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Default Market Offer prices Options Paper on the methodology to be adopted for the 2022-23 determination (and subsequent years)

Alinta Energy welcomes the opportunity to respond to the Australian Energy Regulator's options paper on the methodology for the determination of default market offer prices from 2022-23.

Alinta Energy, as an active investor in energy markets across Australia with an owned and contracted generation portfolio of nearly 3,000MW and more than 1.1 million electricity and gas customers has a strong interest in the method the AER will apply to determine DMO prices as the decision will impact consumer choice and the competitiveness and viability of the retail energy market.

The case for change

We do not believe the case to fundamentally change the basis for determining the DMO has been made. In absence of strong evidence demonstrating how and why the current approach is failing to meet the DMO objectives (and it has been acknowledged that it is meeting those objectives), further regulatory change at this time cannot be justified.

There are significant reforms underway that will impact the retail energy market in the medium term that retailers will need to implement and manage. These include:

- The Energy Security Board's post 2025 National Electricity Market reforms, including twoside markets and the integration of distributed energy resources;
- The implementation of the Consumer Data Right;
- Likely changes to the deployment of advanced metering following the Australian Energy Market Commission's Metering Review;
- The introduction of the Better Bills Guideline by the AER; and
- Ongoing network tariff reforms including changes to export pricing by distributors and cost-reflective pricing.

In addition, wholesale market impacts from the retirement of large thermal generators, continued uncertainty regarding long-term carbon abatement policies, the impact of electric vehicles and degasification strategies and the introduction of hydrogen are all contributing to uncertainty and the regulatory burden faced by retailers.

In this environment, given the lack of evidence that the current DMO approach is failing to meet its objectives (in fact the opposite is the case), Alinta Energy strongly supports the maintenance of the current method applied by the AER.

An alternative model that satisfies the DMO objectives

If the method for determining the DMO is to change Alinta Energy recommends further consideration of our proposed approach to price oversight to meet the objectives and recommendations of the ACCC's Retail Electricity Pricing Inquiry set out in our submission to the AER's position paper on the DMO in December 2018.¹

The approach suggested by Alinta Energy would require the AER to set a maximum allowable percentage differential permitted between individual retailer's standing and market offer prices. This simple method of price oversight would:

- 1. Through competitive pressure on retailer's market offer prices, set a ceiling on their standing offer tariffs;
- 2. Eliminate:
 - The regulatory cost and burden of the AER having to determine a regulated DMO maximum;
 - The regulatory oversight and compliance burden placed on retailers;
 - The material risk of attempting to use regulation to identify an efficient price, which inevitably will be too high or low.
- 3. Allow individual retailers to manage wholesale cost and other pricing risks in a manner that best matches their circumstances, their customers and their competitive strategy. The current (and alternatives presented in the Options Paper), significantly limit retailer's flexibility and rely on data and market conditions whose currency will always be historic.

This approach would serve the objectives of the DMO, which was not intended to regulate the price of energy for small consumers, but to ensure that customers who chose not to engage in the market were able to access a standing offer that was not excessive. The current DMO method has achieved its key objectives. A cost build-up approach (discussed below), is very unlikely to provide additional benefits to consumers.

Options presented

Alinta Energy does not support a cost stack approach to the determination of retail energy prices (option 1). Attempting to identify what a reasonable, sustainable profit margin for an energy retailer runs the risk of impacting the viability of retailers and the level of competition in the market. Given the uncertainties discussed above, moving to a cost stack approach when the existing approach to determining the DMO is meeting its objectives does not seem reasonable or likely to result in improved outcomes for energy consumers.

While some stakeholders have bizarrely suggested there are too many retail market participants (perhaps preferring the duopoly or oligopoly structure of some other sectors), we do not believe it is the role of regulation to determine this (through a cost build-up or alternative option). Consumers benefit in the long term from being able to choose amongst as many competitors as the market can sustain and suggestions that there is an optimal level of participants conflicts with basic tenets of efficient competitive markets.

Options 2 and 3 are variations of the existing DMO, with option 3 using ACCC data reported by retailers as the basis of retail operating cost adjustments. Option 3 inevitably builds in a process of perpetual 'catch up' of retail operating costs and is based on past reported data, which in turn may not match how overheads and other corporate costs are accounted for by retailers in

¹ See: <u>https://www.aer.gov.au/system/files/Alinta%20Energy%20-</u>

<u>%20AER%20Default%20Market%20Offer%20-%20Submission%20to%20Position%20Paper%20-%207%20December%202018_0.pdf</u>

their annual reports (whether publicly listed entities or not). Smaller retailers without the scale or customer base of larger retailers (with or without generation assets) are set at a disadvantage under both Option 1 and to a lesser extent Option 3.

Length of the DMO period

If the AER adopts one of the three options presented, a three, rather than five-year period is preferred as it would align with likely changes in the retail market (in particular the DER and twosided markets design initiative) as part of the Post 2025 NEM reforms recommended by the ESB. While we do not believe the case has been made to adopt alternative methods to determine the DMO, Alinta Energy believes the AER should remain flexible in its approach and seek flexibility in relation to determining the DMO.

Conclusions

The price-banding model recommended by Alinta Energy in 2019 would:

- Support a vibrant, sustainable and competitive market;
- Provide for price monitoring light-handed oversight by the AER and policy makers; and
- Place competitive pressure on retailers to determine market (and standing offers via the maximum differential).

In absence of this, maintaining the <u>existing</u> approach to determining the DMO is the optimum approach, particularly given there is no evidence to suggest it will not continue to deliver on achieving the objectives of the DMO. There is scope to improve the existing framework to support an efficient allowance to account for the growing impact of advanced metering costs and the costs of implementing the CDR and other substantive market reforms that will impact retailers.

Responses to questions in the Options Paper are set out the attachment below. We welcome further discussion with the AER as it works towards its draft determination. Please contact David Calder at <u>David.Calder@alintaenergy.com.au</u> in the first instance.

Yours sincerely

Graeme Hamilton General Manager, Regulatory & Government Affairs

	Question	Alinta Energy Response
1	What is the most appropriate approach to estimating retail operating costs under a cost-based approach?	While making use of cost data reported by retailers to the ACCC avoids further data requests from the AER, this data will always lack currency and does not account for all retail costs and overheads. It also is impacted by the weighting of the costs reported by larger retailers.
		If ACCC retail price data is used, a reasonable allowance should be added to it to reflect the efficient costs of smaller new entrant retailers.
2	What information should we have regard to in estimating retail costs?	As discussed above, the AER should give attention to the growing impact of advanced metering costs and the costs of substantive reform programs like the CDR and the Post 2025 NEM market design initiatives recommended by the ESB.
3	What are the impacts on retailers facing a time lag for recovery of retail costs?	Some exogenous cost drivers may not be trivial in nature as suggested by the AER on page 24 of the options paper.
		For example, the implementation of the CDR will impose substantial costs on retailers as Data Holders under the regime (an obligation that all energy retailers will face). These costs involve development, engaging IT vendors to support the peer-to-peer architecture of the CDR, engaging contractors and assigning employees to CDR implementation and ongoing maintenance (including the opportunity cost associated with such diversion of resources) and constantly updating processes, dashboards and application programming interfaces to meet new standards.
		We would encourage flexibility in the AER's approach to determining the DMO and believe the current approach (or Alinta Energy's preferred model) would provide such flexibility and minimise the risk of under-recovery and catch up of costs incurred.
4	Is the DMO protecting customers from unjustifiably high prices? If so, why?	We believe the DMO is achieving its objectives of providing a reasonable price for the small number of customers remaining on standing offers. The current method provides for this outcome and any change to this approach should be justified by clear evidence. In the absence of such evidence and an assessment of the benefits and costs of changing the approach to regulation, we do not consider change is warranted.
5	What factors are relevant in considering whether a price is excessive?	Alinta Energy believes effective competition is present in all east coast retail electricity markets. As such, active rivalry amongst (the many) retail market participants ensures prices are not "excessive." Competition (even in the presence of the DMO), places downward pressure on prices available to customers.

	Question	Alinta Energy Response
6	What other factors should we consider when assessing the DMO allowance required to incentivise customers to engage in the market?	While customers continue to engage in the retail electricity market, acquiring customers is becoming more difficult and smaller retailers in particular face challenges from the cost of implementing market reforms and complying with the ever-increasing number of obligations placed on authorised retailers. The ongoing lack of harmonisation with the Victorian retail energy market continues to generate higher operating costs for retailers, who will generally wish to compete in the Victorian and NECF jurisdictions.
7	Should the margin above efficient costs in the DMO price be consistent across all DMO regions and customer types?	Alinta Energy does not believe that the margin above efficient costs should be consistent across all DMO regions. Given the retail energy market is effectively competitive, the appropriate DMO margin would ideally reflect competitive market outcomes. The difficulty in regulating prices is that oversight cannot determine what an 'appropriate' margin is. Alinta Energy believes that the policy objectives have largely been achieved in any event and the number of standing offer customers will continue to decline.
8	What is an appropriate DMO margin to achieve the policy goals?	Given the retail energy market is effectively competitive, the appropriate DMO margin would ideally reflect competitive market outcomes. The difficulty in regulating prices is that oversight cannot determine what an 'appropriate' margin is. Alinta Energy believes that the policy objectives have largely been achieved in any event and the number of standing offer customers will continue to decline.
9	Should we continue indexing the current residual?	Of the three approaches set out in the Options Paper, option 2 provides the greatest certainty and continuity. If this approach is applied, it is appropriate that the residual remain subject to indexation and if consumption levels for small business customers are changed, recalibrating DMO 1 prices and cost stack components should reflect these new settings.
10	What are the benefits and disadvantages of this approach?	Option 2 (including changes to the step change framework) provides greater certainty for consumers and retailers alike, supports flexibility for the AER in determining the DMO and accounts for changes in retailer operating costs (for example advanced metering costs). It does not lock the AER into a formal cost build up approach, which the DMO was never intended to be (in contrast to a 'basic service offer', which is what the Victorian Default Offer more closely resembles.
11	How could the step change framework be improved?	Standardising templates for retailers to provide the AER with information on step- change costs may improve the framework.
12	Should we perform an adjustment to reflect movement in retail costs, and if so should this be performed on an annual basis?	If option 3 is adopted, an annual adjustment would be appropriate. Additional costs faced by retailers, including metering costs and CDR implementation costs would need to be accounted for.
13	How long should we retain the methodology we adopt in this	A three-year duration is preferred for any method chosen. Customer consumption

	Question	Alinta Energy Response
	review?	levels, wholesale market impacts and exogenous impacts on retailer costs from Post 2025 NEM reforms, along with the reporting of retailer costs to the ACCC, suggest any benefits to a five-year duration are outweighed by its costs.
14	Is our existing wholesale cost forecasting methodology, in terms of its approach and considerations (modelling of demand and supply, spot price, hedging etc.) complete, appropriate and representative of costs to supply energy?	Alinta Energy believes the existing wholesale cost forecasting approach applied by the AER remains appropriate.
15	Should our existing assumed hedging strategy be adjusted to allow for a higher level of spot market exposure? And if so, what is the appropriate level of exposure? (please also consider this question in conjunction with Margin for forecast error discussion)	Alinta Energy considers the current approach to spot market exposure remains appropriate rather than assuming a higher level of exposure.
16	Does our assumption of a retailer building their hedge book from the time of the first trade recorded by ASX Energy, remain appropriate, or is a shorter period justified? What is an appropriate period and why?	We support the continued use of a longer book build period assumed for retailer hedging. There is no evidence that this approach is not contributing to the DMO objective at present.
17	Does the 95th percentile hedged WEC estimate remain appropriate, in context of the hedging strategy? What alternative percentile could be applied and what would the justification be?	We believe the 95 th percentile hedged WEC remains appropriate.
18	Do you agree with the appropriateness of our environmental cost forecasting methodology for DMO 4?	We agree that the current approach to environmental cost forecasting remains appropriate.
19	Should the calculation of network costs for residential customers continue to be based on flat rate tariffs only? If yes, as what level of TOU tariff penetration should this approach be reassessed?	The number of customers on TOU tariffs is growing as noted by the AER in section 7.2 of the Options Paper. For DMO 4, it may be premature to move to an approach that assesses networks costs for TOU customers, but we believe the AER should closely monitor the growth in TOU customers and reassess the need to assess network costs to account for TOU customer profiles as penetration approaches 30 per cent.
20	If TOU network tariffs are included in our assessment, should we use a simple weighting of customers on each tariff type across all jurisdictions, or a separate weighting for each network area?	There are material differences in network costs (even within regions) for customers with different consumption patterns assigned to TOU tariffs. This complexity needs to be balanced against the advantages of maintaining simplicity in setting the DMO for different customer classes. Alinta Energy would encourage the AER to find a compromise that may involve jurisdictionally based weightings (rather than by network area or assuming the same weighting for all jurisdictions).
21	Is the DMO daily load profile (provided to retailers to calculate annual market offer costs for TOU offers) sufficient for calculating annual TOU network costs?	The use of the DMO daily load profile has deficiencies in determining annual TOU network costs. Further analysis by the AER (and retailers) is required however before changes to the application of the profile are made.

	Question	Alinta Energy Response
22	Should we assess metering costs separately from network costs?	Alinta Energy believes that metering costs need to be separately identified and included as part of retail operating costs.
23	Do you agree with our preferred position to not true up network costs in calculating the DMO price?	If the DMO is to reflect underlying costs, a true-up of actual network costs should be applied when a material over or underestimate is identified. As the AER notes, if the DMO is set at a level that is sufficient for retailers to recover their costs, including variances in network costs, unless a substantial error in estimate network costs is identified, a true up may add more complexity and costs than benefits.
24	Should the DMO 4 methodology include an allowance for advanced meter costs? And if so, is the proposed approach above viable to calculate and account for its cost?	Alinta Energy supports an allowance for advanced meter costs in DMO 4. The proposed approach is appropriate- allowing for advanced meter costs based on the proportion of customers in a network area that have had such meters installed is reasonable and can be adjusted in subsequent DMO determinations.
25	Do you support our use of DNSP data, cross-checked with other sources, to determine residential annual usage?	It is appropriate to use cross-checked DNSP consumption data to determine residential consumption levels for DMO 4.
26	Do you support applying a single figure of 10,000 kWh for small business usage across all DMO regions?	While we understand that the current 20,000kWh annual consumption for small business is likely to reflect larger small business customers, adopting 10,000kWh as the basis across all DMO regions may create unintended consequences for the purpose of DMO comparisons by consumers. Noting that this is the AER's preferred option, we believe further analysis of the impact of adopting this figure is required before it is adopted for DMO 4.
27	Do you support applying individual ACCC reported median usage figures in NSW, SA and south-east Queensland? If so, please outline the advantages of this approach.	While there are differences in the reported median usage for small businesses across different jurisdictions, we note the challenges with this approach and the importance of maintaining a basis for DMO comparisons.
28	Do you support averaging across 3 years of data to calculate annual usage?	We support the use of averaging consumption data over three years to calculate annual usage as this would account for changes in consumption patterns driven by the COVID pandemic and the increase in customers working from home into the future.
29	Would you prefer we reflect TOU usage in annual usage estimates, or calculate annual usage based on flat rate usage, given most customers are flat rate customers?	Unless material differences in annual usage between flat and TOU customers can be identified, Alinta Energy suggests the AER maintain the basis for calculating annual usage on flat rate customer annual consumption levels.
30	Do you support updating the usage profiles by averaging across 3 years of usage data?	We support the AER's approach to updating usage profiles across three years of usage data. This will reduce the impact of volatility in the profiles and provide consistency for DMO 4 and 5.
31	Do you support maintaining the profiles based on a mix of TOU and flat rate offers?	We support maintaining the profiles based on a mix of TOU and flat rate offers and agree that any benefits that may arise from basing the profiles solely on TOU customers will be marginal relative to the cost of developing them at this stage.