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Victorian Default Offer 2021
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12 April 2022

Victorian Default Offer 2022-23 – Draft Decision

AGL would like to take this opportunity to respond to the *Victorian Default Offer 2022-23 – Draft Decision* (Draft Decision) released by the Essential Service Commission (ESC) on 15 March 2022.

AGL support the ESC's decision to largely use the same approach as the 1 January 2022 VDO as this provides some certainty for industry participants. We also agree with the proposed updates in the data used for wholesale energy modelling and the customer weighed average approach used to calculate metering costs.

We remain concerned about the ESC's benchmarks for retail costs and margin. The latest ACCC report on retail electricity prices can provide some insights on retail costs.

More detailed comments in response to aspects of the Draft Decision are detailed in an Attachment A.

If you have any questions in relation to this submission, please contact Meng Goh, Senior Manager Regulatory Strategy, at mgoh@agl.com.au.

Yours sincerely

Elizabeth Molyneux
GM of Policy and Market Regulation

Attachment A: AGL Responses to the ESC Draft Decision

Wholesale electricity costs

AGL continues to generally support the market approach used by Frontier to estimate wholesale electricity costs for the purpose of determining VDO prices.

In this Draft Decision, the ESC has proposed to use the three most recent years of data to estimate electricity demand. This is to reflect the changed pattern of electricity demand due to rooftop solar. AGL supports this update to the methodology.

The current prices from 1 January 2021 is applicable for only six months but were derived using wholesale energy costs over a full year. This ignores the impact of the high Q1 cost over the six months. We believe that a one-off adjustment to the 2022-23 VDO would be required to ensure that retailers recover their reasonable wholesale energy costs over the 18-month period.

Metering costs

The ESC has proposed to assess metering costs using a customer weighted average approach instead of the cheapest meter configuration. AGL supports this update as it will better reflect the metering costs charged by network businesses to retailers.

Retail operating costs

In AGL's previous submissions, we have explained why the retail operating costs do not include all the costs of operating a retail business. The ESC's description of retail operating costs includes "information technology systems" but by excluding depreciation and amortisation (D&A) costs, these IT costs have not been considered so that the retail operating cost benchmark does not include all the costs of operating a retail business.

Data from the ACCC's November report on the Inquiry into the National Electricity Market provides some insight on retail costs, noting that there are differences in the definition of retail costs in the ACCC report and the ESC's decisions.

From the first VDO decision, the ESC has allowed a $10 per customer increment to the retail operating cost benchmark for "additional regulatory costs and Victorian specific operating costs". In the accompanying Appendix E to the report, retail costs by jurisdiction are provided. Comparing the Victorian retail costs with the costs in other jurisdictions, Victorian retail costs are now about $20 per customer higher which infers that the ESC's allowance is understated by about $10 per customer. Details are provided in Table 1 below.

Table 1 Retail & other costs[1] reported by ACCC - $ per customer

	VIC	NSW	SA	SEQ	VIC vs non-VIC
2018-19	187	165	160	165	22-27
2019-20	168	150	146	151	17-22
2020-21	151	132	133	132	18-19

Source: ACCC, Appendix E - Inquiry into the National Electricity Market – November 2021 report

Another insight from the ACCC report is the downward trend in retail costs over time. This is not unexpected as investments on technology to digitalise and improve customer experience displace operating costs. However, the costs of investing in technology, manifesting as amortisation expense and asset write-offs, are not included as part of retail operating costs. Similarly, the significant costs involved in the preparation for five-minute settlement, consumer data rights and other regulatory compliance are not included in the retail operating cost benchmark.

Customer acquisition and retention costs (CARC)

The ESC has acknowledged that the benchmark used is lower than the actual CARC incurred by retailers. These are costs which retailers incur to operate in a competitive market. It is not in retailers' and consumers' interest for retailers to incur unnecessary costs. If retailers are unable to retain their customers, operating costs will need to be recovered over a smaller customer base and the retail operating cost benchmark should be adjusted accordingly.

The ACCC report[2] showed that in 2020/21, CARC average $38 per customer for the 'Big 3' retailers and $61 per customer for the 'non-Big 3' retailers. For the January 2021 VDO, the ESC used a benchmark for CARC which was similar to the average for the 'Big 3' retailers.

Under the VDO Order in Council, the ESC has to have regard to a "modest" CARC. As pointed out by DELWP[3], the term "modest" has no clear economic meaning. In our view, the term "modest" is neither the high nor the low of the range of costs. It should be the average or mid-point of the range.

New legislation in Victoria has now banned marketing practices such as door to door sales, cold calling and win-back and save. Selling door to door is a costly acquisition channel. The Big 3 retailers ceased door to door sales to residential customers many years ago, with AGL ending this practice in 2013. Following this legislation, we anticipate that third party sales channels will adjust and innovate.

Another point to note from the ACCC report is the downward trend in CARC since 2017/18. A key reason for this is the increasing use of digital sales channels including AGL's website, to sign-up customers. However, as with retail operating costs, the amortised cost of investment in technology is not reflected in CARC.

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[1] These retail costs are not directly comparable with the ESC's retail operating cost benchmark as they do not include bad debt expense. (Bad debt expense is treated as an offset to revenue in the ACCC report.). These costs include customer acquisition costs but like the ESC's benchmark, exclude depreciation and amortisation expenses.

[2] Inquiry into the National Electricity Market, ACCC, November 2021, p 37

[3] Consultation Paper on the Review of the Victorian Default Offer Order in Council, Department of Environment, Land, Water and Planning, March 2022, p 30

Retail operating margin

We have previously pointed out that the retail margin benchmark of 5.7 per cent can be traced back to the 2013 IPART review. This benchmark has remained unchanged for 10 years.

As discussed above, D&A costs have not been included in the retail operating cost benchmark so that these costs can only be recovered through retail operating margin allowance. D&A costs has been increasing over the years. As an illustration, AGL's D&A costs directly attributable to the retail business has increased by over 30% from $101 million in 2018-19 to $134 million in 2020-21 (Note this does not include D&A costs incurred as centrally managed expenses). Since the retail operating margin benchmark has remained unchanged for 10 years, the effective retail margin, net of D&A costs, has reduced significantly over time.

The retail margin benchmark presumes that the components of the cost stack have been set at reasonable levels. As noted above, retail operating costs specific to Victoria and CARC are understated. In addition, the increasing D&A costs have not been accounted for. Therefore, if the effective retail margin is to be maintained, the benchmark should be set at a higher level.