AGL Energy Limited
ABN: 74 115 061 375
Level 24, 200 George St
Sydney NSW 2000
Locked Bag 1837
St Leonards NSW 2065
t: 02 9921 2999
f: 02 9921 2552
agl.com.au

Victorian Default Offer 2020 price determination
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne, Victoria 3000

Online via: https://engage.vic.gov.au/victorian-default-offer-draft-decision

17 October 2019

Victorian Default Offer to apply from 1 January 2020 – Draft Decision

AGL would like to take this opportunity to respond to the *Victorian Default Offer to apply from 1 January 2020 – draft decision* (Draft Decision) released by the Essential Service Commission (ESC) on the 28 September 2019.

It is important to recognise that the introduction of the Victorian Default Offer (VDO) on 1 July 2019 was a fundamental change to the regulatory framework for the Victorian retail electricity market and represented a return to regulated pricing.

The Draft Decision by the ESC predominantly follows the same methodology used for determining the initial VDO which provides some certainty for industry participants. However, during this consultation period, the ESC has used its legislative powers to obtain cost data from retailers in the Victorian market. AGL anticipates that analysis of this data is should support further consideration by the ESC of cost elements such:

- the Large-scale renewable energy target;
- retail operating cost; and
- the cost of customer acquisition and retention.

The significant new issue for the 2020 VDO is the requirement for the ESC to set appropriate VDOs for non-flat retail tariffs from 1 January 2020.

The Draft Decision sets a maximum annual electricity bill amount based on flat tariffs which will be used to derive the VDO for non-flat tariffs.

Firstly, AGL supports the ESC's decision to not pursue the concept of setting the maximum annual electricity bill for all consumption levels as raised in its Issues Paper[1]. This methodology would have created an artificial price cap or ceiling for customers on non-flat tariffs and because of the operating complexities it would have introduced, had serious consequences on the use of ToU retail tariffs.

[1] *Victorian Default Offer to apply from 1 January 2020 – Issues Paper,* 23 July 2019

However, AGL still has concerns with setting the VDO for non-flat tariffs based solely on flat network tariffs as in some instances, this will create a VDO that will not recover the retailer's costs.

This issue is likely to be exacerbated in the future given the Victorian distribution networks are signalling a greater reliance on time-of-use (ToU) network pricing structures from 2021[2] and it is unclear how these future ToU tariffs will compare with the flat tariff used for the VDO e.g. they may be significantly higher for some load profiles.

Further explanation of these concerns and other comments in response to the Draft Decision are attached.

If 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

Elizabeth Molyneux
GM of Energy Markets Regulation

[2] *Victorian Electricity Networks: Household Network Pricing*, October 2019

Attachment: AGL Responses to the ESC Draft Decision

Environmental schemes and other regulatory costs

Although AGL largely supports the ESC approaches for estimating the costs of the environmental schemes, it does not believe the market-based approach for estimating the cost of the Large-scale renewable energy scheme (LRET) is appropriate for continued use. AGL believes that these market prices are no longer reflective of the cost of the scheme and urges the ESC and Frontier to consider an alternative approach.

This is discussed below along with additional comments on cost elements.

Large-scale renewable energy target (LRET)

For the 2019 VDO, AGL accepted the ESC using the market price for LGCs to determine the cost of complying with the LRET. However, we identified at the time that estimating the cost of the LRET through LGC market prices was becoming less relevant and that the ESC would need to consider an alternative approach for 2020. This remains our view.

The ESC noted in its draft decision that many stakeholders questioned the appropriateness of a market-based method and believed the current LGC prices are not reflective of the investment a prudent retailer would have made to cover their environmental obligation.

However, the ESC has concluded that this market price provides a transparent and verifiable way to estimate the cost of the LRET as it is an option currently available for retailers to meet their obligations. The ESC has consequently used the market price for LGCs in the draft decision to determine the cost of complying with the LRET.

This view ignores the practicalities of the LRET which was designed to encourage investment in generation.

AGL would contest the ESC's justifications for using market prices based on:

- *Large-scale certificate spot and forward prices represent the efficient cost of meeting the scheme.*

  An "efficient, prudent and risk adverse retailer with an established customer load" is much more likely to meet their LRET obligations through Power Purchasing Agreements (PPAs);

- *prices at which the market currently trades are efficient because a retailer is able to purchase certificates in this market.*

  Only a small percentage of LGCs are actually traded on the spot market and it is completely de-coupled from the commercial drivers of LGC contract prices.

  A large retailer would not be able procure enough LGCs from the market to meet its obligation and current market prices would not be representative if it was required to do so; and

- *the ESC not required to consider the actual costs of a retailer.*

  The ESC has indicated that the LGC market price is the most transparent way to estimate the cost of the LRET however the actual costs for retailers provides a more realistic measure of the costs of the scheme. For LRET, the practicalities are that retailers have been required to invest in PPAs over time to encourage generation investment and fulfil their LGC obligations. It is inappropriate to use a thinly traded market price to represent the costs which a retailer has incurred[3].

AGL understand that every retailer will have a different cost for LGCs which makes the task for the ESC of estimating the reasonable cost for an efficient retailer a difficult one. However, the data request issued to Victorian retailers should provide the ESC with relevant cost information on the LRET scheme across the industry.

AGL expects this information to highlight that the current market prices are non-representative of retailers' costs and an average or median of this data may be more representative.

This issue is likely to become critical in 2021 and AGL believes the ESC will need to change its methodology to estimate a long-term industry cost based on historical PPA prices and LGC formation.

Small-scale Renewable Energy Schemes (SRES)

The Small-scale Technology Percentage (STP) establishes the rate of liability under the SRES and is used by liable entities to determine how many STCs they need to surrender to discharge their liability each year.

Unfortunately for this VDO decision, the STP will not be published until 31 March 2020. However, the Clean Energy Regulator (CER) also publishes a non-binding estimate of the STP and the ESC proposes using this non-binding STP of 14.56 per cent in its calculations, as the best publicly available information.

There will be differences due to the forecast of the STP and the ESC's intention is to use a cost pass-through to account for these in its second VDO price determination. This will include any over or under-recovery associated with changes to renewable obligations in the 2020 VDO price determination.

Although AGL fully supports this recovery mechanism, it believes the ESC should also endeavour to make its forecasts for 2020 as realistic as possible and avoid any significant over and under recoveries in later years.

Recently, the non-binding STPs published by the CER have significantly underestimated the final binding STPs as illustrated in table 1.

Table 1: Binding and non-binding STPs

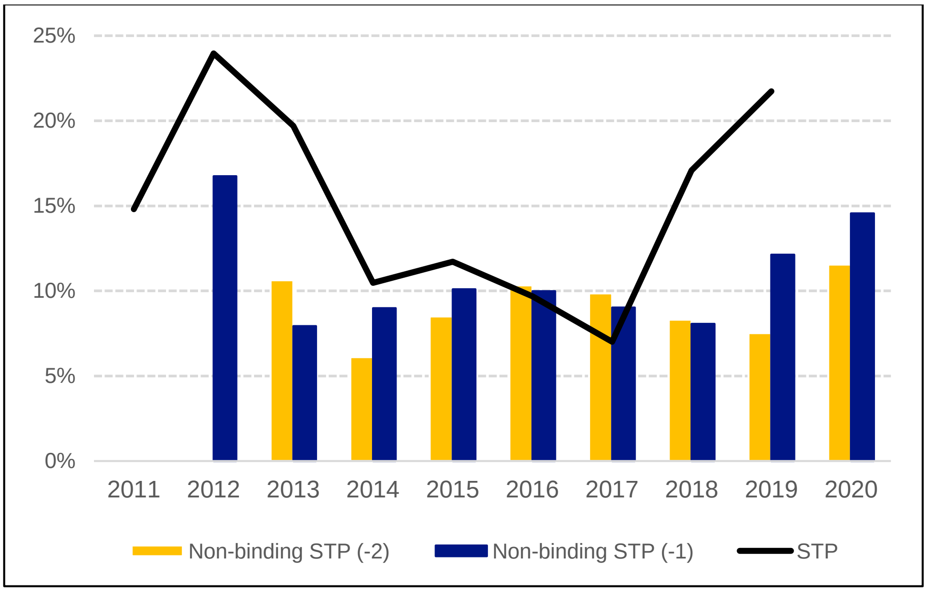
	STP	**Non-binding STP** (previous year)	**Non-binding STP** (2 years before)
2020		14.56	11.55
2019	21.73	12.13	7.52
2018	17.08	8.06	8.31

Source: Clean Energy Regulator

[3] The *Residential Electricity Price Trends – Wholesale Market Costs Modelling 2018* noted the LGC market price is not relevant because only a small percentage of LGCs are traded on the spot market.

In fact, the non-binding STPs published over the last 9 years have consistently underestimated the final STP (see Figure 1 below). This is clearly the case for 2020.

Figure 1: Accuracy of non-binding STP estimates



Source: Clean Energy Regulator

The non-binding STP estimate for 2020 of 14.56 per cent is not a realistic nor defendable forecast and should not be used simply because it is public information. Using the non-binding STP will have a material impact on the 2020 VDO and will effectively reduce the retail margin from the allowed 5.7 per cent to under 4 per cent.

AGL expects the 2020 STP to be higher than the current 2019 STP of 21.73 per cent and believes any forecast used by the ESC should at least be set equal to the 2019 STP.

AGL supports Frontier making its own reasonable forecast.

Reliability and Emergency Reserve Trader (RERT) costs

The ESC has included the latest cost data of the RERT in the VDO rather than a forecast for 2020. AGL support this approach and concurs with the ESC that any impact because of using the lagged estimate will be small on the total VDO price.

AGL has previously highlighted and would so again that the method used by AEMO to allocate the cost of RERT is not cost reflective. AEMO appears to allocate costs based on annual consumption which attributes much of the cost to large industrial energy users and underestimates the significantly larger contribution to demand from mass market customers during the peak demand periods when the RERT is procured.

The cost used in the derivation of the VDO should be based on the share that mass-market demand contributes to total demand during the times when RERT is utilised, not just by volume.

AGL previously indicated that the mass-market proportion of total demand in 2019 when RERT was utilised is around 70-75 per cent.

AEMO Directions

AEMO directions are a cost that, although currently minor, should be accounted for in the VDO. Forecasting these costs is very difficult but, as with the RERT costs, the actual cost of the current year should be included in the 2020 VDO determination.

Ancillary charges

The ESC has used AEMO data to estimate ancillary charges by taking the average of the past 52 weeks (ending 18 August 2019) for ancillary service payments in Victoria. This results in an average ancillary service payment of $0.30/MWh for the regulatory period beginning 1 January 2020.

AGL believes this is a conservative cost forecast for 2020 given the increase in ancillary charges experienced during 2019. At a minimum, AGL expect the ESC to use updated data up to and including November 2019 in its annual average which should improve the estimate.

Network costs

AGL supports the ESC's methodology of using the simplest network tariff in each distribution zone in the VDO, including metering cost per customer.

However, since the draft decision, AGL notes that the Victorian distribution networks have submitted their network price proposals for 2020 to the Australian Energy Regulator (AER) for approval. The AER is currently reviewing these proposals with an expected approval date of 10 November.

AGL has analysed the price proposals and the potential increases are shown in Table 2. As highlighted, the proposed network price increases are significantly higher (often double) than the network tariff increases used by the ESC to derive the 2020 VDO in its draft decision.

AGL expects the ESC to use the network prices that the AER will be approving by the 10 November in its final decision when calculating the 2020 VDO.

However, if the AER approval of network prices is delayed and they are not available, AGL strongly supports the ESC using the proposed network prices given the significant increases and the need for the 2020 VDO to be cost reflective.

Table 2: Draft Network Cost increases as proposed for Victoria

Distributor	Residential	Business
Ausnet	11.7%	3.3%
Citipower	4.6%	7.3%
Jemena	7.1%	8.4%
Powercor	7.1%	9.6%
United	9.2%	11.9%

Source: AGL, based on annual consumption of 4MWh and 20MWh

Retail costs and margin

Retail operating costs

AGL supports the ESC continuing its benchmarking approach for estimating retail operating costs for the VDO to apply from 1 January 2020.

We note the ESC has gathered cost data using its formal information gathering powers and expect that this additional information will enable the ESC to better inform its derivation of a retail operating cost benchmark and to determine the appropriate annual escalation of these historical figures.

AGL believes the ESC will also need to consider some major changes to retail operating costs that are being driven by major changes in the Victorian energy market and are yet to impact on this cost data. Regulatory changes that have increased costs and were not included in the recent ESC benchmarking include:

- Clear advice entitlement;
- Best offer information; and
- GST inclusive pricing.

The costs of these activities will impact on AGL's future financial accounts.

Other regulatory changes in the National Electricity Market (NEM) will also increase the cost of operating in Victoria and will impact on retailers from 2020. For example, the introduction of 5-minute settlement in the NEM.

AGL currently estimates the cost to implement the system changes to accommodate the transition to 5-minute settlement will be over $18 per customer. The AEMC has identified the cost of 5-minute settlement as actual costs that will be borne by industry and determined that "...*the enduring benefits of five-minute settlement will quickly outweigh the one-off and ongoing costs*."[4]

Customer acquisition and retention costs (CARC)

As with retail operating cost, AGL supports the estimation of customer acquisition and retention costs using benchmarking and understands the ESC data request will provide additional data to be used to inform this process.

This data should highlight to the ESC that these costs have not fallen with recent market interventions.

Although the allowance for CARC should be a "modest" estimate, basing it on the out-dated NEM-wide average for 2013-14 from the ACCC inquiry final report seems overly conservative given the ESC now has further data available for use in its current VDO price determination.

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[4] (https://www.aemc.gov.au/sites/default/files/content/18f019ff-de8c-40f3-836f-1bf3c8e43d2b/3-Info-Sheet.pdf)

VDO compliant maximum annual bill

The ESC is required to determine a VDO compliant maximum annual bill (maximum bill) that will apply to standing offer customer that are on non-flat tariffs.

AGL noted in its submission to the ESC's Issues Paper that there is a risk of the VDOs for non-flat standing offers being under-estimated if the maximum bill is only derived from the flat tariffs when the actual non-flat network tariff costs are higher. This remains the case.

AGL has examined the Victorian networks' price proposals for 2020 and Table 3 highlights examples of our concerns.

Table 3: Proposed 2020 Network Costs and VDO margin impact

Network	Type	Tariff	Network Cost ($)	Network Variance ($)	Residual Margin (%)
Citipower	Res	Single rate	$446	-	5.7%
Citipower	Res	TOU	$477	- $31	3.2%
Citipower	Res	Flexible	$504	- $58	1.0%
Powercor	SME	Single rate	$1997	-	5.7%
Powercor	SME	5 Day TOU	$2051	- $54	4.6%
Powercor	SME	7 Day TOU	$2279	- $282	0.0%

Source: AGL, based on annual consumption of 4MWh and 20MWh

For the Citipower network, the network cost for a residential customer on TOU or flexible tariffs is higher than for the flat network tariff by $31 and $58 respectively (based on the ESC's designated consumption and load profiles). Similarly, for the Powercor network, the network cost for a small business customer on 5-day or 7-day TOU tariffs is higher than for the flat network tariff by $54 and $282 respectively.

These variances are significant because the VDO retail margin of 5.7 per cent equates to around $69 for the residential customer and $285 for the small business. Consequently, using the flat tariff to set the maximum bill will greatly reduce the residual margin provided by these regulated non-flat VDOs, as shown in the table.

Despite this issue, the ESC's draft decision is to calculate the non-flat VDOs using its estimated flat VDO tariffs.

The reasoning for the ESC's draft decision relies on an understanding that:

- the maximum annual bill must be based on the standing offer tariffs that the ESC determines for flat tariffs and customer electricity usage according to the Order-in-Council[5]; and
- the VDO is only a safety net for consumers unable or unwilling to engage in the electricity market.

[5] Order-in Council available at http://www.gazette.vic.gov.au/gazette/Gazettes2019/GG2019S208.pdf.

AGL would highlight that:

- the Order-in-Council requires the maximum bill to be based on the flat tariffs and customer consumption profiles but does not prohibit the ESC taking account of additional, relevant factors so AGL believes it could adjust the maximum bill to account for this issue; and
- suggesting the non-flat VDO is just a safety net ignores the introduction of Clear Advice Entitlement[6] and Best offer notification[7]. These regulatory requirements result in customers being notified when their current retail price exceeds the retailer's best offer or the level of the VDO. If the VDO is set below a cost reflective level, then even customers on low market offers will receive notification of the VDO being a better offer.

  The VDO will not be acting as a safety net for disengaged customers but will be being communicated as the best market offer available to engaged customers.

AGL understands this may only have a moderate impact in 2020 by only affecting certain networks and tariff combinations but it is likely to be a significant factor in future years with Victorian networks moving to ToU pricing structures as default or mandatory network tariffs.

6 Essential Services Commission, *Building trust through new customer entitlements in the retail energy market: Final Decision*
7 https://www.esc.vic.gov.au/getting-best-energy-plan