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Victorian Default Offer to apply from 1 January 2020 – Issues Paper

AGL would like to take this opportunity to respond to the *Victorian Default Offer to apply from 1 January 2020 – Issues Paper* (Issues Paper) released by the Essential Service Commission (ESC) on the 23 July 2019.

The stated objective of the Victorian Default Offer (VDO) is to provide a simple, trusted and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the electricity market[1]. However, the VDO was introduced on 1 July 2019 in combination with many other reforms to the Victorian retail energy market including the:

- Clear Advice Entitlement[2];
- Advanced notice of changes that impact a customer's bill; and
- Best offer notification[3].

These changes, in conjunction with the referencing requirements of the Order-in-Council ensure customers will be quickly notified if any retail price exceeds the level of the VDO. Consequently, the VDO is quickly becoming more than its stated objective and acting in principle as a price cap for the retail electricity market.

AGL believes the ESC needs to be cognisant of this fundamental change when using its cost-based approach to estimate the VDO to apply from 1 January 2020, especially if it is to avoid:

- significant impacts on retail competition in Victoria;
- market participants failing to engage in innovative retail products and offerings; or
- slowed investment in alternative energy supplies in Victoria.

AGL does acknowledge that the ESC's final advice to the Victorian Government contained improved cost estimates for the VDO to apply from 1 July 2019[4], especially when compared to the ESC draft advice.

[1] Order-in Council available at http://www.gazette.vic.gov.au/gazette/Gazettes2019/GG2019S208.pdf.
2 Essential Services Commission, *Building trust through new customer entitlements in the retail energy market: Final Decision*
3 https://www.esc.vic.gov.au/getting-best-energy-plan
4 Essential Services Commission 2019, *Victorian Default Offer to apply from 1 July 2019: Advice to Victorian Government*, 3 May

However, greater consideration will be required on several cost elements if the VDO is to better reflect the actual costs of running a retail business including the allowances for:

- the cost of the Large-scale renewable energy target; and
- retail margin.

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

We note the ESC is proposing the to set a maximum annual electricity bill amount that will apply to non-flat tariffs to retain some flexibility for retailers to set the Time-of-Use VDO rates.

AGL supports such an approach in principle but has concerns that the underlying network costs for time-of-use tariffs can be higher than the flat tariff equivalent.

Furthermore, the ESC is considering a methodology to deal with situations where an individual customer's bill exceeds the VDO compliant maximum annual bill. Such a process would be unduly complex, likely make time-of-use tariffs impracticable for retailers and lead to the withdrawal of cost reflective tariffs from the retail market.

Further explanation of these concerns and other specific comments on the Issues Paper are attached.

If you have any questions in relation to this submission, please contact me on [redacted] or Patrick Whish-Wilson on [redacted]

Yours sincerely

Elizabeth Molyneux
GM of Energy Markets Regulation

Attachment: AGL Responses to the ESC Issues Paper

Wholesale electricity costs

AGL generally supported the futures market approach used by Frontier Economics (Frontier) to provide an estimate of wholesale electricity costs for the VDO from 1 July 2019 and therefore is supportive of the ESC maintaining a consistent approach for the 2020 VDO.

The ESC has stated that it will work with stakeholders to improve the transparency of the modelling approach which would be welcomed.

Environmental scheme and other regulatory costs

The ESC used a market-based approach to estimate environmental scheme costs and publicly available data to estimate other costs for the 2019 VDO.

AGL largely supports the approaches previously used by the ESC but considers that market-based approach is no longer appropriate for the estimation of the cost of the Large-scale renewable energy scheme. This and other several other cost elements that AGL has previously highlighted need further analysis are discussed below.

Large-scale renewable energy target (LRET)

For 2019, AGL accepted the ESC using the market price for LGCs to determine the cost of complying with the LRET. However, we identified at that time that estimating the cost of the LRET through LGC market prices is no longer relevant and that the ESC would need to consider an alternative approach for 2020.

Only a small percentage of LGCs are traded on the spot market and it is completely de-coupled from the commercial drivers of LGC contract prices. Recent LGC market prices are not reflective of retailers' underlying cost of procuring LGC certificates. This is particularly true for retailers who have hedged or procured LGC certificates via bilateral long-term Power Purchasing Agreements (PPAs) over time to meet their LRET obligations.

The LGC costs implicit in such long-term PPAs (especially those struck before 2016-17) are generally higher than the recent market prices for LGCs.

Unfortunately, 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 as difficult one. Some options for the ESC to consider include:

- estimating a long-term resource cost for industry based on historical PPA prices and LGC formation; or
- considering a range of actual retailers' portfolio LGC costs and then using data analysis or taking a representative median.

The *Residential Electricity Price Trends – Wholesale Market Costs Modelling 2018* produced by EY for the AEMC noted the LGC market price is not relevant and suggested that the weighted average cost of LGCs for large retailers would be in order of $40/MWh.

Victorian Energy Upgrades

Currently, the cost of this scheme is calculated by multiplying the greenhouse reduction rate for electricity by the 12-month average price for Victorian Energy Efficiency Certificates (VEEC). AGL supports this basic approach but believes the cost of carrying the VEEC needs to be included in the cost estimation because retailers are required to obtain and hold the compliant 2020 VEECs until 30 April 2021 when they are surrendered.

Reliability and Emergency Reserve Trader (RERT) costs

As stated previously, AGL believes a more rigorous assessment of the cost of the RERT to small consumers is required.

AEMO uses the RERT to maintain power system reliability and system security using reserve contracts by paying for additional capacity to be on stand-by. In reporting the RERT cost, AEMO appears to allocate costs based on annual consumption which underestimates the significantly larger contribution to demand from mass market customers during the peak demand periods when the RERT was procured.

RERT is only called upon in case of emergencies when the demand and supply balance is tight. In AGL's experience, these situations are predominantly driven by periods of high demand which in turn are largely driven by the demand profile of mass-market customers rather than commercial and industrial customers.

The cost allocated to domestic and small business customers for the RERT should therefore be based on the share that mass-market demand contributes to total demand during the 2019 RERT periods. This can then be multiplied by the total RERT cost for 2019.

Although specific to AGL's portfolio, we have identified that the mass-market demand proportion of total demand was between 70-75 per cent during the peak hours on the 24 and 25 January in 2019 when RERT was utilised. This highlights the underestimation of the cost of the RERT using the current approach.

AEMO Directions

AEMO issued the first major set of directions in Victoria in November 2018. AGL expects voltage and/or system strength issues to worsen and although the cost impact of directions per Victorian customer is currently small, AGL believes the ESC should account for this cost in its 2020 VDO determination.

AGL proposes that the cost of these directions could be estimated by taking a proportion of the total cost, allocated based on the mass-market consumption during these directions, and then dividing it by the total number of mass-market customers.

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 intention to gather cost data using its formal information gathering powers to provide additional context to the publicly available benchmarking data. As the ESC would be aware after performing its 2019 VDO setting process, getting consistency of data from retailers to allow direct comparability is difficult and will require both flexibility and detailed communication when gathering the information.

In addition, it is critical that all relevant costs are included, particularly corporate overheads or centrally managed expenses which may be accounted for seperately.

Any actual cost data will be historical, and the ESC will also need to consider major changes to the retail market which will impact on future retail operating costs. AGL has noted significant increases in operating cost driven by:

- higher bad and doubtful debts expense;
- increasing customer facing staff numbers;
- investments required to implement changes in regulatory requirements.

Regulatory changes that have increased costs and were not included in the recent ESC benchmark include:

- Clear advice entitlement;
- Best offer information;
- GST inclusive pricing;
- Increases in penalties for wrongful disconnections; and
- Domestic violence resources.

Future regulatory changes will also come at a cost to a retail business and may impact on retailers in 2020 including the introduction of:

- Changes to market transfers and customer save activities;
- Changes to back-billing requirements;
- five-minute settlements;
- Consumer data rights; and
- wholesale demand response.

Customer acquisition and retention costs

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.

Retail operating margin

The ESC included an allowance for retail profit margin in the 2019 VDO. Although a reasonable benchmark in the context of previous regulatory determinations, the retail margin allowance for the VDO is based on providing a reasonably priced electricity option for disengaged customers.

However, AGL believes the many market reforms in conjunction with the VDO will result in the VDO becoming a price cap for the retail electricity market. As this eventuates, setting the retail margin at a benchmark level will therefore result in the allowed retail margin becoming the maximum possible margin for a firm and not the average or benchmark retail margin as allowed in other regulatory decisions. The expected impacts on retail competition, innovation and firm participation are easy to predict.

VDO compliant maximum annual bill

From 1 January 2020, the ESC is required to determine the maximum annual electricity bill amount for domestic and small business standing offer customers on non-flat tariffs or any combination of a flat and non-flat tariff. The Order-in-Council states the VDO compliant maximum annual bill must be based on:

- the standing offer tariffs that the commission determines are to apply in respect of flat tariffs; and
- the prescribed customer's electricity usage.

The two approaches put forward by the ESC to comply with these requirements are inherently flawed and would have serious detrimental impacts on the working of the retail energy market.

The first approach considered by the ESC is the calculation of a compliant maximum annual bill amount using only the flat VDO price for a single level of consumption. The retailer can set its own tariff price components provided the annual bill for the representative customer equals the maximum bill.

This appears workable if the ESC is allowing the bill outcomes to vary for all other customers that are not consuming the representative consumption levels but there are two immediate issues to be resolved.

Firstly, AGL's interpretation of the Issues Paper is that the ESC is expecting all customer bills (for a customer with representative consumption) to fall below the complaint maximum annual bill. A retailer cannot guarantee this would occur unless it sets all time-of-use tariff rates (e.g. peak and off-peak rates) at or below the VDO flat rate. This does not reflect the underlying costs of these retail tariffs and would be unsustainable.

Second, even if the compliant annual maximum bill is only applicable to the setting of the non-flat tariff rates and individual customer's bill outcomes are allowed to be above this level, there is still the issue of basing it only on the flat VDO which may not be cost reflective when you consider the underlying network tariffs.

AGL has analysed the network tariffs for flat, and time of use network tariffs in each network zone for a residential customer consuming 4 MWh per annum. AGL has used the peak and off-peak consumption split suggested under the VDO but also using AGL's own portfolio of time-of-use customers in Victoria. The results are shown in Table 1 and any instance where the time-of-use network tariff would exceed the flat network tariff is shown in red.

Table 1: Residential network tariffs (4 MWh consumption)

Vic Network	Flat tariff	Time-of-Use (5 Day)	
	VDO	VDO	AGL
Jemena	$433	$430	$430
Citipower	$427	$461	**$504**
Powercor	$492	$353	**$513**
Ausnet	$575	**$630**	**$589**
United	$441	$430	**$517**

There are many instances where we see unfavourable discrepancies in network costs for the representative customer when referenced against the flat tariffs. As time-of-use network costs can be higher than the flat equivalent, setting time-of-use retail tariffs based on the flat retail tariffs would price some of the time-of-use VDO rates at less than cost-reflective levels.

The same issue is identified for SME customers on two different variations of time-of-use tariffs and is shown in Table 2.

Table 2: SME network tariffs (20 MWh consumption)

Vic Network	Flat tariff	Time-of-Use (5 Day)		Time-of-Use (7 Day)	
	VDO	VDO	AGL	VDO	AGL
Jemena	$2156	$1742	$1951	$1961	$2103
Citipower	$1823	$1806	**$1993**	$1789	**$1876**
Powercor	$1823	**$1871**	**$2025**	**$2078**	**$2110**
Ausnet	$3573	$2427	$2674	$2255	$2283
United	$2119	$1668	$1909	$1839	$1927

The second approach proposed by the ESC is even more problematic as it suggests calculating the compliant maximum annual bill amount using the flat VDO price for a range of consumption levels from zero to 40,000 kWh per year.

It infers that the retailer would be prohibited from charging a customer more than the maximum bill and the ESC will look to provide a method to deal with any overpayment by customers.

This method cannot be practically implemented using a time-of-use tariff and would force retailers to set all tariff components at the flat tariff rate. The Victorian Government would be ceasing all cost reflective tariff reform.

AGL believes there are two possible alternatives for the ESC that would result in sensible outcomes:

1. The ESC could progress the first approach it highlights in the Issues Paper and use the flat tariffs in constructing the maximum annual bill for the specified consumption amounts for domestic and small business customers. However, it would need to adjust these maximum annual bills where the underlying time-of-use network cost is greater than that of the flat tariffs.

   It would also need to allow for variation in the bill outcomes for all other customers without overpayment requirements;

2. The ESC can use a bottom-up methodology and construct VDO tariffs for all relevant time-of-use tariffs.

   AGL does not agree with the ESC that there is not a strong basis for designing a more complex approach for non-flat tariffs given that 40-50 percent of business customers are on TOU tariffs and that the Victorian networks are proposing mandatory reassignment of residential customers to time-of-use tariffs in the next regulatory period.

Other Issues

Network Costs

AGL supports the ESC's approach to pass through the quantum and structure of network tariff costs directly to the residential or small business customers, including published metering charges and believes the tariffs set out in the Issues Paper are still the most appropriate tariffs to use in setting the VDO.

Form and Structure of the Victorian Default Offer

AGL is comfortable with the ESC maintaining its previous approach to allocating the fixed and variable costs for the 1 January 2020 VDO price determination.

Embedded network customers

The General Exemption Order 2017 was amended on 30 May 2019 so that the maximum price for embedded networks is currently frozen at the standing offer prices that were available from the local area retailer in each distribution zone as at 27 May 2019. AGL notes the introduction of the VDO saw significant reductions in Standing Offer rates on 1 July 2019 which were therefore not captured by embedded network customers.

Furthermore, the existence of many embedded networks has been driven by arbitrage of network cost – i.e. the average network cost for an embedded network residential customer is significantly less than that of a stand-alone residential customer.

AGL believes that the protections for customers in embedded networks should not be any different from other consumers and would therefore question the merit and equity of not applying a maximum price for embedded networks through this VDO price determination process.