



8 April 2019

Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne, Victoria 3000

By email: RetailEnergyReview@esc.vic.gov.au

Victorian Default Offer: Draft Advice

Alinta Energy Retail Sales Pty Ltd (**Alinta**) welcomes the opportunity to make a submission regarding the Essential Services Commission's (**ESC**) Draft Advice (**the Draft Advice**) that outlines the methodology used to determine the Victorian Default Offer (**VDO**) that is intended to be implemented on 1 July 2019.

Alinta is an active investor in energy markets across Australia with an owned and contracted generation portfolio of nearly 3,000MW, including 1,700MW of gas-fired generation facilities and 1,070MW of thermal generation facilities, and in excess of 1.2 million electricity and gas customers including more than 630,000 in east coast markets, and is therefore well placed to provide comments on the Draft Advice.

Alinta recognises that the gap between consumers on attractive market offers and those remaining on high-priced standing offers (paying a "loyalty tax" - largely with the large incumbent retailers) is too wide and needs to be narrowed. We agree with Minister D'Ambrosio, when announcing the VDO, that Victorians have "put up for too long with big corporations ripping consumers off." We estimate that those residential customers who have switched to Alinta have decreased their electricity costs by up to \$200 a year, a total saving for Victorians of up to \$30 million per annum.

We support the Victorian Government in its terms of reference to the ESC for the VDO to provide a safeguard "without impeding the consumer benefits experienced by those who are active in the market." This is consistent with the ACCC's recommendations for an adequate safeguard within a competitive market in which new entrant and second-tier retailers can invest, differentiate and maintain competitive pressure on the large incumbent retailers.

However, the ESC's Draft Advice has set the VDO so low that in our view it would have a severe negative impact on retail competition, establishing it as a viable alternative to market offers, and limiting the ability of second-tier retailers like Alinta Energy to compete given the dominant market position of the large incumbent

retailers. As the ACCC has warned, if regulated prices become a viable alternative for engaged consumers it would not be in the long-term interests of consumers as “engaged consumers drive efficiency and innovation in the electricity sector by responding to new offerings from retailers.”

The Government has significantly boosted engagement through the Victorian Energy Compare website via its \$20 million-plus Home Energy Assist package. We believe the VDO should be set at a level that complements this investment by ensuring challenger brands can continue to incentivise customers to switch.

At its current level the VDO risks breeding mass disengagement among Victorian energy users, marginalising second tier retailers who have been driving market activity and therefore entrenching the market power of the large incumbent retailers.

There are several opportunities available to the Commission to adjust the VDO for the Final Decision to prevent these negative impacts:

- A consistent 12-month approach to calculating wholesale energy costs and environmental costs;
- An allowance in the retail margin to account for customers transferring to another retailer within the 12-month fixed-price period, (also reflecting the greater market risks in the current Victorian market);
- Customer acquisition costs that reflect the actual costs of retailers and the higher regulatory costs in Victoria;
- Recognition of increased wholesale market volatility through either a re-opening mechanism or additional wholesale cost risk premium; and
- Utilising segregated MRIM data that provides the relevant load shape profiles for residential customers and small business customers below 40 MWh per annum.

We would also like to highlight the difficulties retailers like Alinta Energy are facing from a change management perspective given the rapid speed of implementation contemplated here. A major billing system update driven by a regulatory change such as this would typically involve a sustained and coordinated effort involving operational, regulatory and IT staff from across our business managed under a project framework so we can check, test and carefully implement changes so as not to risk non-compliance or customer disruption. At a minimum we would typically require months of effort and investment to effect such a change successfully and be comfortable with the various risks that are presented.

Our further detailed comments on the ESC's Draft Advice are contained in the attached. Should you have any questions or wish to discuss any aspect of our submission I may be contacted on [REDACTED] or via email:
[REDACTED]

Yours sincerely



Shaun Ruddy
Manager National Retail Regulation

Essential Services Commission Draft Advice- Victorian Default Offer

Approach to Determining the VDO Price

In setting market contract prices, retailers are continuously monitoring the retail and wholesale markets, and adjusting their energy purchase and retail pricing decisions in response. The VDO, as a price regulated product, is a form of fixed-term pricing which allows no ability for retailers to respond to changed market dynamics once the price has been set. For this reason, the setting of the VDO at a level equivalent to the current median market offer should be viewed as a flawed outcome, whereby the risks inherent in establishing that fixed-price have not been adequately captured. The final VDO should be set a level closer to existing Standing Offers, which reflect the additional risk of supplying customers on a 12-month fixed price.

We agree with the ESC that the setting of the VDO should align with the calendar year timing of network tariff determinations. On this basis, we believe the initial VDO should be delayed to 1 January 2020. The setting of a VDO price for 6 months from 1 July 2019 will result in additional unnecessary and costly administrative, system and customer communication activities. A delay would also allow for the collection of more accurate data on the impact of the Payment Difficulty Framework (PDF) on the debt profiles and risk factors of Victorian retailers, as the PDF would have by then been in place for 12 months.

Inconsistent methodologies used to develop the cost stack

The Draft Advice has considered several methodologies to determine the individual cost stacks components to develop a VDO price. Of concern to Alinta, is that the methodologies proposed in the Draft Advice are inconsistent and on occasion appear to be selected purely on the basis of what will produce the lowest possible cost outcome.

Thus, whilst the wholesale cost is calculated using a 12-month average, the LRET is calculated using a 40-day mark-to-market model. Similarly, whilst the retail margin uses a benchmarking method, the retail cost component does not.

The unpredictable nature of such an approach has implications for the long-term investment decision making of market participants and imposes greater regulatory risk than is necessary.

To minimise regulatory risk, and provide some level of confidence, we recommend:

- a consistent approach of 12-month averages across both energy and environmental charges, and.
- a consistent approach to benchmarking retail costs and retail margins.

Retail Operating Margin and CARC

The Draft Advice adopts retail margin benchmarks based on recent decisions set by Australian energy regulators. Although the recent decisions have all set the retail margin at 5.7%, the determinations have ultimately relied on the Independent Pricing and Regulatory Tribunal - New South Wales decision in 2013 (the **IPART decision**).

Our first concern is that the IPART decision was based on the 2012/13 financial year and a market very different to Victoria. Consequently, the identified margin reflected period and a retail market with less wholesale market volatility, lower rates of retail competition, and much less regulatory risk. These are all factors justifying a higher allowable retail margin for the VDO.

More significantly however, when determining the retail margin in 2013, IPART also took into consideration the offsetting impact of an exit fee for customers that terminated their energy contracts during a defined period. Table 1 below illustrates the exit fees applicable to customers in NSW¹. The relevant amount in the case of the VDO is the \$130 for contracts terminated within 12 months, the defined period of the VDO price setting arrangement.

Table 1

Contract termination period	Exit Fee Cap
<i>12 months from the date of supply</i>	\$130.00
<i>Thereafter (until the end of the fixed term contract or fixed benefit period of a market retail contract)</i>	\$45.00

Alinta further notes that subsequent regulatory decisions that relied upon the IPART decision (Independent Competition and Regulatory Commission (Australian Capital Territory), Queensland Competition Authority and Office of the Tasmanian Economic Regulator) all allowed for exit fees in their jurisdictions when setting the retail margin at 5.7%.

¹See: https://www.ipart.nsw.gov.au/files/sharedassets/website/trimholdingbay/final_report_-_early_termination_fees_-_regulating_the_fees_charged_to_small_electricity_customers_in_nsw_-_december_2013.pdf

The Draft Advice suggests that the cost to retailers of customers switching to another retailer has been captured as a component of CARC, stating;

Switching risk – retailers face the risk that customers will switch to other retailers at short notice. The energy rules allow retailers to charge an exit fee to customers who switch away. Moreover, our cost-based approach to setting the VDO provides an allowance for retailers' customer acquisition and retention costs (CARC). This provides retailers with funds to manage this risk.²

However, there is no guidance on the calculation or allowance for this switching risk. Furthermore, given that the Draft Advice has calculated the total CARC at \$51.48, well below the \$130 ETF for 12-month contracts in NSW, and must also account for all other aspects of the CARC calculation, the only conclusion possible is that almost no allowance has been made in the VDO for customers transferring retailers within 12 months of transferring in.

Given the Draft Advice (and ultimately all price determinations made after the IPART decision) relied on data from the IPART decision, it is Alinta's view that the retail margin should be adjusted to adequately account for a retailer's exposure to terminating contracts within the defined period, consistent with IPART's decision.

To be clear, we acknowledge the Victorian Government's prohibition on early termination fees, and we make these comments in the context of advocating for an adjustment to the retail margin.

Finally, we note that the Terms of Reference state that the VDO price should "include an allowance for the maximum retail profit margin".³ The IPART decision in fact identified a range for the retail profit margin, with an upper bound, or maximum, of 6.1%. This should be the starting point from which the other factors identified above should be added.

In summary, we believe the retail margin allowance should be revised upwards to reflect:

- The maximum of the margin range identified by IPART, consistent with the Terms of Reference
- The materially higher energy market risks in Victoria in 2019 compared to NSW in 2013
- The risk of customers switching to another retailer within the pricing period, consistent with the IPART decision.

Retail operating costs

Alinta acknowledges and welcomes the ESC's allowance for the costs of regulatory reform associated with the payment difficulties framework as part of the VDO cost components. However, we are also currently budgeting for additional costs associated with the following regulatory reforms;

² ESC (2019), *Victorian Default Offer to apply from 1 July 2019 – Draft advice*, page 61,

³ *Ibid.*, page 84.

- Independent Review into the Electricity and Gas Retail Markets
- ACCC's Retail Electricity Pricing Inquiry, and
- The Victorian Government's Energy Fairness Plan

In assessing the retail cost component, allowance for abnormal or non-recurring items relating to regulatory reform must be accounted for, to accurately to capture the costs associated with implementing these changes.

We also note that Terms of Reference states that the VDO should be "based on the efficient cost to run a business." The Draft Advice proposes the NEM average from the ACCC REPI. In doing so, the ESC dismissed the Victorian CARC as it was the highest amongst contestable regions.

We believe that the higher costs shown for Victoria reflects the fact that Victoria, operating under its stand-alone regulatory framework and widely acknowledged as the most regulated region, imposes the highest retail and compliance costs in the NEM. This should be reflected in the retail cost allowance. Thus, if the ESC is to use the ACCC REPI data, it should be based on the Victorian CARC, adjusted for the additional regulatory reforms identified above.

With regard to the time period over which forward contracts are purchased, significant differences will exist across retailers depending on several factors, including the retailer's overall risk profile, corporate structure, access to debt/finance and overall business strategy. As such, there is no clear "typical" time period methodology the ESC can utilise in the VDO model. However, Alinta suggests that a prudent approach would be a 12-month average, given the VDO will be set for 12 months as this would be more representative of market conditions.

Cost to Serve and Costs to Acquire Assumptions

In regards to the cost to serve and cost to acquire assumptions as outlined in Table 12 of the ESC's advice, Alinta strongly considers that the proposed methodology has determined annual allowances that are unrealistically low, and if enacted will have the effect of setting allowable operating costs lower than Retailer's actual costs.

Publicly available information from AGL's 2018 **Financial Results**⁴ (pg 31) set the costs of customer acquisition at \$101 and the costs to serve a customer at \$83 (a total of \$184 per annum). Table 12 of the ESC's advice sets the costs of customer acquisition at \$51.48 and costs to serve at \$104.5 (a total of \$156 per annum) which represents an immediate price differential of -\$28 per customer per year.

These cost figures relate to a vertically integrated tier 1 retailer, as opposed to a notional retailer who is, '*a stand lone retailer and is not vertically integrated (i.e. does not have economies of scope)*'.⁵ In Alinta's view, relying on these types of

⁴ <https://www.agl.com.au/-/media/aglmedia/documents/about-agl/asx-and-media-releases/2018/180809appendix4e2018annualreport1829055.pdf?la=en&hash=1AB7F5C8F960CED1C474846A26BFC816>

⁵ https://www.esc.vic.gov.au/sites/default/files/documents/ESC%20Staff%20working%20paper%20Victorian%20Default%20Offer%20for%20small%20electricity%20customers%20-%2020181220_0.pdf, page 6,



benchmarks would lead to understated costs to serve and acquire that are not aligned with a notional retailer.

Alinta would encourage the ESC to revisit the annual allowance calculations with a mind to aligning retailers allowable operating costs to industry standards of notional retailers who do not have vertical integration.

Wholesale Electricity Costs

Broadly speaking Alinta’s view is that the Futures Market Method (FMM) is an appropriate approach to calculating the wholesale energy costs for the ESC’s VDO model. However, we do not believe that the model accurately captures the additional risks imposed upon retailers by the setting of a 12-month fixed price, given the seasonal fluctuations in the demand for energy.

To illustrate the material impact of seasonal pricing, Alinta has used Frontier Economics’ data and FMM to determine the quarterly cost of wholesale energy. This analysis was conducted for only one distribution network to simplify the illustration and impacts of seasonal demand on the wholesale energy cost. The CitiPower zone was chosen so as not to over-state these impacts, as it has the lowest wholesale energy cost.

The quarterly wholesale energy costs in Table 2 below shows that the Q1 wholesale energy cost is significantly more expensive at \$131.64 than the 12-month cost of \$94.21.

Table 2: Wholesale electricity costs (\$MWh, per quarter)

Distribution zone	12 months (\$ per MWh, nominal)	Q1 (\$ per MWh, nominal)	Q2 (\$ per MWh, nominal)	Q3 (\$ per MWh, nominal)	Q4 (\$ per MWh, nominal)
CitiPower	\$ 94.21	\$131.64	\$81.73	\$86.40	\$80.46

The higher Q1 cost, as shown in the Frontier Economics’ data, is due to higher base swap prices, peak swap prices and base cap prices in Q1, as shown in Table 3 below.

Table 3: Inputs used to calculate Wholesale electricity costs (\$MWh, per quarter)

Quarter	Base swap price	Peak swap price	Base cap price
1	\$94.66	\$131.04	\$24.57
2	\$71.62	\$95.04	\$4.62
3	\$79.46	\$94.05	\$3.62
4	\$69.96	\$86.62	\$5.99

As the VDO applies for a calendar year, it reflects the price paid by the customer regardless of which quarter they were acquired. Thus, if a customer is acquired in Q1 and then transfers to another retailer during or shortly after the end of Q1, the retailer will incur a loss on the wholesale cost component. This does not appear to have been adequately accounted for the Frontier Economics modelling, and, as discussed earlier, is compounded by the lack of an allowance for customer transferring out within the 12-month VDO pricing period.

To manage this new exposure of having an annual regulated price, subject to seasonal demand exposure, with no allowance for customer's transferring out with in the period, the ESC could either increase the wholesale energy cost allowance or increase the retail margin.

Regarding forecasting demand and load profiles, Alinta supports the use of the most recent manually read interval meter (MRIM) data. However, we urge the ESC to obtain segregated MRIM data that provides the relevant load shape profiles for residential customers and small business customers below 40 MWh pa. The existing MRIM data used by Frontier Economics incorporates blended profiles, for all customer types up to 160MWh pa. The implication of having a blended profile of all customer types up to 160MWh pa is that it does not accurately reflect the peakier profiles of the residential and small businesses (up to 40 MWh) segments, thereby significantly understating retailer hedging costs.

Transitional Hedging Period

Alinta considers the proposed VDO hedging methodology, as currently drafted, risks locking in retailers to an immediate loss-making hedging position for the initial period beginning 1 July 2019 until retailers operational hedging practises are aligned with the VDO's methodology going forward.

By way of example, the proposed VDO hedging methodology is set using a 12-month averaging period, in which retailers can hedge in the future based on how the wholesale cost allowances are set by the VDO. However, retailers have only seen the draft VDO's methodology after the end of the proposed 12-month average hedging period, therefore, retailers have had no way to hedge as per the new VDO methodology creating the risk of an immediate gain/loss scenario on 1 July 2019.

Alinta has undertaken a simple analysis to demonstrate the impact during the initial period of the VDO's operation which ranges between an operating loss of -\$12 and -\$110 per customer, the top range of which is far in excess of the VDO's allowable retail margin.

	VDO wholesale price (12 month average) (Frontier)	VDO wholesale price (40 day average) - (Frontier)	Time weighted average (6th April 2018 - 5th April 2019)	Last Price (5th April 2019)
	A\$/MWh	A\$/MWh	A\$/MWh	
Base Swap average	78.93	91.21	81.44	102.00
Load shape cost per VDO (%)	19%	19%	19%	19%
Citipower electricity price allowance	94.21	108.87	97.21	121.75
Variance to Draft VDO (\$/MWh)	0.00	-14.66	-3.00	-27.54
Variance to Draft VDO (\$pa on 4MWh customer)	0.00	-58.63	-12.01	-110.18

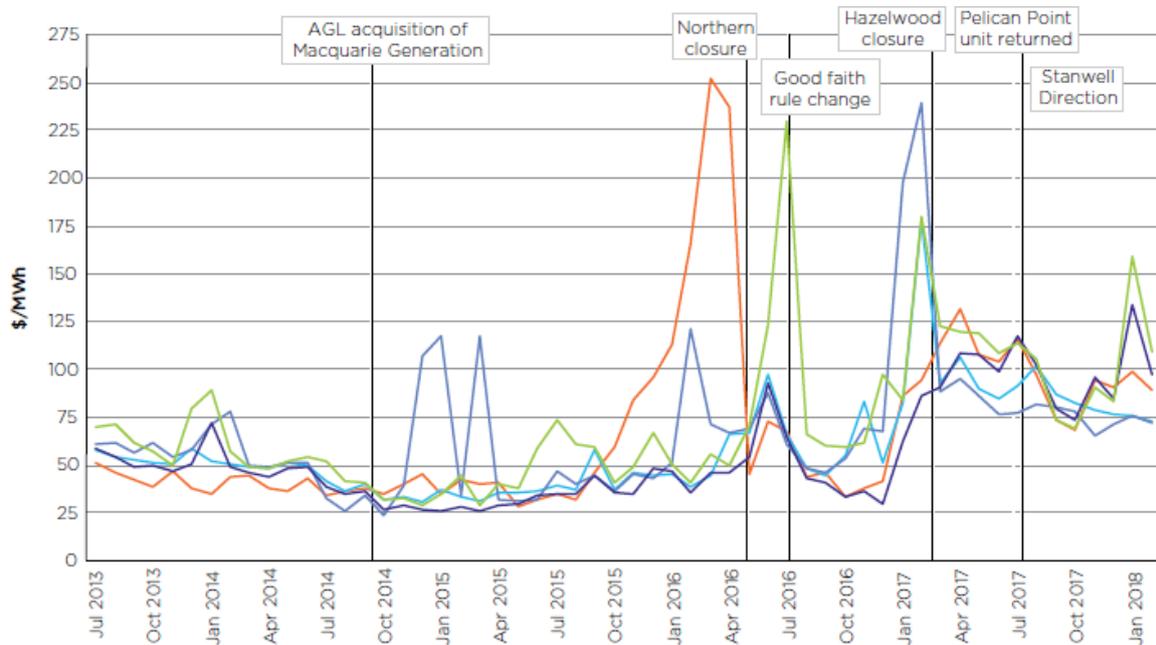
In future years Retailers will be able to hedge based on how the wholesale cost allowances have been legislated under the VDO; but only if the averaging period starts after the VDO is in operational practise i.e. this remains a large risk for the Calendar 2020 prices, where the hedging methodology is yet to be implemented fully.

Provision for a VDO Re-opening mechanism to allow for high price events

An additional risk of a 12-month fixed-price VDO is that wholesale price volatility is impacted by external factors over which retailers have no control. Figure 1 below, taken from the ACCC's Retail Electricity Pricing Inquiry: Preliminary Report⁶, highlights the number of diverse NEM events that can occur to cause an unexpected increase in the wholesale spot price. It shows that the wholesale market is becoming increasingly volatile, and that high price events are becoming more frequent.

⁶ <https://www.accc.gov.au/publications/accc-retail-electricity-pricing-inquiry-preliminary-report>

Figure 1: Monthly average spot prices by NEM region, July 2013 to February 2018 (\$/MWh nominal)



Retailers currently have the ability to manage high price events and price volatility by re-setting their retail prices. With the introduction of a 12-month fixed price VDO, retailers will be required to modify their hedge positions, and ultimately their risk appetite, to manage this new futures price exposure, impacting prices in both the spot and contract markets.

To manage this new exposure of having a 12-month fixed price VDO, we recommend developing a provision for a re-opening mechanism, whereby the ESC must consult on the potential recalculation of the VDO within the 12-month price period in response to a significant price event. Further, the re-opening mechanism can be triggered by the ESC or through the application from a retailer to the ESC. If a re-opening mechanism is not allowed for, it is only reasonable that wholesale energy cost is adjusted to contain an additional risk premium.

Prudential Management Costs

The FMM also fails to include prudential management costs for a typical retailer requiring finance funding to manage their wholesale trading activities across Australia's var. As disclosed in GloBird Energy's public presentation, these costs can represent a substantial component of a Retailer's hedging costs that needs to be accounted for within the VDO methodology. Participants face several costs associated with managing their prudential and trading obligations including:

- A percentage fee charged by financial institutions on the face value of bank guarantees;
- Ongoing financial fees and administrative costs in servicing security deposits; and

- The weighted average economic opportunity cost of holding cash in escrow as a prudential, which could have been otherwise used to pursue other productive business opportunities.

Prudential management costs are ultimately priced into wholesale market bidding and hedging strategies, which in turn impact retail prices. Furthermore, depending on the individual commercial terms reached with different financial institutions, prudential management costs will vary across participants. For instance, prudential costs for new entrants and smaller participants (especially those whom are non-vertically integrated) are likely to be proportionately greater as they likely face higher costs of debt and charges for bank guarantees.