increase, particularly with the current market design reform. This market design reform will see changes to AEMO's systems costed at between $250-330 million[9], which will be mirrored in Retailer systems.[10] Where Retailers meet these requirements via investments in assets, they are treated as capital expenditure (capex) and amortised across multiple years. These costs will not be reflected in ACCC Retail operating costs and the DMO.

A detailed explanation of the issue is below.

Under accounting standards, capex on retail technologies is amortised over future periods depending on their useful lives. To illustrate and contrast:

- Retailer 1 may invest in a billing platform which will return benefit over a number of years. This is capitalised and the payment for that system would be entered into the balance sheet in the first year but then expensed over multiple years via depreciation in the profit and loss statement. In this case, the cost of the billing system will not be categorised as

[9] 1629944958-post-2025-market-design-final-advice-to-energy-ministers-part-a.pdf (aemc.gov.au) p 53. For more detail, see 1629945838-post-2025-market-design-final-advice-to-energy-ministers-part-c.pdf (aemc.gov.au) p 59

[10] Market design reform will consider reforms around capacity markets which could involve AEMO establishing new systems that allow it to administer auctions and recover costs for additional generation and storage capacity, with potential requirements for Retailers to periodically submit information on their load forecasts and contract for capacity certificates.
The market design reforms also introduce new system security mechanisms to reward providers of services which help to stabilize the electricity flows in the national electricity market. E.g. a new market for Fast Frequency Response; registration and dispatch changes for the integrating energy storage rule change; and the anticipated operational security mechanism. All these reforms require changes to AEMO's systems to support these market mechanisms.

operating expenditure (opex) or reported to the ACCC as a retail operating cost and therefore it is not reflected in the DMO.

- Conversely, Retailer 2 may instead not invest in a billing system but outsource its billing requirements to a third party e.g. use software as a service. The Retailer pays an annual fee which is treated as an opex item that is reported to the ACCC as a retail operating cost and is therefore included in the DMO.

The technology costs incurred by Retailer 1 and 2 (as capex or opex) should both be considered relevant when determining the DMO. The difference in accounting treatment is irrelevant for the purposes of recovering efficient costs under the DMO.

The ACCC's Retail Electricity Pricing Inquiry reports observe that non-Tier 1 Retailers have significantly higher retail operating costs than Tier 1 Retailers.[11] While this could be due to economies of scale resulting in lower cost to serve, it might also reflect that non-Tier 1 Retailers are claiming their technology costs as operating costs, and Tier 1 Retailers depreciating those costs instead.

In summary, the issue of capex/depreciation is relevant to the DMO and material enough to warrant initial investigation by the AER, even if that means deferring the use of the cost build up methodology to DMO 5. The AER could initially assess the issue by comparing depreciation data submitted by Retailers against retail margin (EBITDA) in the DMO. We have provided our depreciation data in Figure 2 of the Attachment. We would be pleased to discuss this issue further with the AER.

1.2 Metering costs when accumulation meters are replaced before end of life

EnergyAustralia welcomes the AER's additional allowance for advanced metering costs. We wish to raise a specific issue on metering costs, which arises when a customer's accumulation meter is replaced with an advanced meter before the accumulation meter has reached its end of life. In these circumstances, although the opex (or "non-capital" costs as per distribution network service provider's (DNSP's) documents) for the meter is removed from DNSP charges, the Retailer still continues to be charged for the capex for that meter even though it is not in use. Under the AER's DMO methodology, it appears the AER removes both the capex and opex for the removed meter, but we consider that the capex should still be allowed for in the DMO, given Retailers continue to pay for it and this payment is beyond their control to change. Replacement of accumulation meters before their end of life is usually due to a change at the customer's premises, for example, the installation of a solar PV system.

Our analysis shows that a large majority of our customers with advanced meters are still paying for the capex of their old meter. **[Confidential:**

] Our analysis is based on a count of NMIs with charge codes that denote a capital charge or no capital charge. We have separately provided the AER the specific charge codes, but the DNSPs have the source information and would be able to provide this data directly for all customers in their areas.

Using the AER's Appendix B to the Draft determination paper, we have calculated a revised cost which is based on the addition of capital costs for the old meter for the proportion of advanced meter customers which we expect are being charged that cost. Please see Figure 3 of the Attachment to this submission.

11 Inquiry into the National Electricity Market - November 2021 report - Copy.pdf (accc.gov.au) pp 33 and 37

[**Confidential:**

] Our calculations are based on data about our customers only but should be indicative of the broader market. They illustrate that the effect is not immaterial and justifies further exploration by the AER.

We have also checked Ausgrid documents to corroborate our view on this issue. [12] Accordingly, the proportion of advanced meter customer sites for which Retailers are still paying capex for the old meter appears to be over 90%. Our lower figure [] might be explained by the number of new connections since the introduction of Power of Choice in December 2017 as these sites do not form part of the original base for the DNSPs.

The AER will be able to request from DNSPs data about the number of advanced meter customers (by NMIs) still paying for the capital costs of their old meter and the individual charges. This would provide definitive data across all Retailers to support changes to the meter cost adjustment for the retail operating cost component in the DMO.

1.3 Other issues with using ACCC retail operating costs

EnergyAustralia agrees with submissions by other Retailers that the lag in time for Retail operating costs being incurred by Retailers and then passed through under the DMO (a lag of two years) is a material issue. The AER could address this by providing a working capital cost adjustment in the DMO.

2. Retail allowance

With regard to the retail allowance, we have an issue around the transition pathways. The AER states:

> We intend to provide a transitional pathway to these allowance targets over 3 years where required to minimise price increases for some customers while maintaining similar levels of revenue in the market as a whole.

EnergyAustralia agrees that a glide path approach helps to provide a smooth price path for customers and Retailers. However, we disagree with the inconsistent approaches adopted by the AER. Pass through of DMO price increases for Energex residential (no controlled load) is provided for over three years, but for DMO price decreases for Ausgrid, Endeavour and Essential residential customers there is a once off pass through. The inconsistency is stark, given that the price decreases that are quantitatively larger are applied immediately (i.e. between -2.4%-3.5%), whereas the lesser price increase of 1.6% for Energex is applied over three years.

We ask the AER to take a consistent approach across its decisions and provide for a glide path for similar sized movements in the DMO in the price reductions noted above. The importance of smoothing the impact on Retailers from DMO reductions is acknowledged by the AER for SME customers, to ensure that no cross subsidisation between customer groups during the transition to the new retail allowances occurs. We believe that this policy rationale equally applies to the decreases for residential customers.

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[12] https://www.aer.gov.au/system/files/AER%20-%20Final%20decision%20-%20Ausgrid%202019-24%20-%20Metering%20PTRM%20and%20pricing%20model%20-%20Public%20-%20April%202019.XLSM

3. Wholesale electricity costs

3.1 95th percentile simulated Wholesale Electricity Cost (margin for forecast error)

The AER's proposal to move from the 95th to 75th percentile simulated Wholesale Electricity Cost (WEC) is a material change in methodology which we believe is inappropriate given what is occurring in the market and inappropriate ahead of the upcoming and planned peer review of the WEC methodology.

ACIL Allen's model (if unchanged) is an acceptable approach to estimating the WEC. It recognises that the WEC will vary depending on spot price outcomes, and models different spot price outcomes reflected in the spread across the 1st to 100th percentiles.

The AER explains that its proposal to use the 75th percentile is appropriate because "several aspects of the DMO hedging assumptions are inherently cautious". The AER states that adopting the 95th percentile estimate is overly risk averse given that other settings assume that Retailers are almost entirely hedged.

ACIL Allen's model does adopt a conservatively hedged position (i.e. limited spot price exposure etc.) which is the same across the WEC simulations i.e. 1-100th percentiles. However, the choice of the 95th or 75th percentile does not relate to the hedging strategy at all. It controls for the potential forecasting error in ACIL Allen's *spot price modelling* because it is an imperfect way to predict forward market outcomes. We question whether the percentile decision can be traded or substituted for decisions on the hedging strategy.

3.1.1 Changing generation mix

The AER may compare the 75th to the 95th percentile and conclude that the impact on wholesale costs for DMO 4 is small e.g. less than $2. This is still a material impact for Retailers, over their standing offer customer base and across future years. It is also difficult to predict what the impact will be on the WEC in future years where spot prices are more volatile.

Even recently in the National Electricity market there has been a moderate level of volatility. This is reflected in the rise in forward contract prices for 2022-23. **[Confidential:**

] This rise has been driven by rising gas and coal prices in Queensland and NSW, and appears to be a sustained increase due to those supply side issues.

In terms of high volatility due to a changing generation mix, we look to the UK experience over the last year. It may be easy to minimise the UK experience as the worst-case scenario, but it is a demonstration of how a large number of Retailers can be surprised with wholesale market outcomes at short notice. It is important that a regulator does not seek to remove necessary coverage for worse than average outcomes particularly at a time the wholesale market is continuing to rise and become more volatile.

The UK experience of extremely high spot prices has been driven by shortages in gas. We note that the National Electricity Market may not experience gas shortages to the same extent. However, there are currently gas and coal supply side challenges, and the generation mix is changing even faster than anticipated, as businesses announce earlier exits of coal generation due to those assets becoming uneconomic and climate change policy goals. EnergyAustralia has committed to its own Climate Change Statement to transition out of coal generation assets by 2040.[13] The wholesale market will be a state of change for some time, and price volatility will be an issue where the

[13] EnergyAustralia Climate Change Statement | EnergyAustralia

cheapest coal generation sources exit the market and other sources of supply do not fill the void. This is further reason to adopt a conservative approach and retain the 95th percentile.

3.1.2 Practical effect on Retailers and market

The potential practical effects of the move to the 75th percentile on Retailers and the energy system are also important:

1. Under the 95th percentile, Retailers adopting a hedging strategy consistent with the WEC in the DMO, would not be hedging for the most extreme 5 percentile or 1 in 20 *spot price outcomes*. However, if the AER were to change to the 75th percentile, Retailers would not be hedging for 1 in 4 spot price outcomes exceeding the 75th percentile point.

2. If the actual 1 in 4 spot price outcomes happen, Retailers will not be hedged and would be exposed to those spot prices. They will have to pay AEMO for electricity consumed by their customers at those spot prices.

3. The DMO would not provide an allowance to pay for this additional spot price exposure, and so the important question is how will Retailers pay AEMO? As the maximum spot price is currently $15,100 per MWh, large amounts of capital could be required for even a short high-priced event to cover a Retailer's customer base. There is a real risk to Retailer viability if a Retailer is unable to pay AEMO and they become insolvent, which would lead to Retailer failure and the RoLR process. This is a particularly acute risk for smaller, non-vertically integrated Retailers who are more likely to have limited capital resources.

4. This is where the ESC's approach is different. While it adopts the median simulated WEC, it recognises that Retailers may be exposed to the 100th percentile of modelled spot price outcomes, and provides for the cost of capital of meeting the cost of energy at the 100th percentile (discussed more below).

5. Another important risk concerns the broader system. Hedging contracts guarantee revenue to generators, as much as they lock in electricity prices to help Retailers manage spot price risk. If Retailers are not hedging and buying contracts for the 25 percentile of spot price outcomes, then the investment in generation assets to supply that electricity does not occur. From a system perspective it could lead to supply side issues and undermine having sufficient reliability in the system.

3.1.3 Comparison to ESC approach

The AER might draw comparisons of its proposed change to 75th percentile with the ESC's adoption of the median WEC. It is important to note the differences:

- **The ESC decisions on the VDO are driven by a different policy outcome to set an efficient price**, where the VDO is the prescribed price for standing offers. In contrast, the DMO is the price cap and standing offers can be priced below it.

  This conceptual difference would support the AER adopting a high margin of error for ACIL Allen's modelled outcomes - to reflect the full variability of spot prices which Retailers' might hedge to. This is important because Retailers hedge in different ways, and different assumptions that underpin that hedging may be adopted. Judgements as to whether those assumptions are too conservative or would result in inefficient hedging, are exceedingly difficult to make and unnecessary where the DMO is the price cap.

- **The Frontier model incorporates a volatility allowance**, as noted above. Importantly, this allowance recognises that there is residual risk where real world outcomes diverge from the median simulated year. And, that Retailers hedging/contracting in line with the VDO will be exposed if that occurs. The volatility allowance provides Retailers the cost of holding working capital to fund cashflow shortfalls to pay AEMO, when the actual WEC is higher than the median year. Importantly, "The working capital requirement is based on the difference between the WEC that [Frontier] have estimated for the median simulated year and *the WEC for the most costly simulated year for each distribution area***"** i.e. the 100th percentile. Frontier estimates the cost of holding working capital by applying a weighted average cost of capital of 7.5 per cent. While it is useful to compare the volatility allowance, it still presents a higher risk to Retailers as it only reflects the cost of capital versus a full provision of the actual capital required (for hedging).

- **The methodology in the ACIL Allen and Frontier models are different**. The two cannot be compared as they are both likely to be internally balanced. For example, the ACIL Allen report recognises that at times the 95th percentile is used to moderate other uncertainty in their model. E.g. lower certainty around trade volumes for cap products in South Australia is accounted for by adopting the 95th percentile WEC.

In conclusion, in view of the above points around models being imperfect, increasing volatility in the wholesale market, and the practical effects, we firmly believe the AER should retain the 95th percentile for the margin for forecasting error. The percentile decision is not a simple input assumption which can be changed without a clear rationale which is currently lacking. It is incomprehensible that the AER believe that now is the time to be less risk averse when all indicators are pointing in the opposite direction.

3.2 Other aspects to be revisited in peer review

3.2.1 ASX contract prices

Consistent with our previous submission, we support the continuation of a trade weighted approach if the ACIL Allen model is retained in its current form. However, as the AER is undertaking a holistic peer review of the ACIL Allen model, we ask the AER to consider a small adjustment regarding the date of contract prices it uses in its final DMO (including for DMO 4).

The current forward contract prices are increasing. If these contract prices continue to increase after the AER sets its DMO price, it will mean that the final DMO price will not reflect these higher costs, which means Retailers will not recover them. i.e. if the AER uses the forward contract prices up to 25 March 2022, then the forward contract prices after that will not be reflected in DMO 4.

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The AER should survey Retailers about their hedging strategies to inform the materiality of this issue and whether it should review its weighting of contract prices in any peer review.

The AER could also help to address the issue by using contract prices drawn at a later date (start May 2022). This would also be possible if the AER is releasing its final DMO prices later this year due to the election (around 21 May 2022). If the AER's timelines will not allow for it – the AER could also take a reasonable estimate of expected forward contract prices. For example, use the forward contract prices as at the date they are drawn (late March) and extend this out for a further period to start May 2022.

We also accept that this approach would have to be applied in a falling market to ensure consistency. This is still appropriate as the risks of a rising market are far greater than those of a falling. That is, the risks are asymmetric. In a rising market it is a risk of substantial under-recovery of costs and risks to Retailer viability, versus in a falling market there is little or no risk as Retailers will pass through lower wholesale costs in lower retail prices to maintain competitive pricing in the market.

3.2.2 Illiquidity in contract markets

We also agree with AGL's submission to the AER's position paper which states that the AER needs to carefully consider sourcing alternative benchmarks/data points to ASX energy data to determine the wholesale electricity cost in South Australia. We observe very limited ASX Energy and over-the-counter trading in South Australia. The AER would need to consider whether it should base the WEC (and LGC costs) on prices contracted under offtakes with generators. We understand the AER's reluctance to do so, due to the lack of transparency of data from offtake agreements, but the AER will need to consider this approach at some point in the broader context of the changing generation mix.

That is, as the National Electricity Market transitions to greater volumes of renewable generation, the financial products (swaps, peaks and cap contracts) typically sold by base load (coal) and peaking (gas) generation that currently allow price risk management, will become more scarce and less relevant. Retailers will progressively need to manage risk via other means and by contracting with intermediaries, including through power purchase agreements or other financial products as they evolve.

Attachment – Confidential