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Essential Services Commission
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Melbourne, Victoria 3000

By email: Retail EnergyReview@esc.vic.gov.au

Victorian Default Offer Staff Working Paper

Alinta Energy Retail Sales Pty Ltd (**Alinta**) welcomes the opportunity to provide comment on the Essential Services Commission (**Commission**) "Staff Working Paper" on the Victorian Default Offer (**VDO**).

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 620,000 in east coast markets. As such, we are well placed to provide comments on the Staff Working Paper.

Alinta continues to be supportive of initiatives that assist customers in making clear, transparent and informed choices when it comes to their energy supply. However, we are not supportive of price regulation in any of its forms. Price regulation, such as that provided under the VDO, has the potential to stifle competition and innovation whilst creating price uncertainty that undermines future investment. The VDO as proposed will result in the setting of an artificial "Price Cap". An artificial price cap has the potential to introduce unintended consequences associated with but not limited to quality of service and consumer behaviour.

The Staff Working Paper poses several questions on the methodology for both determining the VDO price and the cost elements that go to its makeup. This highlights the complexity of determining an artificial price cap. The risk of setting the VDO price at an inappropriate level has wide reaching implications for customers, retailers the market and Government.

In implementing a VDO price the Commission needs to be cognisant of any potential impacts it may have on existing products and their pricing arrangements currently

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already in market. The implementation pathway to the introduction of a VDO price should not introduce unintended consequences to existing products already in market. A transitional approach is required to ensure that any new pricing arrangements under the VDO do not impact existing pricing arrangements of products currently in market. Existing products must be allowed to run their term on current pricing arrangements.

At the same time as the Commission is seeking to determine both the methodology and cost elements to be included in the VDO price, there are significant Victorian market reforms occurring that will have a material impact on these elements. One such key reform is the recent implementation of the "Payment Difficulty Framework" (**PDF)** which commenced on 1 January 2019 and has required significant investment from retailers in its implementation. The framework is anticipated to impact the debt collection and credit management activities of retailers. Given the infancy of these changes, the ability to quantify their impact on any evidentiary basis is limited until the new obligations have been in place for some time. However, allowances for this change in cost structure must be accounted for when determining any VDO that is to take effect from 1 July 2019, creating a significant challenge and risk for the Commission.

Any methodology / VDO price must include a trigger mechanism that allows for a recalibration following significant market events that would have an influence on end prices to customers. Failure to include such a provision would introduce an unacceptable risk.

Prices determined under the VDO by the Commission, from a Governance perspective, must be subject to independent assessment, (full audit and review, inclusive of an option for a merits review). Independent assessment is important to ensure market confidence in the prices which retailers are required to make available. Consultation on and implementation of an assessment guideline should occur prior to the introduction of a VDO price.

Further, concerns exist on the limitations of the application of the VDO and alignment with the network tariff assumptions that underpin the VDO. For example, a VDO price based on a Residential single rate tariff cannot be expected to be used as a representative tariff for a Time of Use customer. The VDO pricing in its current form is not aligned to consumption and demand management initiatives being undertaken through network tariff reforms.

Our further detailed comments on the Staff Working Paper 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] [redacted] [redacted] or via email: [redacted]

Yours sincerely

Shaun Ruddy
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Essential Services Commission Staff Working Paper- Victorian Default Offer

Approach to Determining the VDO Price

The Commission's recommended approach to determining a VDO price is that of using a cost-based approach to energy pricing. When using a cost-based approach the ability to determine both the quantum of and the costs elements to be included in the price determination is of key importance to ensure the determined price is cost reflective of the true costs of operating in the market.

Whilst the commission has identified (high level) main costs to be included in determining the VDO price, each of these costs has an underlying level of detail to be considered that will influence the cost. This underlying level of detail is influenced by the retailer's business model and risk profile. Varying business models and risk profiles across the retail sector can see significant variances in retail business cost structures.

What is an Efficient Retailer?

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

As part of the methodology in determining costs that would make up the VDO price, an assumption must be made on the type of retailer / retail model to be used as the base for assessing efficient costs.

The Staff Working Paper sets out one possible definition of a notional efficient retailer. The challenge with any such proposal is that it will only ever be a notional (fictional) retailer that is used as the basis for formulating what is deemed to be the efficient costs faced by a retailer in servicing the market. The notional definition included in the Staff Working Paper is one that assumes the retailer;

Has achieved economies of scale (i.e. one that has an efficient cost base)

Such an assumption would preclude accessing the costs faced by new entrant retailers who have yet to achieve economies of scale. However, it is often these retailers that drive competition and innovation as they challenge the norm. Costs faced by these retailers can be incrementally higher as they seek to establish a foothold in the market.

Is a standalone retailer and is not vertically integrated (i.e. does not have economies of scope)

This assumption further narrows the field of retailers from which to assess baseline prudent costs of operating in the market, in particular the wholesale market. Vertical integration should not be seen as a negative; rather, it is one of the strategies available to market participants to manage risk. The benefits or otherwise of vertical integration can vary greatly across business models. Where a standalone retailer model is to be used, it should be further defined as a standalone retailer that has a defined long-term wholesale supply strategy underwritten through existing contractual and financial instruments such that it has an effective practice in place for managing wholesale risk.

Serves domestic and small business customers in Victoria, and potentially across the National Electricity Market

This is a reasonable element to include in the definition of an efficient retailer, however it does assume that the majority of retailers operating in Victoria would also operate across the NEM, which may not be the case e.g. for new-entrant retailers who choose Victoria as a starting point, or those that operate in a few jurisdictions only.

Currently can offer both standing offer & market offer contracts

It is expected that this would be a minimum requirement of an efficient retailer operating in the market.

Has an existing customer base that it defends

In determining the "existing customer base" element, consideration has to be given to the size of the customer base that is representative of an efficient retailer. This would need to be linked with the "Economies of Scale" element. All retailers regardless of size will seek to defend their customer base. This is a function of protecting their investment in acquiring their customers. Retailers will invest significant resources and effort in acquiring customers, noting that returns on these customers are not immediate, hence the need to defend their customer base.

Does not adopt a loss leading pricing strategy to acquire customers

We agree an assessment of the costs of a retailer that operates a "loss Leading" pricing strategy would not be reflective of assessing the efficient costs of operating in the market.

Under previous periods where price regulation was in place, there was significant debate over what constituted an efficient retailer and the business model, risk profile and wholesale strategy would such a retailer adopt.

Regardless of the definition chosen by the Commission, it will not be representative of a section of the retail market. This is particularly more so now than in previous periods where the Victorian market operated under price regulation. This is due to the significant divergence in retail business models that have evolved, partly as a result of technical advancement and innovation shaping the way customers are serviced and supplied energy.

This creates a greater challenge for the Commission in determining a price level that is representative of all retailers operating in the Victorian market.

The above comments highlight the challenges faced by the Commission in attempting to define a "notional" retailer. Elements of what the Commission is proposing are at a high level reasonable, however it is the detail that underpins each of these elements that is critical.

The definition of a standalone retailer that is not vertically integrated, needs to be further defined as a standalone retailer that has a defined long-term wholesale supply strategy underwritten through existing contractual and financial instruments such that it has an effective practice in place for managing wholesale risk.

Wholesale Electricity Costs

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

Broadly speaking, Alinta is comfortable with the use of the proposed futures market approach within the Commission's VDO model. In terms of the time period to purchase forward contracts, significant divergence will exist amongst different retailers depending on a host of variables such as the individual 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 Commission should utilise within their VDO model for purchasing forward contracts for retailers. This being said, Alinta would suggest that an "average" retailer would be developing their hedge book up to an average of 6-12 months ahead of time, and this would be a more representative (accurate for market conditions) than the "point in time" option. As such Alinta support the use of a 12-month rolling hedge approach. Any approach taken by the Commission also must consider the impact of wholesale market rule / operational changes, such as the changes five-minute settlement will introduce to the wholesale market.

In regard to forecasting load profiles, Alinta supports the use of the most recent manually read interval data, however would caution against only using a single year's data point. Typically, utilising a short time frame, for example a single year, leaves itself open to high variability across time periods because of weather dependencies, or because of market structure changes such as generator retirement (e.g. Hazelwood). Utilising a rolling weighted average (e.g. three years) may help decrease variability between years whilst not compromising on broader accuracy.

Regarding the contract purchasing profile, Alinta is of the view that a trade weighted approach is more aligned to industry best practice and is preferable to a time weighted index.

Alinta would also encourage the Commission to consider within its analysis the wider implications of selecting a "standardised" or "typical" methodology for wholesale costs and processes. There is a growing view amongst industry that if, as part of the VDO modelling process a selection by the Commission is made on what retailer business practices are considered "typical", this selection may become the industry norm and other retailers will move to align their practises to match the Commission's. As such, Alinta would encourage consideration of what wider effects and implications this may have on the dynamic flexibility of industry practises going forward. There is a risk, that the industry may become more concentrated and aligned regarding process and practices, potentially to the detriment of innovation.

Network Losses

How should the Commission calculate transmission losses

In order to accurately reflect network losses, the Commission should look to use the Australian Energy Market Operator (**AEMO**) published data for network losses. The data used for network losses should be applied at a distribution zone level.

If the Commission were to only select certain nodes for each distribution zone it risks a significant distortion and cross subsidies for the calculation and application of network losses.

Network Costs

Are the tariffs set out in Tables 1 & 2 the appropriate tariffs to use for estimating the VDO? ***How should the Commission treat the calendar year network revenue determinations in the context of the introduction of the VDO from 1 July 2019?***

Network costs are a key cost component that contributes to the final price customers face for the supply of energy. Network costs are, on average across the NEM, the largest component of the overall bill paid by electricity consumers, with network costs making up 43% of the overall costs.[1]

Given their level of impact on the final customer price, it is important that the Commission accurately assesses the level / value of network costs. To that end, network costs must be treated as a pass-through cost.

The tariffs set out in the Working Paper for use in estimating the VDO are only a small subset of the available network tariffs and are therefore not representative of the majority of tariffs that are levied on retailers and subsequently passed on to customers through their retail bill. For example, the tariffs proposed do not account for domestic two rate tariffs or flexible tariffs.

We remain concerned at the disjoint that will be created under the VDO where the VDO tariff will only be set for a flat tariff however will be available to customers where their underlying network tariff may be a time of use or demand tariff. This not only undermines network initiatives it creates a potential pricing risk exposure for retailers to manage due to the misalignment that will exist between network & retail tariff.

The risk in only using a subset of available tariffs is the VDO will not be representative

[1] ACCC Retail Electricity Pricing Inquiry – Final Report Section 7 Network Costs, 7.1 Background. *"The ACCC's estimates based on retailers' cost information are that, for 2017–18, the network costs make up 43 per cent of the overall costs.*

of the costs of supplying the majority or at least a substantial minority of customer types. This may result in customers being misled on what pricing is available to them given their meter and tariff type. In addition, this may create a cost exposure for retailers, potentially resulting in cross subsidies in order for the issue to be addressed.

Timing of the network revenue determinations must be considered when seeking to set the VDO. Misalignment between the VDO and underlying network tariffs / costs that will ultimately make up such a significant proportion of the customer costs will create serious cost distortions.

The two options available to the Commission to address this are;

1. initially set the VDO for a period of 6 months to allow for the calendar year network revenue reset, or
2. delay the implementation of the VDO such that it will align with the calendar year network reset.

Environmental Costs

Assessing the environmental cost component of the proposed VDO requires an assessment of the volatility and liquidity in the environmental certificate market. Where retailers are required to extinguish their liability for environmental schemes through the surrender of certificates and an option for the retailer is to purchase certificates from the market, market liquidity is a key risk factor that will influence the cost / price paid for certificates.

The forward market (price) for certificates is subject to significant fluctuations (linked to liquidity) then these fluctuations need to be captured such that a risk premium needs to be included in the future assessment of certificate prices.

The environmental costs element of the VDO is an element heavily influenced by parties outside of the energy supply chain. As such there is a greater risk on the continuity of costs associated with the scheme and therefore their influence on the end price to customers.

This further highlights the need to include a provision in the methodology / VDO price determination that supports the revision of prices following a significant market event where such an event would have an impact on prices.[2]

NOTE: The Staff Working Paper refers to the different components of the environmental costs to be assessed as being set out in “Table 3” however Table 3 in the working paper covers “proposed methods for other costs”

[2] For example, the introduction in 2012, and subsequent repeal of Carbon Pricing in 2014 had a significant impact of retail energy prices. This type of material regulatory change / intervention must be accounted for by the VDO through a revision process.

Retail Operating Costs and Customer Acquisition and Retention Costs

Do you agree with the Commission's approach to using benchmarking? If not, why not, and what alternative approach should be considered? What should be included as efficient retail operating costs and a modest customer acquisition and retention costs allowance? For electricity retailers – how readily can retailers separate customer acquisition and retention costs from other operating costs? What issues might need to be considered?

At any time, a regulator attempts to set prices to cover the provision of a competitive service there is a risk to the market from the regulator's inability to complete an accurate assessment of costs. This is more so now than in the past for the retail energy supply market. Advances in technology coupled with market changes have seen significant innovation in the way retailers seek to operate in the competitive energy market. Traditional (common) retail supply models are becoming the minority, creating greater challenges for the Commission to set a common VDO price that accounts for, and is reflective of, the costs across all retailers.

The most efficient way for prices to be set in a competitive market is that of allowing market forces to influence the price setting of individual participants that compete and operate in the relevant market.

We continue to hold the view that competitive markets should be free from the encumbrance and risk levied on them through price regulation

Using the Benchmarking approach to determining costs to be included in the VDO price requires the Commission to make several assumptions, not least of which is the assessment of what constitutes an "efficient retailer". A failure on the Commission's part to make an accurate assessment will have significant market impacts.

Benchmarking requires the Commission to make "point in time" assessments of crucial cost elements that are to apply for the entire determination period. This requires several assumptions to be made on ongoing market conditions and the retailers' long-term interactions with ongoing market conditions. In undertaking a benchmark approach to determine retail operating, customer acquisition and retention costs the Commission must be clear on which costs are to be included and the business model and risk profile that will apply to the definition of an efficient retailer. That is, whether the benchmark for an efficient retailer is a Tier 1, Tier 2 or even a Tier 3 retailer. In using a benchmark approach the Commission must consider the inclusion of the following cost elements:

Operating Costs

In assessing what costs should be included in an efficient retailer's operating costs first there needs to be a determination on the (business) model that supports an efficient retailer, noting that there are significant divergences across business models of current retailers.

As previously highlighted the Payment Difficulty Framework which commenced on 1 January 2019 will have a significant impact on the operating model of Victorian retailers. At a minimum the framework is anticipated to impact the debt collection and credit management activities of retailers. The ability to quantify the impact on any evidentiary basis is limited until the new obligations have been in place for some time. However, allowances for this change in cost structure must be accounted for when determining any VDO price.

The variation in business models has significant flow on impacts to retailers' operating models and therefore operating costs. At a minimum however, the following costs must be accounted for;

- Customer service costs,
    - Market transaction costs,
    - Billing costs,
    - Credit management & debt management costs,
    - Call centre operation costs,
    - IT system management and development costs,
- Audit & Compliance costs
    - Periodic reporting costs,
    - Auditing costs,
    - Performance reporting costs,
    - Government comparison site administrative costs,
    - Regulatory compliance costs

Customer Acquisition and Retention Costs

In determining the allowable customer acquisition and retention costs the Commission must give consideration to the efficient retailer's business model and within that business model the approach taken towards customer acquisition and retention activities.

Acquisition activities can include;

- Direct acquisition activities,
    - Direct marketing activities such as door to door acquisition,
    - Telesales acquisition,
    - Kiosk sales acquisition

- Indirect acquisition activities,
    - Website customer acquisition
    - Comparator service acquisition
    - Above the line brand & marketing activities with directed calls to action,
    - Research and development costs related to product innovation

Any benchmark approach used in determining these costs would need to account for the variation of business (risk) models to ensure the determined prices are representative and reflective of the costs of supply applicable to the majority, if not all, retailers operating in Victoria.

Retail Operating Margin

Retail operating margins as with the other components of the bundled retail cost stack are best determined through competitive forces. Any approach to estimating a retail operating margin needs to ensure it accounts for the retailer capital investment and risk associated with that investment. All of which are unique across retailers.

Historic retail margins used in previous regulatory determinations have been insufficient to stimulate robust competition and investment. Whilst also stifling new market entry and placing the viability of smaller retailers at risk creating the potential for market exit.

Operating margins are unique to each retail business model as they are influenced by the investment and risk factors associated with individual business models.

The Commission's challenge is to determine a retail operating margin that is representative of the number of retail business models with different risk and investment profiles, that operate in the Victorian market.

If the Commission under estimates the operating margin it may stifle investment in the sector and worst-case lead to participants exiting the market. If the Commission over estimates the operating margin, it may result in potential detriment to end customers.

The proposed transition period, as suggest in the staff working paper where the retail operating margin is to be set at a level and reduced each subsequent year, itself implies there will be potential inaccuracies with the initial setting of the operating margin allowance that will ned to be redressed over time.

Such an approach only goes to entrench uncertainty in the process of setting the VDO price. Whilst assuming the risk profile of operating in the market will reduce or at best remain stable. Any such assumption is significantly misguided, given the more recent levels of market uncertainty driven by political intervention and energy policy uncertainty.

Further detailed consultation will be required once the Commission narrows down its preferred approach to determining retail operating margin.