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Victorian Default Offer 2023-24: Consultation Paper

AGL welcomes this opportunity to provide comments on the Essential Services Commission's (ESC) *Victorian Default Offer 2023-24: Consultation Paper* (Consultation Paper) as published on 8 December 2022.

AGL operates nationally across the energy supply chain and delivers 4.3 million gas, electricity, and telecommunications services to our residential, small and large business, and wholesale customers across Australia. We also operate Australia's largest electricity generation portfolio, with a generation capacity of over 11,000 MW, accounting for approximately 20% of the total generation in the National Electricity Market.

AGL notes that the ESC is largely committed to using the same approach for calculating the 2023-24 Victorian Default Offer (VDO) prices as was used last year. The Consultation Paper is seeking stakeholder feedback on whether refinements should be made to the methodology such as:

- accounting for market intervention costs;
- escalating the retail cost benchmark by a different factor rather than CPI;
- including costs arising because of Consumer Data Right (CDR); and
- amending the future consultation process for VDO prices.

AGL strongly believes the ESC should avoid making amendments to the current methodology that are simply aimed at engineering preferred pricing outcomes in response to the current market conditions.

However, where the VDO pricing methodology does not reflect a new cost or significant cost changes then amendments to the methodology are worth exploring and may be warranted. AGL would make the following comments on the issues raised in the Consultation Paper and other concerns.

Wholesale costs

AGL generally supports the current market-based approach used by Frontier to forecast the wholesale energy cost, including the continued use of trade-weighted ASX futures contract prices over the most recent



12 months available. Frontier's assumptions largely reflect most retailers' hedging practices of building contract positions over time and the ASX Energy futures contracts are a reasonable proxy.

AGL would highlight that option contracts have become popular in the current market and their value has also escalated exponentially in 2022, in line with increases in the futures market. It is therefore appropriate that in this determination, the ESC closely consider its treatment of option contracts in its methodology.

Firstly, it should be recognised that calendar year options are exercised 6 weeks prior to the start of the calendar year or mid-November while financial year options must be exercised 6 weeks prior to the start of the financial year in the middle of May. The quantity and strike-price of any exercised options is then included in the ASX forward contract data.

In previous years, the smaller option volumes and values would have had a minor impact on the modelling of the wholesale energy cost. With the increased option volumes and values, AGL now believes it is necessary to specifically consider the impact.

AGL proposes two practical ways for the ESC to appropriately account for options in its calculation of the wholesale energy costs for 2023-24, namely it:

- removes the data for the exercised options from the book-build of the trade weighted forward contract prices (this would be those exercised in November 2022); or
- retain the options data in the trade weighted average calculation but then account for the premiums paid to enable these option volumes and values to be struck and exercised.

Market Intervention Costs

The Consultation Paper highlights that retailers are facing additional costs because of the market intervention in 2022 which the ESC has not previously included in the VDO prices, namely:

- suspension pricing compensation; and
- administered pricing compensation.

The Australian Energy Market Operator (AEMO) is calculating the cost of the market suspension which will be confirmed prior to the setting of the 2023-24 VDO prices. The Australian Energy Market Commission (AEMC) is calculating the generator claims for the direct and opportunity costs that occurred under administered pricing. Some of these costs will be known prior to the 2023–24 Victorian Default Offer and can be passed through at that point. The additional costs will become known over subsequent months.

AGL supports including costs arising from the market compensation in the wholesale electricity cost component for 2023-24, while recognising that the final cost of some of the indirect compensation claims are unlikely to be finalised before the final VDO decision.

Despite this, AGL would recommend that the ESC use all available information to estimate these residual compensation claims to allow them to be included in the 2023-24 VDO prices and recovered in the financial year when retailers will be making the relevant payments. A 'true-up' can be used by the ESC in the following year to account for any variation between estimated and final compensation payments.

Delaying the recovery of these costs would result in significant costs being included in 2024-25 VDO prices, over 12 months after this cost have been incurred by retailers.



Retail Operating Cost

In its VDO methodology, the ESC has constantly used an historic benchmark for retail operating costs (per customer), increased this benchmark by the annual change in consumer price index (CPI) and often added new regulatory costs not included in the original benchmark.

The ESC has consistently represented that this approach is simple, transparent, and appropriate as it provides retailers with a reasonable opportunity to recover efficient costs as shown when the ESC cross checked it with cost data provided by Victorian retailers.

In the Consultation Paper, the ESC appears concerned that this method may no longer apply because CPI is higher than it has been since 1990.

The CPI is a basket of many varied goods and services and while some components on their own are considered to have little relevance to retailers' costs, the index on a whole is the most relevant for assessing general cost changes. In AGL's view, alternative indices are less useful.

AGL would also highlight that the ESC has accepted change in CPI as the best proxy for changes in retail operating costs in all previous VDO reviews. This was the case in periods of low and negative inflation when the resultant changes in retail operating benchmark due to CPI escalation were not reflective of the changes in cost as highlighted by retailers' cost data.

The operating cost benchmark remains a simple and transparent method and AGL does not believe the increase in CPI justifies a change to the methodology.

Consumer Data Right (CDR)

CDR is a reform designed to allow consumers greater access and control over their data. AGL is one of only two energy retailers who have implemented CDR to date.

The implementation costs were significant and AGL previously submitted these costs to the ESC noting that the ESC determined that these costs were not part of retail operating cost but of retail margin. The ongoing operating costs for CDR are also material and include additional labour as well as system maintenance. AGL would hope that the experiences and cost data provided from more retailers will allow the ESC to better assess and provide for the cost of this reform.

AGL would also highlight that the implementation of CDR is not a single IT activity but will require regular on-going system and process alterations as amendments continue to be made to the underlying regulations.

AGL would expect these costs to also be captured as part of a retailer's on-going operating costs.

Consultation process for the Victorian Default Offer reviews

AGL supports the ESC continuing to publish a Consultation Paper each year. This provides a formal pathway for stakeholders to publicly raise concerns about changes in the market and suggest how they believe the ESC's VDO methodology should account for these concerns.

This consultation step does not need to be a laborious or costly exercise.

If the ESC has no immediate concerns with the VDO methodology then AGL supports the ESC simply releasing a short request for comment or submissions rather than producing a rigorous Consultation Paper.



If you have any questions in relation to this submission, please contact Patrick Whish-Wilson on pwhish-wilson@agl.com.au.

Yours sincerely

Chris Streets
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Policy, Market Regulation and Sustainability