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4 April 2019

Re: Victorian Default Offer to apply from 1 July 2019 – Draft advice

AGL would like to take this opportunity to respond to the *Victorian Default Offer to apply from 1 July 2019 – Draft advice* (Draft advice) released by the Essential Service Commission (ESC) on the 7 March 2019.

The *Final Report of the Independent Review of the Electricity and Gas Retail Markets in Victoria* (Thwaites Report) made several good recommendations to improve the effectiveness and transparency of retail energy markets. These are currently being implemented.

In contrast, AGL believed the Basic Service Offering (BSO) was an unworkable recommendation and was therefore pleased to see the Victorian Government reconsider its introduction. However, the Victorian Default Offer (VDO) is likely to result in a very similar regulatory instrument that will damage retail energy competition in Victoria as:

- the Terms of reference¹ has been drafted to prescribe a VDO with no headroom and allowance for competition; and
- the ESC is interpreting the Terms of reference as requiring them to estimate the most “efficient” price for the VDO.

AGL does not support re-regulation of energy prices because it risks freezing the investment in supply that is needed for long-term energy affordability and reliability, and risks removing choice for customers.

There is a high level of concern on energy affordability which is why AGL is investing more than any other company in new supply in order to bring energy prices down. AGL has also reduced electricity prices in all states, developed new measures to help vulnerable customers and implemented a safety net that automatically discounted bills for standing offer customers. AGL has also been strongly supportive of a reference rate as the best way to address the difficulties customers face and provide more effective price comparison.

¹ <https://www.esc.vic.gov.au/sites/default/files/documents/retail-market-review-victorian-default-offer-terms-of-reference-20181221.pdf>



In saying that, AGL recognises the ESC is required to calculate the VDO for small electricity customers in Victoria and provide this advice to the Victorian Government by 3 May 2019.

One of the ESC primary objectives under the *Electricity Industry Act 2000* is to promote competition in the generation, supply and sale of electricity and AGL believes the ESC can satisfy both the Terms of reference and its legislative objective. AGL believes the current Draft advice will not satisfy both objectives as it is likely to damage retail competition.

While the Draft advice indicates that the ESC is cognisant of the impact the VDO can have on retail competition, it has not managed to adequately mitigate this risk and has focussed primarily on deriving the “efficient” or “fair” price for the VDO.

The following chart replicates the figure from the ESC’s Draft advice which intimates that the VDO outcomes are only in line with median market offers, but considerably below the highest and median standing offer prices.

Figure 1: Comparison of VDO with other available offers, typical residential customer²



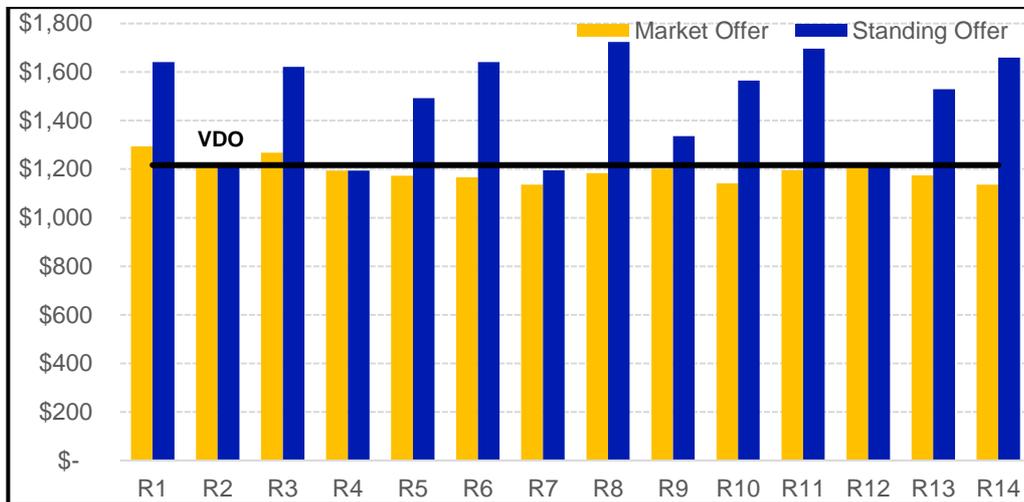
However, to clearly put the VDO in context, it is useful to consider a specific VDO price from the Draft advice as an example of the current situation.

AGL has analysed the VDO for a medium residential customer in the Jemena network area and compared it to leading retail markets offers and associated standing offer prices or base rates for itself and its competitors. This is shown in Figure 2.

The figure demonstrates that the VDO has been set in line with leading market offers, rather than any median level that would sustain retail competition.

² ESC Victorian Default Offer to apply from 1 July 2019 – Draft advice

Figure 2: Jemena VDO compared to retailers' leading market and Standing Offer Bills³



In fact, in AGL’s analysis only three retailers have best market offers that could provide savings to customers of \$50 a year or more when compared to the VDO. In AGL’s experience, this will not encourage customers’ engagement in the market. The ESC has also expressed this view and recently highlighted that:

“Research shows that for many customers, relatively significant savings are required to prompt them to switch. Our testing for this project indicates that 90 per cent of customers would require a saving of \$50 or more to consider switching.”⁴

ESC Draft Advice

The ESC is using an appropriate cost-based approach to estimate the VDO to apply from 1 July 2019. However, in applying the cost-based approach the ESC is not simply making reasonable estimates of the costs faced by a retailer but is estimating the most efficient costs of running a retail business.

Even if the ESC accurately estimates the efficient cost for all these inputs:

- the resultant VDO will be at the most efficient price for supplying electricity and will impact on retail competition in Victoria; and
- retailers are unlikely to pursue alternative operating models, innovative retail products and offerings or invest in alternative energy supplies that are not aligned with the benchmarks or at the most efficient cost level.

If the ESC fails to estimate the efficient cost and underestimates any cost impost, then the impact will be more critical as there is no headroom to provide any buffer nor has any cost estimate been set conservatively to account for variations or risks.

AGL believes this is the case for several of the estimates in the Draft advice, namely:

³ Annual bill for customer consuming 3.6 MWh per annum.

⁴ ESC, *Building trust through new customer entitlements in the retail energy market: Final Decision*, 30 October 2018



-
- the allowance for retail operating cost is set below that of an efficient retailer;
 - the allowance for the cost of the Large-scale renewable energy target fails to compensate a retailer for the actual cost of the scheme; and
 - the retail margin is set at the average benchmark level but is applied as the maximum retail margin for the VDO. Therefore, any market offers that are provided to customers will only make the benchmark retail margin unattainable for a retailer, when considering its entire customer base.

AGL requests the ESC to revise these cost estimates.

AGL would also encourage the ESC to reconsider the entire calculation of the VDO prices and select more conservative estimates for the cost stack. The VDO would then be more likely to sustain the financial viability of the industry⁵ and allow retailers to continue to operate and invest in service improvement and innovation.

In its original Working Paper⁶, the ESC noted the first VDO would only be in place for 6 months and this was a perfect opportunity to consider a conservative approach and to then assess the impact on the retail energy market and make necessary adjustments.

AGL supported this idea. Taking an initially conservative approach would still providing current Standing Offer customers with significant savings through the VDO but would have the added benefits of:

- insulating the ESC from the potential of having to increase the level of the VDO in 6-month time; and
- minimising the chance of economic harm to the competitive retail market and its participants.

As highlighted in the Draft advice, this is a profound regulatory intervention and is likely to have adverse consequences on customers and on the retail electricity market of Victoria generally.

Should you have any questions in relation to this submission, please contact me on (03) 8633 6207 or Patrick Whish-Wilson on (02) 9921 2207.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Elizabeth Molyneux'.

Elizabeth Molyneux
GM of Energy Markets Regulation

⁵ A matter that the ESC must have regard to under s8A of the *Essential Services Commission Act*.

⁶ ESC, Staff working paper: *Victorian Default Offer for domestic and small business electricity customers*, Dec 2018



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1. Wholesale electricity costs

The ESC engaged Frontier Economics (Frontier) to provide an estimate of wholesale electricity costs for the VDO to apply from 1 July 2019 using a market method. AGL supports the Frontier futures market approach and makes the following comments on the required inputs.

1.1. Customer load and wholesale spot price data

The data used is half-hourly load data sourced from AEMO's MRIM data for each of the five distribution network areas in Victoria which AGL accepts this as representative. Frontier has then performed a Monte Carlo simulation using the five recently available years of data to increase the volatility into the expected distribution of wholesale electricity costs. The Monte Carlo simulation produces 500 simulated years using the five years of data up to 30 June 2017.

ESC then takes the median value to calculate wholesale electricity costs. AGL agrees that this approach is reasonable but notes that in using the median value the ESC is electing an efficient estimate rather than a conservative allowance. Other regulators usually take conservative positions to mitigate the risk for retailers. In this instance, although the estimate may be efficient, there remains the possibility that an extraordinary hot year or change in demand could result in wholesale costs well above the allowance.

1.2. Futures purchasing time period and profile

AGL supports Frontier using ASXEnergy contract prices for base and peak swaps, and base \$300 caps and is pleased that Frontier has accepted that using a 40-day average period is unlikely to reflect the actions taken by retailers in purchasing hedging products. Frontier has selected a 12-month averaging period.

Frontier is correct that no single approach reflects the practices of the industry nor delivers the lowest costs in every circumstance and the 12-month period is therefore justifiable. However, AGL does not support the use of the time weighted averaging of contract prices by Frontier as it is not reflective of reality.

To estimate the most representative contract price, it is more realistic to calculate a trade or volume-weighted contract price over the selected time period. As shown in figures 12 to 14 of the Frontier report⁷, open interest and trade volumes generally increase as time move closer to the start of the contracting quarter or year. Volume weighted averaging of contract pricing would capture this behaviour so AGL supports the use of a trade weighted approach over the 12-month period for estimating contract prices.

1.3. Contract position

Frontier has used its STRIKE model to calculate a set of efficient contracting options. It is suggested that this produces the lowest energy purchase cost assuming retailers will adopt a minimal risk position when contracting.

AGL cannot comment on what is predominantly a "black box" approach but accepts that the outcomes of the Frontier's modelling are in line with industry metrics.

⁷ Frontier Economics, *Wholesale Electricity Costs, A report for the Essential Services Commission*, Feb 2019



2. Environmental scheme and other regulatory costs

The four main environmental costs faced by Victorian energy retailers estimated by the ESC are:

1. Large-scale Renewable Energy Target (LRET);
2. Small-scale Renewable Energy Scheme (SRES);
3. Victorian Energy Upgrades (VEU); and
4. Feed in tariff (FiT).

The ESC has also reviewed costs such as market participant fees, ancillary service charges, the Reliability and Emergency Reserve Trader (RERT) scheme and licence fees. AGL generally supports methodologies used to estimate these costs, especially given the timeframes for this review, but does have significant concerns with its assessment of the likely cost of large-scale generation certificates (LGCs). This is discussed further below.

AGL has also highlighted some concerns with the costs of RERT and AEMO directions that need to be considered in greater depth when the ESC is conducting its review for a 2020 determination and has time available to it.

2.1. Large-scale renewable energy target (LRET)

To comply with the LRET, electricity retailers are required to purchase and surrender a certain number of large-scale generation certificates (LGCs) each year to meet their renewable energy obligations. This requirement, the renewable power percentage (RPP) has recently been updated by the Clean Energy Regulator on 12 March 2019 and will need to be taken into account in the ESC's final advice.

Knowing this obligation, a prudent retailer will contract for LGCs in advance of the forecast year.

The cost to retailers of obtaining LGCs can be determined either using the resource costs associated with creating LGCs, or on the basis of the market price which LGCs are traded.

For 2019, AGL agrees with Frontier using the market price for LGCs to determine the cost of complying with the LRET. However, AGL does not believe the Frontier method of taking a 40-day average of LGC prices, as reported by Mercari, is justifiable as it is:

- unrealistic because it does not reflect how a prudent retailer would procure LGCs; and
- inconsistent with the approach adopted by Frontier for contract prices.

The methodology should be consistent as they are similar market situations with retailers procuring LGCs or forward contracts over a period to mitigate risk. No retailer would only buy LGCs in the 40 days leading up to the year to meet their obligation. Furthermore, the LGC prices in that 40-day window are not reflective of the market liquidity that would enable retailers to acquire such a volume.

Table 1: Price comparison of LGCs

Item	12 months to 21-March	40 days to 21-March
LREC	\$62.03	\$36.32



Table 1 shows the large difference between the 40-day average and the 12-month average of LGC prices. For 2019, AGL proposes the market cost of the LRET should be estimated using the prices of LGCs over the last 12 months at a minimum, although two years would better reflect AGL's risk profile.

This also highlights another issue, that the LGC market is becoming less relevant to the cost of the LRET. LGC market prices are becoming less reflective of the investments being made in renewable generation because the investments are being driven through bilateral PPAs. This is resulting in the market for LGCs only indicating the price for incremental purchases.

Consequently, measuring the cost imposed of the LRET through LGC market prices will not be applicable in the near future and the ESC will need to consider an alternative approach such as the resource costs of creating LGCs.

2.2. Small-scale renewable energy scheme (SRES)

AGL agrees with the approach of estimating the cost of complying with the SRES by multiplying the quantity of small-scale technology certificates (STCs) a retailer must surrender by the price a retailer is likely to pay for each certificate. AGL notes the binding small-scale technology percentage (STP) liability for 2019 has been published by the Clean Energy Regulator on 12 March 2019 and expect this to be updated in the ESC's Final advice.

2.3. Reliability and Emergency Reserve Trader costs

AEMO uses the RERT to maintain power system reliability and system security using reserve contracts by paying for additional capacity to be on stand-by.

The RERT cost in Victoria was \$50.76 million⁸ and AEMO has estimated that these events cost on average \$6 per customer which the ESC proposes to use, updated for inflation.

Given the timetable for the initial VDO calculation, AGL understands and supports the current methodology and cost estimate used by the ESC. AGL believes a more rigorous assessment is justified in the consultation for the 2020 VDO.

It appears the current AEMO calculation simply allocates the RERT cost based on annual consumption. However, RERT is only called upon in case of emergencies when the demand and supply balance is tight. In AGL's experience, these situations are predominantly driven by periods of high demand which in turn are largely driven by the demand profile of mass-market customers rather than commercial and industrial customers.

The current approach therefore underestimates the significantly larger contribution to demand from mass market customers during peak demand periods, during which the RERT was procured.

Going forward, the cost of the RERT needs to be allocated more accurately so that the actual cost for mass market customers better reflects their impact.

⁸ AEMO, *Summer 2017-18 operations review*, May 2018

2.4. AEMO Directions

AEMO issues directions to generators to maintain system security in the NEM. In November 2018, AEMO issued the first major set of directions in Victoria.

AEMO issued four directions in total to units to ensure system strength and control voltage levels in Victoria with units in the region directed for 1.9% of the time over the quarter⁹. The costs of the directions were recovered from market customers.

AGL expects voltage and/or system strength issues to worsen in the short term. The cost of these directions could be estimated by the taking a proportion of the total cost, allocated based on the mass-market consumption during these directions, and then dividing it by the total number of mass-market customers.

Although the cost per Victorian customer may only be currently small, it is a cost to retailers and AGL believes the ESC will need to account for this cost in future VDO determinations.

Figure 3: AEMO Charts¹⁰ on impact of security directions on Victoria

Figure 27 Directions for system security in South Australia and Victoria

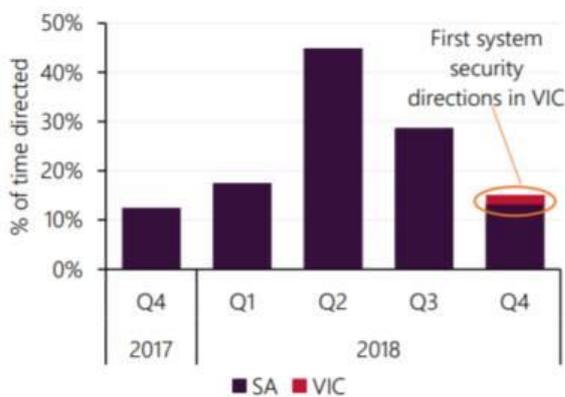
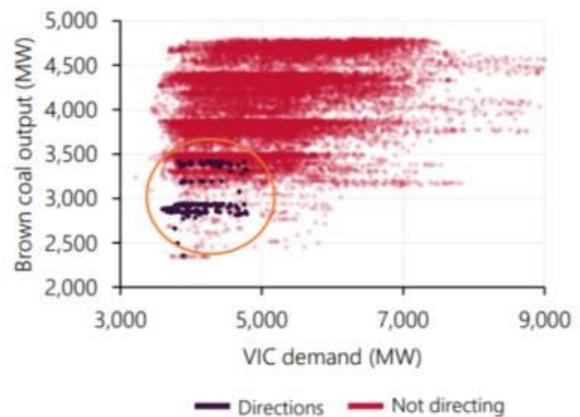


Figure 28 Conditions for system security directions in Victoria



⁹ AEMO, *Quarterly Energy Dynamics, Q4 2018*

¹⁰ AEMO, *Quarterly Energy Dynamics, Q4 2018*



3. Retail costs and margin

The ESC also procured Frontier to provide benchmarks and analysis on retail costs incurred by retailers in conducting their business, namely:

- Retail operating costs; and
- Customer acquisition and retention costs.

Frontier also provided benchmarking advice for retail margins including an expected returns analysis.

3.1. Retail operating costs

The ESC has used benchmarking to estimate retail operating costs for the first VDO to apply from 1 July 2019 and AGL supports such an approach.

The benchmarking is intended to consider:

- the recent analysis by the Australian Competition and Consumer Commission (ACCC) in its Retail Electricity Pricing Inquiry (REPI) of retail operating costs;
- market data, both publicly available and that provided by stakeholders in submissions; and
- recent regulatory changes that could have an impact on costs.

3.1.1. ACCC analysis of retail operating costs

In the REPI, the ACCC used actual information from energy retailers over the years 2007-08, 2010-11, and 2013-14 to 2017-18 to assess retail operating costs.

Retail operating costs in the REPI in 2016-17 were:

- a NEM average of \$90 per customer;
- a Victorian average of \$92 per customer; and
- the average of the big three retailers of \$75 per customer.

AGL provided detailed costs to the ACCC however there is no transparency in how this data was processed and then applied to establish the costs that were reported in the REPI.

It is unclear how AGL's financial structure was considered and how its Centrally Managed Expenses were allocated. These costs are significant and AGL provided a consultant report to the ACCC on how these costs should be allocated appropriately. Whilst it is unclear, the outcomes of the REPI suggest that these costs may not have been adequately included.

What is clear from the REPI is that operating costs are well below AGL's assessment of fully allocated costs for operating a retail business and furthermore, do not reflect recent increases in operating costs.

3.1.2. Frontier Benchmarking against other regulatory decisions

Frontier found that the regulatory allowance for retail operating costs has been between \$89-\$129 per customer in regulatory decisions since 2013 and publicly available data from Origin Energy and AGL in their annual reports provided the following ranges of operating costs from 2012-13 to 2017-18:



- AGL, from \$69-84 per customer; and
- Origin Energy, from \$119-168 per customer.

Although Frontier has considered a reasonable range for benchmarking retail operating cost of between \$90 and \$114 per customer (in \$2019), it appears the low end of this range was heavily reliant on the most recent 'market data' from AGL of \$84 per customer reported for 2017-18. AGL is unclear how Frontier's 'market data' is derived but it appears the 2017-18 estimate is very similar to AGL's reported Cost to Serve¹¹ in its financial statements.

AGL's published Cost to Serve is not equivalent to retail operating cost as it does not include all the costs required to operate an efficient retail business.

The Cost to Serve reported in AGL's Annual Report is a management performance metric used by AGL to monitor operating efficiency at the direct cash generating unit level. AGL's operating and financial review in its Annual Reports are reported according to areas of management responsibility.

There are many other expenses, including information technology and insurance, which are centrally managed to minimise costs and optimise service levels across the business divisions. While these costs are incurred as a direct result of the business units, such as retail (i.e. Customer Markets), they have not been formally reallocated because the management of these costs is the responsibility of various corporate functions.

As explained in AGL's submission to the ESC's Staff Working Paper, these Centrally Managed Expenses need to be allocated to AGL's reported Cost to Serve to assess an appropriate level of retail operating cost. In the table below, AGL has included indicative adjustments to make AGL's reported figures comparable to the regulatory benchmarks.

Table 2: AGL Retail Operating Costs

Item		FY15	FY16	FY17	FY18
Reported Cost to serve ¹²	(\$/customer)	72	69	70	83
Centrally Managed Expenses	(\$million)	236	225	248	313
Retail Allocation - CME	(\$million)				
Retail Allocation - CME	(\$/customer)				
Total ROC	(\$/customer)				

In 2017-18, AGL's estimated retail operating cost is over \$120 per customer when the allocation of Centrally Managed Expenses is included. This is significantly above Frontier's 'market data' of \$84 per customer and more in line with the figures reported by Origin and in the ACCC REPI.

Note that the cost of managing the operation of wholesale market activities has not been included (and should also be included).

¹¹ The reported Cost to Serve in the note 1.4.2.3 of AGL's 2018 Annual Report is actually \$83 per customer.

¹² As reported in AGL Annual Reports.



3.1.3. Additional regulatory costs

AGL's 2018 Annual Report reported that across AGL's national customer base:

- Cost to Serve per customer increased by 18.6% over the previous year;
- Cost to Grow per customer (acquired and retained) increased by 16.1%; and
- Centrally Managed Expenses increased by 25%.

The increase in Cost to Serve was due to higher bad and doubtful debts expense and payment channel costs, and labour cost increases due to reorganisation activities and increasing customer facing staff.

The increase in Cost to Grow was due to investment into the Customer Experience Transformation program, continued brand investment and increased sales channel and marketing campaign costs.

Centrally Managed Expenses included costs associated with responding to a period of intense regulatory activity and IT transformation. These two factors have continued in 2018-19 and will continue to do so in future years.

AGL's investment in the Customer Experience Transformation program is estimated to cost about \$300 million. With changes in market reforms and regulatory requirements not only in the retail market but in wholesale markets, the costs of operating in the retail electricity market should not be underestimated.

In addition to initiatives to improve customer experience, significant investments are required to implement changes in regulatory requirements. The different requirements in Victoria compared with the other jurisdictions under the National Energy Customer Framework (NCEF) have also created diseconomies of scale.

Current and impending retail regulatory changes in Victoria (in addition to the Payment Difficulties Framework) include the introduction of:

- the Victorian Default Offer;
- Advance notice of price changes;
- Clear advice entitlement;
- Best offer information;
- GST inclusive pricing;
- Customer self-meter reads;
- New energy fact sheets;
- End of benefit notification;
- Changes to market transfers and customer save activities;
- Changes to back-billing requirements;
- the abolishment of unsolicited calls (i.e. door knocking);
- Increases in penalties for wrongful disconnections;
- Domestic violence resources; and



- Consumer data rights.

These regulatory changes come at a cost to a retail business. Furthermore, wholesale regulatory changes in the NEM also impact on a retailer's cost and currently include the introduction of:

- five-minute settlements;
- global settlement;
- retailer reliability obligations;
- wholesale demand response; and
- coordination of generation and transmission investment.

There are also significant reforms in the wholesale gas market which could impact on the electricity market. It is therefore reasonable to anticipate significant real increases in retail operating cost from a cash investment perspective that will be reflected in future year depreciation. For this reason, depreciation should also be considered in retail operating costs.

3.1.4. ESC retail operating costs

In AGL's view, the benchmark retail operating cost in the Draft advice is significantly understated. The reasons are discussed above but it appears to be have driven by the erroneous use of AGL Cost to Serve data from the REPI and from Frontier's analysis. AGL has highlighted above how this cost information should be correctly interpreted.

3.2. Customer acquisition and retention costs

The terms of reference required the ESC to include a "modest" allowance for customer acquisition and retention costs (CARC) in calculating a VDO. The ESC has estimated an allowance for CARC based on the average for competitive markets from the ACCC REPI final report. Adjusting for inflation, this is estimated to be \$51.48 per customer in 2019.

This cost lies between the estimates of AGL's CARC over the past two financial years of \$43 (2016-17) and \$61 (2017-18) per customer, spread across AGL's entire customer base.

In the half year to 31 December 2018, AGL's cost to grow per account (both acquired and retained) has increased by 9 per cent nationally.

Furthermore, given the new regulatory changes such as Best Offer information and clear advice entitlement, and despite the uncertainty regarding churn following of the implementation of the VDO, it is likely that CARC may further increase this year.

Therefore, compared with AGL's recent and likely costs, the proposed CARC allowance is understated or "modest" and should be considered the minimum allowable cost.

3.3. Retail operating margin

The terms of reference require the ESC to include an allowance for a maximum retail profit margin in the VDO.



It is important that the ESC recognise that in this price determination, where the terms of reference requires all cost inputs to be estimated at efficient levels with no headroom allowed, the retail margin allowance will act as the maximum retail margin and not an average or targeted retail margin as it has in other regulatory decisions.

The ESC is proposing to set the retail margin at 5.7 per cent in the calculation of the VDO, in line with historical regulatory decisions by other Australian energy regulators.

However, these historical regulatory decisions included headroom and generally used conservative allowances for wholesale cost, retail operating cost and other cost elements. This enabled retailers to provide discounted market offer prices for customers and still have expectations that they could average a retail margin of 5.7 per cent across the customer base that they supplied.

This is not possible with the VDO.

The VDO is being set with all components of the cost stack being set at efficient levels. This means that a retailer must be highly efficient in all elements of energy procurement, supply and operations simply to obtain what is considered a reasonable retail margin of 5.7 per cent. Furthermore, any benefits or discounts provided to customers through lower market offer prices will simply reduce the average retail margin of the retailer below this 5.7 per cent benchmark.

For instance, if wholesale energy costs are \$10/MWh and retail operating costs are \$30 per customer higher than the benchmarks, the retail margin for a customer on the VDO will be less than 1%.¹³

If the ESC considers that 5.7 per cent is an efficient retail margin benchmark, then it will need to set the maximum retail margin at a higher level to ensure:

- some retail competition continues to exist; and
- retailers have an opportunity to obtain an average retail margin for their business at, or near, the benchmark level.

3.3.1. Expected returns approach

The ESC asked Frontier to estimate the retail margin for electricity retailers based on the expected returns approach to allow for comparison with the regulatory benchmarks.

Frontier used this approach to estimate a range for the retail margin of 3.1 to 6.1 per cent that considered the sensitivity of key inputs such as WACC, market volatility, demand and the share of total costs represented by fixed costs.

AGL believes the sensitivity of this expected return approach needs to be modelled with additional consideration given to:

- the cost allowances considered in the construction of the VDO are deemed efficient and do not address or allow for additional risks which therefore need to be considered in the expected returns approach;

¹³ Based on a residential customer using 4,000 kWh a year



-
- the WACC used for a retailer is relatively low compared to other businesses with commensurate risk and the equity beta needs to be greater than 1.0 to account for this;
 - the fixed proportions are largely appropriate but in the sensitivity analysis, Frontier needs to set the fixed proportion of WEC at considerably greater than 8 per cent given energy procurement for a retailer is largely fixed when considering systematic risks of this type; and
 - the future cash flows are only used to solve for the retail margin but how does Frontier accommodate the fact that under a regulated price regime, the future cash flows do not necessarily equate with the changes in assumed costs, for instance, it is assumed that cash flows grow by 2.5 per cent per annum beyond year 10.

AGL expects the estimated range will be considerably higher if the market risks and uncertain cash flows under a regulated price framework are duly captured in this modelling.

AGL believes the ESC needs to reconsider its retail margin benchmark to incorporate these increased risks or provide more conservative cost estimates to compensate for these risks in its other cost allowances.

3.3.2. Margin Transition

In its Working Paper, the ESC recognised that the calculation of an initial 6-month VDO price provided an opportunity to set a transitional retail margin which would allow the ESC to monitor the impacts of the regulated price on the retail energy market before adjusting its approach for 2020.

AGL supported this approach as it had the potential to mitigate the likely initial impacts on competition and is disappointed that the ESC has not progressed such a method.



4. Other Issues

4.1. Network Costs

AGL supports the ESC's approach to pass through the quantum and structure of network tariff costs directly to the residential or small business customers, including published metering charges.

The ESC has used the simplest network use of service (NUOS) tariff in each distribution zone for the VDO.

4.2. Form and Structure of the Victorian Default Offer

ESC has proposed a fixed and variable structure determined by allocating costs that vary with consumption to the usage charge, while those costs that are fixed would be allocated to the supply charge.

AGL is comfortable with this approach and predominantly supports the ESC's allocations.

However, the allocation of some cost allowances is not fundamentally clear. Some costs elements such as the procurement of wholesale energy and environmental costs are considered variable charges but are, in practice, procured in advance based on estimated volumes that may or may not be sold. Therefore, a proportion of these costs that should be considered a fixed cost. For example, we note in Frontier's expected returns modelling for retail margin that it apportions 8 per cent of wholesale energy cost as a fixed charge.

AGL believes it is appropriate for this initial VDO that a proportion of these charges are allocated to the fixed charge rather than 100 per cent as a variable charge. This will ensure the pricing structure of the VDO will be better aligned with current standing offer prices so that all standing offer customers, irrespective of their consumption levels, will similarly benefit from moving onto the VDO.

An additional advantage of this approach is that Victorian distribution networks are focussed on increasing the fixed proportion of network charges in order to be more cost reflective, given the general decreases in energy consumption. Therefore, they are expected to increase the fixed network charge for 2020. The ESC will be better placed to accommodate this fixed cost increase without impacting small residential consumers of energy if it takes a balanced approach for this first 6 months.

4.3. Embedded network customers

AGL believes that the protections on customers in embedded networks should not be any different than for other consumers. We note that the Victorian Government previously stated that embedded network customers should pay no more than the VDO.

AGL agrees and supports the VDO becoming the maximum price to be charged to embedded network customers from 1 July 2019.