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Victorian Default Offer for domestic and small business electricity customers

AGL would like to take this opportunity to submit on the *Victorian Default Offer for domestic and small business electricity customers: Staff working paper* (Working Paper) that the Essential Services Commission (ESC) released on 21 December 2018.

AGL does not support re-regulation of energy prices and believes the Victorian Default Offer (VDO) is an unnecessary policy response given the additional market reforms being initiated nationally and in Victoria to improve the effectiveness and transparency of retail energy markets.

However, AGL recognises the ESC has been requested to develop a methodology to calculate a VDO for small electricity customers in Victoria by 3 May 2019 and is not in a position to question the merits of the VDO.

The terms of reference indicate that the VDO price should:

- be set for each distribution zone;
- be based on the efficient cost to run a retail business;
- include an allowance for a maximum retail profit margin;
- include a modest allowance for customer acquisition and retention costs; and
- not include an allowance for headroom.

It is also important to recognise that one of the ESC primary objectives under the *Electricity Industry Act 2000* is to promote competition in the generation, supply and sale of electricity.

We believe the ESC can satisfy the terms of reference and meet its legislative objective by ensuring that it mitigates the likely adverse consequences of this reform through its price determination process. The Working Paper indicates that the ESC is cognisant of the impact the VDO can have on retail competition and will look to moderate this risk in its initial VDO calculation for the 6 months period to the end of 2019.

In AGL's experience, a retail price determination requires a significant period of consultation to ensure the relevant data inputs, forecast loads, forecast spot prices, assumptions and modelling are robust. AGL recognises the ESC can use its previous consultation on a reference price in 2018 to inform this process but

would also highlight that stakeholders have not seen the results of this work and cannot therefore rely on the efficacy of the final report and its outcomes.

Given the time constraints, AGL generally supports the ESC methodology using:

- a futures market method for estimating wholesale electricity costs;
- the pass through of the flat network charges as approved by the Australian Energy Regulator; and
- benchmarking approaches for both retail operating costs and retail margin.

AGL has included in Appendix 1 its detailed responses to the questions raised in the Working Paper as well as comments on the methodology, data and modelling that was outlined by Frontier Economics in the workshop held by the ESC on the 21 January 2019.

If you wish any further information, please contact me on [redacted] or Patrick Whish-Wilson on [redacted].

Yours sincerely

Elizabeth Molyneux
GM of Energy Markets Regulation

Appendix 1: AGL Comments on Working Paper and methodology

Efficient retailer

The terms of reference note that the VDO price should be based on the efficient costs to run a retail business.

1.	Is the definition of a notional retailer suitable for the Victorian retail energy market? What alternatives could we consider for the VDO?

AGL believes that the definition of the notional retailer should refer to a stand-alone electricity retailer that serves about 200,000 domestic and small business customers in Victoria to provide an efficient cost base.

Wholesale electricity cost

AGL agrees with the use of a futures market method for estimating wholesale electricity costs as it is a more accurate reflection of a retailer's costs compared to other approaches.

2.	Please provide your views on the time period, buying curve and load profile that are most suitable to the Victorian electricity market.

Forward contracts

AGL understands that Frontier Economics is modelling the wholesale electricity cost for the ESC.

Frontier has previously stated a preference for a 'point-in-time' approach by using a 40-day average of published contract prices at the end of a year to establish contract prices for the following year.

Although such a method may be theoretically justified for valuation purposes, it makes little sense in the context of setting a price for future default market offers. As AGL has highlighted previously:

- prudent retailers will purchase forward contracts for a period of one to two years in advance of the forecast year, as indicated by the liquidity of forward contracts;
- no retailer, prudent or otherwise would only buy contracts in the 40 days leading up to the year to hedge their entire mass market load; and
- forward market prices in that 40-day window are not reflective of the market liquidity and depth that would enable that volume of trading to occur.

Consequently, AGL supports the use of a trade weighted approach over a 24-month period for estimating contract prices.

If a time-weighted approach is preferred by the ESC, then AGL would suggest a 40:60 weighting be applied to the two years so that the most recent year has a greater weighting more in line with the trading volumes.

Load profile and price trace

AGL understands that Frontier will utilise the load shapes based on Victorian manually read interval meters (MRIM), scaled for AEMO demand forecasts, to provide the appropriate load profile with coincident spot prices for these observations providing the price trace.

AGL accepts that the MRIM data from 2014 onwards provides a credible load shape but believes that using the load data from the last two years is more appropriate because it ensures that the associated price trace is more relevant to the recent behaviour of the Victorian energy market.

Consequently, AGL support Frontier either using the most recent year of data for the load profile and spot price forecast or using a Monte-Carlo simulation approach as highlighted in the workshop of the 21 January 2019.

AGL would also highlight that one of the reasons why only recent load and price data is relevant is the large volumes of solar generation entering the system which are not reflected in the load shape or price curves of previous years. This issue will only be exacerbated in 2019 and onwards as retail load will become 'peakier' with more rooftop solar and the shape of prices will also change in combination with large scale solar.

Finally, AGL does not accept Frontier's assumption that contract prices minus 5 per cent is an estimate of the level of spot prices but concedes its usage for this modelling purpose.

Energy Losses

3.	How should the commission calculate transmission losses?

The ESC should use the 2019-20 transmission and distribution loss factors when published by AEMO.

The average energy-weighted transmission loss factor for each network zone can be derived using the loss factors and energy consumed at each of the Transmission Node Identities (TNI).

The distribution loss factors for LV customers by network zone are also published by AEMO.

Network tariffs

4.	Are the tariffs set out in Tables 1 and 2 the appropriate tariffs to use for establishing the VDO?

AGL supports the ESC using the flat residential and small business networks tariffs for the five distribution networks highlighted in its Working Paper to derive the ten VDO prices.

Further policy clarification will be required to understand the treatment of small customers that choose to select the VDO despite having a network tariff that varies from the above. This is currently not a material issue for AGL because almost all AGL Standing Offer customers are currently on the flat tariffs proposed by the ESC. However, it may become a significant impediment to the introduction of cost-reflective network pricing as well as a material financial risk to retailers in the future depending on the price level of the VDO relative to more cost-reflective retail and network tariffs.

5.	How should we treat the calendar year network revenue determinations in the context of the introduction of the VDO from 1 July 2019?

AGL support the ESC proposal to calculate the initial VDO for a period of six months followed by an annual determination for 2020.

This would align with the AER network determinations and price changes.

It also enables the ESC to take a conservative approach with the initial determination because it will only apply for a 6-month period. It can then monitor the impacts of its decision and adjust its approach accordingly for 2020.

Environmental costs

Retailers in Victoria currently face four main environmental costs that must be included:

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

The ESC proposes to use a market-based approach for forecasting these environmental costs which AGL largely supports for this initial VDO.

AGL would highlight that using a market-based methodology for the LRET may not be cost-reflective in future determinations.

For 2019, the market cost of the LRET can be estimated using the prices of LGCs over the last two years. However, LGC market prices are becoming less reflective of the investments being made in renewable generation because the investments are being driven through bilateral PPAs. Consequently, measuring the cost impost of the LRET through LGC market prices will not be applicable in the future.

Retail operating costs and Customer acquisition and retention costs

Retail operating costs consist of all the costs incurred by the retailer in conducting its business but AGL agrees with the ESC that these costs can generally be separated into:

- Cost to serve; and
- Customer acquisition and retention costs.

6.	Do you agree with our proposed approach of using benchmarking? If not, why not, and what alternative approach should we consider?
7.	What should be included as efficient retail operating costs and a modest customer acquisition and retention costs allowance?
8.	For electricity retailers – how readily can you separate customer acquisition and retention costs from other operating costs? What issues might we need to consider?

AGL supports the ESC using a benchmarking approach for both retail operating costs and for customer acquisition and retention costs given that many Australian regulators have used a range of regulatory benchmarks in similar price determinations and activities.

Many of these benchmarks are originally derived from the review of regulated retail prices for electricity completed by the Independent Pricing and Regulatory Tribunal (IPART) in 2013 but other work by the Queensland Competition Authority (QCA) and the recent reports of the Australia Competition Consumer Commission (ACCC) provide ready support for the benchmarks that have been historically used.

For further support, the financial reports of publicly listed retailers can provide costs relating to retail operations although interpreting such data can be challenging and require adjustment.

For example, AGL publishes cost to serve figures in its Annual Reports in relation to its retail business as shown in table 1 below but:

- the reported cost to serve figure is not a fully allocated cost and excludes centrally managed expenses or corporate costs and can therefore be misleading; and
- the reported cost to grow figure is shown as the cost per acquired or retained customer for that year rather than as a customer acquisition and retention cost allocated across all retail customers.

Table 1: AGL Operating Costs, as reported in Annual Reports

Item		FY15	FY16	FY17	FY18
Cost to serve	($/customer)	72	69	70	83
Cost to grow	($ per customer acquired or retained)	87	89	87	101
Centrally Managed Expenses	($million)	236	225	248	313

Table 2 includes the necessary adjustments required to make AGL's reported figures comparable to the regulatory benchmarks.

AGL's Centrally Managed Expenses (CME) for the business include all IT costs such as hardware maintenance and software licensing fees, depreciation charges on IT Projects, labour and associated on-costs, in addition to group insurance premiums and contractor's fees. Therefore, a proportion of the CME must be apportioned to the retail business based on an allocation methodology and then converted to a cost per customer. This is added to the reported cost to serve figure to make the relevant benchmark.

The relevant benchmark for AGL for customer acquisition and retention cost is derived from the cost to grow figure by apportioning it to all AGL customers rather than just the customers acquired or retained.

Table 2: AGL Retail Operating Costs and Customer Acquisition and Retention Costs

Item		FY15	FY16	FY17	FY18
Reported cost to serve	($/customer)	72	69	70	83
Centrally Managed Expenses	($million)	236	225	248	313
Allocation of CME to Retail**	($million)	[redacted]			
Additional cost to serve for CME**	($/customer)				
Adjusted Cost to Serve**	($/customer)				
Reported cost to grow	($ per customer acquired or retained)	87	89	87	101
Customer acquisition and retention cost	($/customer)	40	39	43	61

**Note that this allocation methodology was derived in response to a specific inquiry by the ACCC. AGL does not allocate CME in the normal course of business.

These figures are directly comparable to and supportive of the regulatory benchmarks as well as highlighting the recent increases in both costs in recent years.

It is important to note that the AGL operating costs are national averages, not state based figures, and energy retailers operating in Victoria must comply with a legislative framework that differs from the National Energy Customer Framework (NECF). Retailers therefore incur additional costs to operate in Victoria and as the ESC has noted in its Working Paper, the ACCC estimated these additional regulatory costs at around $11 per customer.

Retail operating margin

As indicated in the Working Paper, the retail operating margin needs to compensate the investor for the capital invested in the business and the non-diversifiable risks associated with the investment.

AGL supports the ESC selecting a retail margin for 2019 from the range of benchmarks in other Australian energy regulators decisions. However, AGL does not believe that the ESC should consider margin benchmarks from other retail industries given the unique framework of the energy industry.

The final selection of an appropriate retail margin from this range will be highly dependent on the treatment by the ESC of other costs and how adequately risks have been compensated for in this determination.

AGL is encouraged that in its Working Paper, the ESC recognises that calculating an initial 6-month VDO may provide the ESC with the opportunity to set a transitional retail margin and then monitor the impacts on the retail energy market before adjusting its approach for 2020. AGL supports the ESC exploring this option as it may mitigate the severe impacts on competition that stakeholders are expecting.

Other costs

9.	Are there any other costs incurred by an electricity retailer that we should consider? Why?

The ESC has correctly identified AEMO market fees, ancillary charges and ESC licence fees as additional costs for a Victorian electricity retailer.

A new impost for electricity retailers in 2018 was the cost of the Reliability and Emergency Reserve Trader (RERT). AGL recommends the ESC include this in its VDO price determination, especially as it is expected to increase in cost significantly in 2019 and beyond.

The ESC should also consider the impact of AEMO's directions that have been used in Victoria to address voltage and/or system strength issues. These costs should also be passed through.

Proposed structure for VDO

10.	Does this proposed structure provide a simple and practical approach to deal with the variety of standing offers?
11.	What other approaches to cost allocation would you consider appropriate?

The ESC is proposing to apply the VDO for single rate tariffs in each network area and to allocate all costs to a fixed charge or to a single variable rate. AGL is comfortable with this approach and supports the allocation suggested in the Working Paper of:

- Networks fixed charges, metering charges, customer fees, retail operating costs and customer acquisition and retention costs being allocated as a fixed supply charge; and
- Wholesale costs, green scheme costs, energy losses and network variable charges being allocated to the volume charge.