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Mr Mark Feather
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Australian Energy Regulator
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By email: DMO@aer.gov.au

19 November 2020

Dear Mr Feather

Position Paper – Default Market Offer Price 2021-22

AGL welcomes this opportunity to provide comments on the Australian Energy Regulator's (AER) *Position Paper - Default Market Offer Price 2021-22* (Position Paper) published on 22 October 2020.

AGL is a leading energy retailer with about 3.8 million electricity and gas customers in New South Wales, Queensland, South Australia, Victoria and Western Australia as of 30 June 2020. In August 2020, AGL acquired Click Energy with an additional 215,000 energy customer services.

In general, AGL supports the AER's current methodology of using an index-type approach to change the regulated Default Market Offer (DMO) prices for forecast cost changes.

AGL also supports the AER's confirmation that any forecast cost change will be considered relative to the cost components values that were used to derive the 2020-21 DMO prices. That is, there will be no updating of these estimates unless there are fundamental changes to the methodology used to set any of the cost components. This will ensure that any errors in last year's DMO calculation will be corrected going forward in the 2021-22 DMO prices.

AGL note the AER is proposing a largely unchanged approach to forecasting the cost components and support:

- the current method used by ACIL Allen for forecasting wholesale energy costs as it is reasonable and should be retained to maintain consistency. However, consideration of using separate residential and small business load profiles in its modelling is prudent;
- the application of Ancillary Service Charges (ASC) at a jurisdictional level instead of as a national average;
- the use of proposed network charges in circumstances where network tariffs have not been approved by the AER;

- further consideration of how retail cost impacts due to regulatory imposts are included as step changes in the residual cost component. We note the AER has questioned in its Position Paper whether the application of a productivity factor is warranted. AGL believes it is not appropriate given the policy objectives of the DMO but also believes that it is not material relative to these retail cost impacts that have yet to be included as step-changes; and.
- most importantly, the recognition of the impact of COVID-19 on retail operating costs as retailers are unable to avoid the escalation in bad debts and the changed operating environment. The AER is well placed to access further information on these impacts prior to making its draft decision in March 2021.

More detailed comments in response to the questions raised in the Position Paper 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 the Position Paper

DMO 2021-22 price determination – proposed approach

The AER has proposed using its indexation approach for this and future DMO determinations.

1	Do you agree with the principle that forecasts and assumptions from previous DMO determinations should not be retrospectively amended to reflect actual information?

AGL agree that the closing index value for the previous DMO prices should be the opening index value for the 2021-22 DMO prices. However, this is predicated on the basis that there are no changes in approach or methodology in setting of the cost components. If there are changes, such as using the 50th percentile instead of 95th percentile in setting wholesale costs, the opening index value will need to be re-set accordingly.

Changes in price levels, such as forecast network charges which are different from approved network charges, should not result in a reset of the opening index value.

Wholesale costs

AGL is generally supportive of the methodology used by ACIL Allen.

2	Does our assumption of a risk averse retailer building their hedge book from the time of the first trade recorded by ASX Energy remain appropriate, or is a shorter period justified? What is an appropriate period and why?

The current book build assumption of a risk-averse retailer and the 24-month period remains reasonable. This approach reduces the volatility of estimating wholesale energy costs.

Retailers can have different wholesale risk management policies which will lead to different hedging strategies. In our view, there are advantages and disadvantages with each approach, but it is important to maintain a consistent approach from one year to another.

3	Does the Consultant's 95th percentile estimate remain appropriate, given the hedging strategy? What alternative percentile could be applied and what would the justification be?

Given that the DMO is not intended to be lowest price offer in the market, the current approach based on the 95th percentile is appropriate. Consistency from one year to the next is an important consideration.

Furthermore, as the DMO methodology is based on an index approach, it is the annual change that is the relevant consideration rather than the actual level of costs and AGL does not see any benefit in moving from the 95th percentile and potentially increasing year on year volatility.

AEMO Directions

AGL believe the impact of AEMO directions should be estimated and taken into account in the DMO.

There have been several AEMO directions in recent financial years at considerable costs to consumers. [1] There is the potential for these events to become increasingly frequent, especially in South Australia, with AEMO continuing to issue directions to maintain system security in the region. The AER should consider the

[1] AEMO, Quarterly Energy Dynamics Q3 2020 Market Insights and WA Market Operations

impact of AEMO directions in its determination of DMO prices on a jurisdictional basis with the recovery of the costs allocated on an energy basis.[2]

Ancillary Services

Given the difficulty in forecasting the future cost of Ancillary Services charges in advance, the AER estimates these charges based on the weekly aggregated settlements data published by AEMO for the previous 12 months.

4	Do you agree with our proposed approach to assign ancillary service charges to each state, rather than smeared across the DMO jurisdictions?

AGL supports the allocation of ancillary service charges to the regions where the cost is incurred by retailers.

Load profiles

The current wholesale cost forecasting methodology utilises the Net System Load Profile (NSLP).

5	What are the implications of differentiating between residential and small business load profiles to forecast wholesale costs?

AGL supports the ACIL Allen proposal to assess whether the differences between the NSLP and individual residential and small business load profiles across the distribution regions are significant enough to warrant changing its forecasting methodology.

However, it is important to recognise that accumulation meters are still prevalent in New South Wales, South Australia and Queensland. The energy usage on these meters is settled on the NSLP and until there is a large penetration of smart meters, differentiating between residential and small business profiles could result in a misalignment of wholesale costs on settlement.

COVID-19 impact on wholesale costs

ACIL Allen's methodology for forecasting wholesale electricity cost captures the impacts of COVID-19 on the wholesale electricity market through its datasets for demand forecasting, demand profiles and contract prices.

6	Do you agree with our proposed approach to continue using the DMO 2 wholesale energy cost forecasting methodology?

We are comfortable with the methodology developed by ACIL Allen and consider the perceived COVID-19 impacts on the wholesale market have been captured, especially given Victoria is excluded.

2 Section 3.15.8 of the National Electricity Rules (NER)

Environmental costs

7	Do you agree with our proposed approach to continue using the DMO 2 environmental costs methodology?

Large-scale Renewable Energy Target (LRET)

AGL has consistently highlighted that basing the cost of the LRET only on LGC market prices is no longer appropriate as only a small percentage of LGCs are traded on the spot market and these prices are often not reflective of a retailers' underlying and historic cost of procuring LGC certificates.

While recognising the difficulties for the AER in using PPA prices to estimate the costs of complying with the LRET, AGL remains concerned that the price of LGCs can fluctuate greatly in such a thinly traded market and the AER's current market approach could result in unrealistic and commercially damaging outcomes.

AGL suggest one option to mitigate this scenario is for the AER to apply a minimum price to its market price approach (if the LGC price fell below the floor price then the AER would use the floor price in its calculations). This would ensure that in instances of price volatility where LGC prices fall to unrealistic levels (compared to retailers' underlying costs), it does not unduly impact the estimation of the LRET allowance under the DMO.

A potential approach to estimating the floor on LGC prices is to use the Australian Carbon Credit Unit (ACCU) certificate price adjusted by the NEM emissions intensity factor. ACCU's are created by quality carbon abatement projects and generally provide a reasonable proxy for the cost of carbon abatement more generally in the economy. This would be updated at the same time as the market- based price is calculated.

Using the ACCU spot price of $15.85 and an emission factor for H1 2020 of 0.7264 tCO2-e/MW hr from the Clean Energy Regulator (CER) in their Quarterly Carbon Market Report [3] would produce a cost estimate for abating carbon in the NEM of $11.50 per certificate. AGL would propose this provides a reasonable floor price to LGCs in the future if the AER is not willing to explore other options for calculating the actual efficient cost of providing LGCs over the scheme life.

Network costs

8	Do you agree with our proposed approach to continue using the DMO 2 network costs methodology?

The AER's use of indicative tariffs last year resulted in a DMO price that was lower than it would have been if they had access to approved network prices. Under the AER's proposed indexation approach, the difference between the indicative network charges and actual charges in 2020-21 will be corrected for in the 2021-22 DMO prices.

To mitigate this issue going forward, the AER has proposed that in their final DMO determination they would use the network businesses' 2021-22 network tariff proposals if the AER had not approved them in time.

AGL agrees with this approach as under normal circumstances, there is little to no change in the approved network tariffs.

AGL also supports the AER's approach of basing the DMO prices on the flat rate network tariffs in each network area for 2021-22.

[3] http://www.cleanenergyregulator.gov.au/DocumentAssets/Documents/QCMR%20June%20Quarter%202020.pdf

However, the AER needs to consider that default network tariffs for new customers or customers receiving meter replacements will move to demand or time of use (TOU) tariffs in the future. For some of the distribution networks there is a grace period for the current financial year with respect to network tariff allocation, but significant amounts of customers will be reassigned to non-flat network tariffs in the medium term.

AGL encourages the AER to assess the situation when customers are reassigned to demand network tariffs but access DMO prices and:

- consider whether the DMO will need to expand its cost methodology to include non-flat tariffs given the larger scale reassignments of customers to TOU tariffs; and
- track when TOU network tariff costs are likely to be more material than flat network tariffs in the DMO methodology.

Retail costs and step changes

The residual costs referred to by the AER is the cost component remaining after accounting for wholesale energy costs and network charges and covers retail costs, acquisition and retention costs, and retail margin.

Productivity adjustment

9	Is it reasonable to apply a productivity factor to the DMO? What is the evidence retailers' costs are decreasing or increasing?
10	What form should any productivity adjustment take?

Theoretically, AGL support the principle of a productivity factor but does not consider it warranted in the context of the DMO.

In the Position Paper, the AER has pointed out that determining a productivity adjustment implies a level of specificity in retailers' costs that is not consistent with the DMO' original top-down methodology. Retailers' costs are part of residual costs and are not separately assessed. In addition, the AER has also noted that the DMO price is not intended to be an accurate reflection of retailers' efficient costs.

In setting the revenue allowance for distribution networks, the AER considers a productivity factor in relation to operating and maintenance costs. This is applied to each distribution network's operating costs, but under these revenue determinations, the distribution networks can earn annual revenue amounts, with subsequent under and over adjustments.

Unlike distribution networks which are regulated monopolies, retailers do not have a guaranteed customer base. To maintain their customers, retailers must ensure that prices are competitive. Most retail operating costs such as contract centres, billing, debt collection and IT are fixed in the short term. With annual switching rates of 10-20 per cent, a retailer's customer base fluctuates, and any customer losses needed to be replaced by acquisitions as the loss of customers will result in a higher operating cost on a per customer basis. For example, if a retailer loses 5 per cent of its customers, its operating cost per customer will increase by around 5 per cent, since total costs are largely fixed. The reduction in AGL's net operating costs per customer in 2019-20 is partly due to an increase in the customer base.

The Position Paper referred to AGL's 2020 investor presentation which showed an 8 per cent reduction in net operating costs per customer service, and a reduction of $12 per customer service between 2017-18 and 2019-20.

It is important to understand what these statistics represent before drawing broad conclusions. The net operating costs per customer service have been adjusted to exclude COVID-19 impacts on expected credit loss and depreciation and amortisation. The selection of time periods for comparative purpose is also important – for example, the investor presentation also shows that between 2016-17 and 2019-20, the adjusted net operating costs per customer service increased by $18.

When assessing net operating costs, all relevant costs must be considered, and it is important to include Depreciation and Amortisation (D&A) to recognise the significant costs of investment in IT. AGL's Customer Experience Transformation program has achieved cost efficiencies but this has increased amortisation costs. In network regulation, D&A is part of the revenue building block.

The operating costs referred to in the investor presentation also do not include all the costs which a standalone retailer would incur. Aside from D&A costs, corporate and centralised costs such as IT are not included. AGL Annual Reports are prepared according to management structure and caution is required when assessing business segment results in isolation to other group costs, particularly, Centrally Managed Expenses. Centrally Managed Expenses are not reallocated to the operating segments because their management is the responsibility of various corporate functions.

When comparing operating costs from one year to another, it should be noted that there are also one-off costs in some years, cost re-allocations, as well as transfers from business segments to corporate functions due to changes in management structure. For example, in 2019-20 Customer Market's (which represents AGL's retail business) operating costs including D&A were flat but Centrally Managed Expenses increased by 44 per cent.

Step change framework

The AER indexation methodology does incorporate a step change framework that allows the DMO price to be adjusted to account for material increases or decreases in retailers' costs to serve.

11	Do you agree with our proposed approach to continue using the DMO 2 step change framework?

AGL support the continued use of a step-change framework to allow adjustments which are separate to the residual cost component. In AGL's view, this framework is reasonable for significant market and regulatory developments where cost impacts can be separately identified.

These cost adjustments, which would include the impact of COVID-19, can practically be considered on a cost per customer basis.

COVID-19 impacts

The AER propose to consider any impacts of COVID-19 under its step-change framework.

12	What will be the impact of COVID-19 on retailer costs in 2021-22? Are any retailer costs decreasing due to COVID-19?
13	What is the basis for estimating any cost impacts? Please provide information to assist with estimating cost changes associated with COVID-19.

AGL agree with the AER's preliminary view that the COVID-19 cost impacts meet the criteria for consideration as a step-change given they are exogenous and could not be avoided by a prudent retailer.

In its Results Presentation, AGL disclosed that the impact of COVID-19 on AGL's 2019-20 results amounted to $38 million, comprised of $20 million in net bad debt expense and $18 million in increased on-site operating costs[4].

AGL has also provided an earnings guidance for 2020-21. This guidance is approved by the AGL Board and management and provides important information for investors on the company's outlook. This guidance is based on robust processes with detailed build-up of forecast revenue and costs across the business. This guidance forecast the expected credit loss, i.e. bad debt, due to the pandemic to be around $40 million. This will result in a level of bad debt equivalent to 2 per cent of revenue, compared with the underlying historic credit loss of 1.5 per cent[5], an increase of over 30 per cent. This cost is material and therefore specifically detailed in the public statement. While any estimate is uncertain, the actual cost could be higher, depending on economic conditions, and the length and breadth of the pandemic.

Based on AGL's actual bad debt expense in 2019-20 and averaging of the expense forecast over 2020-21, the financial impact of COVID-19 on AGL in 2020 will be around $10 per customer, after adjusting for Commercial and Industrial customer debt.

In the Position Paper, the AER has noted that total debt accumulated for the number of customers with debts of 90 days or greater is elevated above the baseline. In AGL's experience, there is a high correlation between the level of debt, particularly 90+ days outstanding, and bad debt.

Aside from bad debts, there are increases in operating costs including provision of office equipment, upgrades to IT and telecommunication capabilities as result of working from home arrangements. In addition, tasks have been taking longer and been more complicated, especially when third party providers are involved under the current circumstances.

The AER has enquired whether some retail operating costs have reduced because of COVID-19, for example due to staff working from home. As highlighted above, a retailers operating costs are largely fixed so any cost reductions are likely to be incremental, not accounted for separately and unlikely to offset the cost increases because of COVID-19.

Consumer Data Rights (CDR)

14	What impact will meeting CDR obligations have on retailer costs in 2021-22? What is the basis for estimating any cost impacts? Please provide relevant cost information to assist with estimating cost changes associated with CDR.
15	Aside from CDR and COVID-19, are there other regulatory or operating environment changes that are likely to materially increase or decrease retailers' costs to serve customers in 2021-22?

Although the new CDR obligations for the energy sector are likely come into effect during 2021-22, AGL is not currently in a position to estimate or track the costs relating to the implementation of CDR. AGL can affirm that the initial estimates for implementation and ongoing costs to meet the CDR obligations as reported in the Position Paper significantly underestimate AGL's expectations based on the current CDR scope. AGL will seek to provide further information on the cost of meeting CDR obligations during this DMO process.

AGL believes the cost for introducing five-minute settlement (5MS) was similarly under-estimated when AEMO estimated the costs of implementing the 5MS for industry participants to be $250 million including

[4] AGL, ASX announcement - FY20 Results Presentation, 13 August, p. 23
[5] Ibid, p.24

system change costs of $150 million.[6] 5MS represents a fundamental change to the operation of the NEM and impacts most of a retailer's business processes including customer billing, metering, pricing, forecasting, bidding and settlements.

AGL has a project underway to ensure AGL's compliance with, and readiness for, these changes and believes the cost of 5MS should also be included as a step-change in the 2021-22 DMO prices.

Model annual usage and TOU determination

AER's proposal in the Position Paper is to continue to apply the same annual usage amounts for residential and small business customers.

16	Do you agree we should retain the same annual usage amounts used for DMO 2? If not, what alternatives are more appropriate and what are their benefits?

The model annual usages for residential customers continue to be appropriate. However, as highlighted previously, the model usage for small business of 20,000 kWh a year is too high and a more representative annual usage for small business customers would be around 10,000 kWh per annum.

Although it is generally important that these usages are consistent from one year to another for consistency, simplicity and comparative purposes, AGL suggests that the average usage for a single rate Business customer be reduced to be more representative for the average business customer.

Timing and pattern of supply

The AER propose three possible options for usage profiles including a:

- One-day profile – a single day, with usage specified at 30 minute or 1-hour intervals;
- Two-day profile, comprising a weekday and weekend day pattern; or
- Eight-day profile, comprising a weekday and weekend day pattern for each season.

17	What is the appropriate level of detail to include in the daily usage profile? What are the risks and benefits of a simple TOU profile compared to a detailed one?

AGL is supportive of continuing with the AER's preferred Option 1.

We do consider that a two-day profile has some merit and is workable but AGL would need to test these profiles across our customer base to help assess materiality.

The eight-day profile is overly complex with very minimal benefit or relevance as seasonal TOU tariffs are only offered in a few situations with very low customer numbers.

Costs to serve TOU and solar customers

The costs of advanced metering are currently not included in the DMO prices, even when a TOU or solar customer with a digital meter is on a Standing Offer.

[6] AEMO, Declared NEM Project – 5MS Program, Final Report and Determination, November 2019, p 8

18	Do you agree our DMO 2 approach to advanced meter costs remains appropriate for DMO 3?
19	If not, what is the evidence that advanced metering costs are impacting retailers' abilities to recover their costs to serve standing offer customers?
20	Is it reasonable to increase the DMO price for flat rate standing offer customers to take account of the higher costs of advanced metering?

AGL does not require the inclusion of additional metering costs in the DMO price for 2021-22.

However, the network tariff assignment policies discussed above will increase the rate of transition from flat to cost reflective tariffs such as demand or TOU and make the need for an allowance for digital metering more pressing and material.

AGL believes that in future AER determinations, the DMO price will require adjustment to reflect the higher metering costs incurred by retailers for advanced meters.

Solar Customers

21	Do you agree our DMO 2 approach to costs to supply solar customers remains reasonable?

Given the DMO methodology and policy objectives, AGL agrees with the AER's proposed approach to apply the DMO price for customers who have installed solar PV without adjusting for solar specific costs.

It is appropriate that the standing offer prices, which have been set in line with the DMO price, are available to customers regardless of whether they have a solar PV installation.