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22 December 2010

Mr Tom Leuner
General Manager
Markets Branch
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

By email: AERInquiry@aer.gov.au

Dear Mr Leuner

AER Issues Paper – RoLR Cost Recovery Scheme

Regulator (AER) *Retailer of last resort cost recovery scheme – Issues paper, November 2010 (***Issues Paper***)*.

AGL is currently a retailer of last resort (RoLR) in Victoria and New South Wales, and provides contractual support to ETSA in South Australia. AGL has been involved in both of the RoLR events in the NEM to date, the most recent of which was the transfer of customers from JackGreen International Pty Ltd in December 2009. As a consequence, AGL is well placed to provide feedback on the issues associated with RoLR events.

This submission has been prepared in parallel with AGL submissions on *RoLR plan development – Issues paper, November 2010* and *RoLR Registrations and Appointments – Issues paper, November 2010*.

AGL is broadly supportive of the principles relating to a RoLR cost recovery scheme set out in the *National Energy Retail Law* (**Retail Law**). The AER notes in Chapter 1 of the Issues Paper that the "AER may also develop a RoLR cost recovery principles and process paper. This paper would provide information on the legal requirements regarding RoLR cost recovery schemes and some of the principles the AER may consider when making RoLR cost recovery scheme determinations." AGL suggests that this consultation would be useful in order to provide further guidance on key terms within the Retail Law relating to RoLR cost recovery (i.e. "reasonable costs") which are currently not clearly defined.

AGL's response to specific questions raised in the Issues Paper is provided in Attachment A.

Should you require clarification of any of the points raised in this submission, please contact Andrew Dudgeon, Manager Regulatory Pricing Strategy on 02 9221 2612.

Yours sincerely

Beth Griggs
Head of Regulated Pricing

Attachment A

1. Process for making RoLR cost recovery scheme determinations: Time limits for RoLR cost recovery scheme applications

In the context of a RoLR event it is in a RoLR's interest to recover any costs as soon as practicable. However, it should be acknowledged that due to the unforeseen nature of a RoLR event that all reasonable costs which should be recovered by a retailer are unlikely to be billed to customers in the first invoice immediately following the RoLR event. Whilst a portion of costs associated with a RoLR event will be able to be identified within this period, in some circumstances, costs may extend beyond the subsequent quarterly bill - for example, obtaining robust settlement data from AEMO can take up to 5 months, or an error may occur in the information provided to the RoLR by the Distribution Service Provider. AGL therefore suggests that any ex-post cost recovery period should cover at least two billing cycles i.e. up to a 6 month period.

2. ROLR Costs: Preparation costs for a Default RoLR

For a default retailer, the costs incurred in preparation for a RoLR event are recognised as part of the costs that should be recovered under a RoLR Cost Recovery Scheme as described in Section 166 of the Retail Law. AGL suggests that this include costs of:

- Ensuring systems have sufficient capability and capacity to deal with a RoLR event;
- Putting in place financial resources to ensure the ability to act as a default RoLR;
- Putting in place documentation and procedures for a RoLR event; and
- Testing of systems and procedures to manage a RoLR event.

The Issues Paper raises the option of requiring a regular transfer of customer data from retailers to a data custodian as part of a RoLR Plan. In the event that significant ongoing compliance costs are incurred as a result of a new process, AGL suggests that costs associated with this process should be recoverable in line with provisions in the Retail Law.

3. Incremental Costs following a RoLR Event

On the basis of an ex-post cost recovery application resulting from a RoLR event, there are a range of incremental costs borne by the RoLR. These include:

- Wholesale energy costs greater than the allowance in the standing offer retail tariff;
- The administrative costs in establishing the failed retailer's customers in the RoLR's billing systems;
- Costs associated with service orders placed by customers of the failed retailer, where payment has been made by the RoLR to the distributor;
- Costs associated with increased financing requirements (i.e. increased prudential requirements associated with larger customer base);
- The cost of communicating with the customer about the event and their new contract; and
- The cost of meter reading.

Wholesale Energy Costs

As noted in the Issues Paper, a RoLR must supply small transferred customers at the RoLR's standing offer prices. Under this arrangement, the RoLR could be exposed to significant financial risk associated with additional energy required for these customers which would need to be purchased on the open market. This is likely to be the most significant incremental cost following a RoLR event.

In the case of retail electricity, retailers manage price risk exposure associated with the difference between fixed tariffs and a volatile wholesale market by entering into financial hedge contracts. These contracts are forward purchased to cover future electricity loads up to one or two years in advance. The nature of a RoLR event means that the RoLR will receive customers from a failed retailer, and will therefore become responsible for a customer load it is unlikely to have any forward contract cover in relation to. This exposes the RoLR to significant financial risk, as it will be required to purchase electricity from the spot market, or purchase cover from the short-term contract market.

The Issues Paper highlights the risk associated with a RoLR taking on unhedged customers and states "if the retailer failure occurs at a time of high electricity prices this may increase the cost of hedging the load of the transferred customers beyond the amount that can be recovered from a RoLR's standing offer prices"[1]. In AGL's experience it is during these times that an electricity RoLR event is most likely to occur.

The Issues Paper also notes that this exposure will be dependent on the load profile of the customers. AGL agrees that the load profile of customers can exacerbate the risk associated with an unexpected customer load.

4. Possible benefits of a RoLR event

Whilst a RoLR event results in the RoLR gaining additional customers from a failed retailer, AGL is of the view that the possible benefits which could be ascribed to the RoLR from this process are difficult to calculate. Obtaining responsibility for a large number of customers unexpectedly is a very different proposition to that of acquiring customers in a planned and managed acquisition campaign or purchase of an existing retail business.

As noted in the Issues Paper, there are a variety of factors which could influence the level of possible benefits. For example, in calculating the benefit which can be gained by a RoLR an estimate is required of the amount of time a customer is likely to remain with the RoLR. The churn rate of transferred customers following a RoLR event will vary depending on retailer competition and other market conditions. AGL suggests that the circumstances in which a customer is transferred to the ROLR is likely to lead to higher rates of churn than would otherwise be anticipated in the context of a normal acquisition.

AGL also notes that due to a proportion of fixed costs being associated with a RoLR event this means that where only a small number of customers are transferred, any economies of scale will be reduced, and therefore a RoLR will incur greater costs per customer.

5. Estimating costs and benefits

Timing of assessment of costs and benefits

AGL is broadly supportive of the 'combined approach' suggested by NERA Economic Consulting (NERA) and Allens Arthur Robinson (AAR) in its advice to the MCE[2]. Under this approach the AER would periodically determine an upfront fee which allows the RoLR to recover its administrative costs i.e. preparation. The RoLR could also apply to the AER after a RoLR event to recover any difference between the wholesale energy costs incurred and the amounts recovered from customers under the RoLR's standing offer price.

Limits on costs that can be recovered

As previously noted, the principles set out in the Retail Law limits RoLR cost recovery to "reasonable costs". AGL is of the view that setting a pre-defined limit on the cost which could be recovered by a RoLR following an event would be unnecessary and introduce further regulatory complexity. AGL notes that the specific circumstances of a ROLR event are hard to predict, and for so long as there is a requirement that the costs be 'reasonable' then it appears to be of little utility to seek to define the limits of this prior to the event.

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[1] AER, Retailer of last resort cost recovery scheme, Issues paper, November 2010.

[2] NERA Economic Consulting and Allens Arthur Robinson, Retailer of last resort – Review of current jurisdictional arrangements and development of a national policy framework (Final report prepared for the MCE Retail Policy Working Group), January 2009.

6. Mechanisms for recovering costs

AGL suggests that the suitability of cost recovery mechanisms should be considered in relation to the type of costs being recovered. AGL suggests that in terms of the timing of cost recovery then the "combined approach" set out by NERA and AAR would be appropriate. On this basis, AGL submits that default RoLR preparation costs would be most efficiently recovered using an ex ante payment spread across all relevant customers. This payment could be set periodically based on input from default retailers on the level of costs incurred.

In relation to the recovery of incremental costs associated with a RoLR event, AGL considers that these costs would be more appropriately recovered through an ex-post recovery process. Two options are proposed in the Issues paper by which retailers recover these costs i.e. retail tariff variation or distribution network tariff variation.

AGL is of the view that, as retail price regulation is still subject to jurisdictional control in a number of states, then it is most appropriate for the cost to be passed through into the distribution tariffs. AGL is concerned that existing state based regulation may preclude a complete pass through of the costs by way of a variation to retail tariffs.

Further, AGL agrees with the concerns expressed in the Issues Paper, and believes it is more appropriate for the AER to adjust through a distribution network tariff variation. In the event that the RoLR event is across multiple distribution areas, the amount of costs recovered could be based on the number of affected customers within that distribution network i.e. costs will be borne by a broader group of customers, but limited to the exposure in their network area. While this is administratively more complicated, AGL considers that this is a more equitable approach than recovering the cost from a single distribution network.