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Australian Energy Regulator Position Paper – Default Market Offer Price

Alinta Energy welcomes the opportunity to make a submission on the above-mentioned Position Paper.

Alinta Energy is an active investor in the energy markets across Australia, with an owned and contracted generation portfolio of nearly 3,000MW, including 1,700MW of gas-fired generation facilities and 1,070MW of thermal generation facilities. Alinta has in excess of 1.2 million electricity and gas customers nationwide, including more than 600,000 in the east coast markets, and is well placed to provide comment on the Position Paper.

Alinta Energy continues to be supportive of initiatives that assist customers in making clear, transparent and informed choices when it comes to their energy supply. However, we do not support price regulation in any of its forms. Price regulation has the effect of stifling competition and innovation whilst creating price uncertainty that undermines future investment. With the Default Market Offer (**DMO**) Price to be determined by the Australian Energy Regulator (**AER**) and the DMO Price replacing the existing Standing Offer pricing arrangements, the DMO Price will result in the setting of a price cap.

Where an enforceable reference price is put into the market, such that the DMO Price will set the maximum price for those customers who choose not to engage in the market, then price regulation has re-entered the market.

The DMO Price, given its nature, will be used as the reference against which all other prices are measured, including market offer prices. Creating a significant level of responsibility on both the AER & Government in ensuring the accuracy and cost reflectiveness of the DMO price.

The AER position paper poses a number of questions to stakeholders on the makeup and approach to determining the DMO Price. These questions highlight the significant issues faced when attempting to set an artificial price to be used as a reference price against which actual pricing will be compared.

Alinta is of the view that if the AER are to set a DMO Price, any price should be set across a spread of offers that would benefit both active & inactive customers.

This can be achieved without the need to set a defined price such as that proposed under the DMO Price. As an alternative, Alinta suggests that setting an allowable percentage variation differential between a retailer's market offer tariffs & their standing tariffs, where the prices are mutually linked to each other, would provide a similar outcome for consumers whilst still allowing retailers to manage their risk (pricing / cost) exposure through maintaining the ability to set prices in accordance with their costs of participating in the market. This approach would result in setting upper limits for Standing offer pricing, whilst maintaining competitive pressure for retailers to keep their market tariffs cost reflective and to do so in a transparent way. Importantly, this alternative proposal would be a least cost and efficient alternative to the creation of a new price regulation function for the AER and the corresponding costs this would entail for the market.

This would achieve the key policy intent of mitigating the impact from high standing tariffs. An ability to monitor retailers pricing would provide the necessary checks and balances. This would be complemented through rule changes that require retailers to periodically advise customers whether they are on the retailer's best offer.

Further as retailers have agreed to introduce a voluntary reference price, for use in marketing and customer communications, and which customers can use when conducting price comparisons, this addresses a key element of the original purpose for the potential introduction of the DMO price. This retailer initiative lessens the viable reason and necessity for an AER derived DMO Price.

Whilst the AER are acting under direction from the Commonwealth Government in developing a mechanism for determining the price of the DMO, it remains cognisant on the AER to ensure that as issues, beyond that of the mechanism for determining the price of the DMO, are identified through this consultation process that they are given due consideration and advised to the Commonwealth to be factored in to the overall policy debate on the introduction of a DMO.



Our further detailed comments are set out in the attached.

Should you have any questions or wish to discuss our submission further I may be contacted on (02) 9372 2653 or via email: shaun.ruddy@alintaenergy.com.au

Yours sincerely

A handwritten signature in black ink, appearing to read "Shaun Ruddy".

Shaun Ruddy
Manager National Retail Regulation

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Seeking to establish any reference point for pricing in the energy market is a complex task where the risk of unintended consequences from poorly designed methodologies is a significant concern.

Historically, we have seen significant issues arise during the period where price regulation was in place. Any artificial approach to establish pricing where by the body seeking to establish those prices is not subject to the risks associated with the prices being set carries with it a greater risk to those market participants operating under such a regime.

In the past retailers have reassessed their level of investment and market activities in jurisdictions where poor pricing determinations were made. In extreme cases we have seen retailers exit markets due to poor pricing determinations.

The position paper states the DMO Price will limit prices charged to Standing Offer customers but not to customers on market offers. The DMO Price will become the price cap that all offers are compared / measured against and therefore will have an influencing impact on retailer's market offers. To state otherwise would be misleading.

The key policy objective of addressing high standing offer tariffs through the introduction of the DMO Price, is becoming less relevant as retailers seek to address the number of customers on standing tariffs and are looking to change their product structure's where discounts and/or benefits are provided to standing offer customers. Likewise, the introduction of rule changes that require retailers to periodically advise customers whether they are on the retailer's best offer will assist in lowering the number of Standing offer customers.

Alinta believes the policy objectives seeking to be achieved through the setting of a DMO Price can be achieved through alternative approaches that will continue to allow retailers to manage cost / price risk in an efficient manner.

The alternative preferred by Alinta is the methodology where the AER set a maximum allowable percentage differential that is permitted to exist between the level of market offer price and the equivalent Standing offer price. The prices would be mutually linked such that any level of discount would be limited to the percentage amount as set by the AER.

This creates a ceiling price for the Standing offer price whilst maintaining competitive pressure on the retailer's market offer prices. This methodology provides retailers with the continued ability to manage cost / pricing risk.

Alinta would be happy to discuss this option in further detail.

Position Paper Questions

Question 1: To what extent and how should we take into account the QCA analysis for maximum prices for South-East Queensland standing offers in determining a DMO price in Energex's distribution zone?

The QCA analysis is undertaken from a unique perspective in determining regulated prices using market prices as a reference, with the overlay of a "bottom up" approach to determining appropriate costs. In ensuring consistence in its approach to determining a DMO price where a "top down" approach is to be undertaken, there is a risk that the inclusion of the QCA analysis and approach will create a distortion in determining a DMO Price for south east Queensland.

Question 2: For residential customers, what type of tariff structures should be subject to a DMO price? Should there be different types of tariff structures subject to a DMO price in different distribution zones? Please provide reasons for your preferred approach.

The proposal in the position paper to create a DMO price for residential customers consisting of a flat-rate usage tariff & controlled-load tariff, and a DMO price for small business customers consisting of a flat-rate tariff only may result in unintended consequences where it has a dampening effect on demand management, cost reflective Time of Use tariff initiatives.

This will also have a limiting effect on the ability to provide meaningful reference point for comparisons across the range of tariff and pricing structures that exist in the market.

As previously stated Alinta hold the view that setting an individual defined price under the DMO is problematic, and a preferred solution is to set a DMO price across a spread of offers through the setting of an allowable percentage variation differential between a retailer's market offer tariffs and their standing tariffs.

Functionally this would work where by the retailer determines their own market offer pricing across its product suite and network tariff configurations. Retailers having control over this ensures they have the ability and capability to manage pricing (and cost) risk. In order then to determine a DMO price, the AER would (based on a number of factors) set a maximum percentage variation that the retailers standing offer tariffs would be permitted to be varied compared to their market offer pricing.

Under this methodology a DMO price could be set covering all tariff arrangements for which the retailer offers supply.

Question 3: For small business customers, what type of tariff structures should be subject to a DMO price? Should there be different types of tariff structures subject to a DMO price in different distribution zones? Please provide reasons for your preferred approach.

As stated above Alinta believe a methodology should be employed that would allow for a spread of tariff configurations to be covered by a DMO price. The methodology to achieve this for business customer should mirror that being used for residential customers. Alinta's supported approach is the application of a maximum percentage variation between a retailer's market offer tariffs and their standing offer tariffs. Importantly, this approach would not risk impeding tariff innovation and other dynamic cost reflective reforms to evolve over time.

Question 4: What factors should we take in account in determining DMO prices?

In seeking to determine any price several factors need to be taken into account. With the everchanging landscape of participants offering energy supply and services to consumers through varying business model approaches, traditional factors in determining pricing while still relevant, are being complemented through non-traditional retailing activities.

Wholesale costs associated with purchasing electricity from the NEM and managing the associated risk attached to this activity remain a key factor. However, the purchasing and trading arrangements under which retailers acquire supply are constantly evolving. We are seeing the advent of possible pier to pier trading models and other alternate trading models entering the market at increasing scale. These new dynamic trading models will challenge the traditional way in which the assessment of wholesale costs and risks are conducted.

In addition, network costs, transmission and distribution are key factors that continue to be of significant relevance in determining any price for end use customers. Key issues exist with the timing and disclosure of final determinations on the trajectory of network tariffs and pricing.

Environmental costs have traditionally included costs associated with the large scale renewable energy target and small scale renewable energy scheme. However, there are several other environmental "type" schemes that contribute to the end cost to consumers. These include schemes such as the Victorian Energy Efficiency Target (VEET), Residential Energy Efficiency Scheme (REES), Energy Savings Scheme (ESS). It is somewhat questionable whether these schemes have been adequately factored in to assessments carried out by regulatory authorities when carrying out price determinations.

Retail operating costs, cost to serve, acquire and retain customers and retail margins continue to be key factors for inclusion. There are significant variations in these costs across market participants and any attempts at "one size fits all approach" will inevitably risk creating windfall variances, this is especially true given the variation of retailer business models and risk appetites.

While arguably the elements that go to the makeup of a customers end price may appear to remain consistent with factors used in past pricing determinations, it is the elements within the factors that are continually evolving and there is no one set of factors or elements that is representative across all retailers. That is to say, pricing and cost elements and risks, today are more unique to individual retailers than they have been in the past. The concept of a "representative retailer" is notion which

requires further considerations. This is particularly the case when using such a notion as an element of determining median offers to set the high & low limits for determining a DMO.

All of which reinforces the view that the use of actual published pricing from retailers, where retailers have accounted for their individual costs and risks, commensurate with their business operations, is the more appropriate input to be used in determining any DMO pricing arrangements, rather than attempting to estimate the costs that a retailer "would" incur in supplying services to customers.

Question 5: What if any other factors or risks should the AER consider in applying the proposed price-based top down approach for determining DMO prices?

Government taking on the responsibility for setting, what will be universally viewed as the maximum retail price of electricity creates both risk for the Government and the market. Where the Government sets a rate that is viewed to be inefficient (high) it will be responsible for any potential consumer detriment, where the Government process results in the setting of a tariff / price that is not representative of the costs faced by retailers in supplying customers it creates the risk of impacting future investment in the energy market, may stifle product innovation and ultimately result in retailers exiting the market, to the detriment of competition in the market.

Historically under past regulated price determinations, the market has seen situations where retailers scaled down their activities and, in some cases, exited markets due to poor pricing determinations. Such a situation must be avoided under any future price setting regime.

To mitigate this risk, the use of actual published pricing and tariff information from retailers should be utilised, thus ensuring the relative costs and risks that vary across retailer business models have been accounted for.

Question 6: For residential customers, are the proposed upper and lower thresholds reasonable, given the policy intent? If a more targeted upper threshold was used, which retailers standing offers should be included? Are there any offers or categories of offers that we should not include as inputs into our proposed methodology? Should the range be the same in each distribution zone? Please provide reasons for your preferred approach.

Consistency in methodology across distribution zones in the way a DMO price is determined is key to ensuring the efficient implementation of any determined price. The use of the median standing offer tariff to set the upper limit and the use of the median market offer to set the lower limit is at a high level a reasonable approach, however key elements within the methodology are open for debate.

In particular in the setting of the lower threshold (median market offers) it is proposed to use market offers within a defined distribution zone inclusive of all conditional & unconditional discounts. Whilst the inclusion of all unconditional discounts would be reasonable, the assumption that conditional discounts are always achieved is flawed, and to make such an assumption in determining the lower threshold may result in the lower threshold not being representative of the

median market offers. A weighting should be applied to market offers with conditional discounts so as to more accurately reflect the median market offer.

Question 7: For small business customers, are the proposed upper and lower thresholds reasonable, given the policy intent? If a more targeted upper threshold was used, which retailers standing offers should be included? Are there any offers or categories of offers that we should not include as inputs into our proposed methodology? Should the range be the same in each distribution zone? Please provide reasons for your preferred approach.

Our comments on small business customers mirror those provided above for residential customers.

Question 8: For residential customers, on what basis should we set the consumption benchmark as part of our proposed methodology? Please provide reasons for your preferred approach.

Attempting to set a consumption threshold that is relevant to the majority of customers is extremely challenging. Customers are individuals and as such will have unique consumption patterns, thresholds and other preferences. Attempting to set a generic consumption threshold as part of the methodology in determining a DMO Price will embed compromises into the end DMO Price.

However, any consumption thresholds used must be consistent with thresholds currently in use with Government comparator sites so as to allow for the opportunity of cross comparisons with pricing information held on Government comparison sites, which are based on actual retailer published pricing information.

Question 9: For small business customers, on what basis should we set the consumption benchmark as part of our proposed methodology? Please provide reasons for your preferred approach.

Our comments on small business customers mirror those provided above for residential customers.

Question 10: Given defined upper and lower bounds, at what point within the range should the DMO price be set? What factors should we take into account in determining this point?

The DMO Price should be set at the high median point between the median Standing Offer & Market Offer pricing. Setting the DMO Price at this level will allow for a smooth transitional phase to this proposed pricing regime allowing retailers to manage risk whilst providing benefits to customers through addressing the perceived high level Standing offer prices.

Question 11: What type (and sources) of information should the AER have regard to in considering the likely direction and magnitude of any forecast changes in the main input cost for 2019-20 in setting a DMO price? How should we incorporate forecast changes in efficient input costs as part of our proposed pricing approach for determining DMO prices?

Alinta's preferred approach is for the AER not to set a DMO Price, as previously stated Alinta's preferred option is for a percentage differential method to be employed. Such a method negates the need to forecast changes in efficient input costs. Costs will be those as published by retailers who will have already accounted for any forecast changes.

Question 12: How should the DMO price be specified? Please provide reasons for your preferred approach?

The DMO Price should be specified as an annual cost. Annual cost representation provide the most efficient method for comparison and is aligned with existing comparison process such as those on Government comparator sites.

Question 13: What should be the duration of the AER's DMO price determination? Please provide reasons for your preferred approach. To what extent and under what circumstances should there be scope to reopen the AER's determination?

The AER's DMO price determination period needs to be flexible enough that it can account for variations in cost inputs as they change in the market. This needs to be balanced with the need to provide retailers & customers with pricing certainty.

Where market prices are to be used in determining the DMO Price, it should be noted that retailers generally only update their prices annually. Any price in the market only reflects the level of costs for that year. Therefore there will always need to be an adjustment for wholesale and network changes for the forthcoming year.

Under current regulatory arrangements retailers are restricted from varying their published tariffs for a period of 6 months post publication. Retailers have somewhat been able to adequately manage the risks associated with the current price variation moratoriums. However, the moratorium does create challenges, where variations in external cost inputs do not align with the allowable period of variations.

Therefore a 6-month to annual determination period would appear to be appropriate. However, Alinta recommends that provisions be included such that a retailer can request a review of an existing determination where there have been significant movements in external prices within any moratorium period.

Cost Considerations

Putting aside Alinta's alternative pathway forward, if a decision to progress with the DMO in its present form is made, Alinta would encourage a detailed consideration of compliance costs within the AER's analysis.

As noted above there is a wide variety of input variables that form the basis for retail pricing within the NEM, the collection of which incurs non-immaterial compliance and participation costs. Under normal market conditions, the establishment of a DMO would necessitate establishment times of several years and require material



and ongoing set up costs for both the AER and participant processes. Under exceptionally tight timeframes the costs for both the AER and participants are likely to be amplified.

In addition, there are a number of associated issues which need to be considered in full, before a final decision on the DMO methodology is made, for example the treatment of individual retailers unique cost inputs. Alinta is of the view that the costs of compliance should be considered within the AER's analysis.