alintaenergy

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Default Market Offer – Draft Price Determination 2022-23

Alinta Energy welcomes the opportunity to respond to the Australian Energy Regulator's draft price determination on the Default Market Offer (DMO4) for 2022-23.

Alinta Energy, as an active investor in energy markets across Australia with an owned and contracted generation portfolio of more than 3,000MW and 1 million electricity and gas customers has a strong interest in the draft determination meeting its objectives and maintaining a vibrant and competitive retail energy market.

Alinta Energy does not support the use of the bottom-up approach adopted by the AER (Option 1 from the consultation on the review of the DMO in October 2021). This approach implies a level of technical precision more akin to formal price regulation, or even the regulation of monopoly services inconsistent with the purpose and intent of the DMO as a safety net. An increasingly forensic approach to the determination of the DMO will lead to debates over the quantum of its various components, and amplifies the risk of impairing competition and reducing customer choice.

Furthermore, the AER has acknowledged the DMO was achieving its policy objectives (under the previous indexation model) and it is difficult to understand the policy justification to adopt a determination approach traditionally applied where market failure would typically be evident.

Nevertheless, given the AER's decision this response addresses elements of the draft determination based on the bottom up approach.

<u>Network costs</u>

Alinta Energy acknowledges the AER view that It is "more likely" approved network costs will be available for inclusion in the DMO final determinations in future, however we do not consider this adequately addresses the legitimate concerns of retailers; this has been a long running historical issue whether retail prices have been regulated or not, impacting retailer billing systems, dates of publishing tariffs and preparing customer notifications for example. As we have argued in previous consultations, the finalisation of network tariffs should be prioritised to support the determination of retail tariffs regulated under the DMO. Network tariffs are one of many components that comprise final retail pricing and the process of their determination (which is within the AER's control) should not delay or impact the accuracy of regulated retail prices, though this has frequently been the case in the past.

In our recent response to the Department of Industry, Science, Energy and Resource's consultation on its Directions Paper consultation on the Industry Code - Retail Regulations, Alinta Energy again emphasised the timing of finalising the DMO and that time available to retailers to implement any changes should not be reduced because network prices have not been finalised.[1]

Should final network tariffs not be determined in time for a final DMO determination, true up approaches should be retained.

In relation to time of use tariffs, while we maintain the view a critical mass of customers need to be assigned to such network tariff structures before they form part of the determination of the DMO, we would argue in some jurisdictions (for example Queensland) such tariff structures are becoming common place. We agree with the AER that incorporating network TOU (and demand) tariff structures into the DMO is complex; we would support the AER closely monitoring the growth in TOU assignments over the next 12 months, which are often linked to the installation of smart meters.

<u>Wholesale Energy Costs</u>

Alinta Energy does not support the shift to using the 75th percentile of wholesale market outcomes. Other than the AER suggesting that the use of the 75th percentile for estimating wholesale market cost purchases is less conservative and therefore reduces overstating the risks facing retailers in purchasing wholesale energy, little to no justification or analysis is offered for this change in estimating WEC.

The wholesale energy market is undergoing rapid and uncertain transition and given the AER intends to apply its approach to DMO5 and 6, it is concerning that it has elected to adopt less risk averse settings for the estimation of WEC when significant synchronous (and hedgeable) capacity is likely to retire from the NEM (Torrens Island A, Liddell and the recently announced early retirement of Eraring).

In addition, significant reforms to the wholesale market are in development through the Energy Security Board's post 2025 NEM market design initiatives. These changes to market design will support the energy transition, but their operation is unknown and a prudent retailer will need to manage a range of changes in the medium term. It is unclear why the DMO would assume a prudent retailer should be exposed to a greater risk profile given the level of uncertainty driven by the ongoing, material changes in the wholesale electricity market.

By adopting the 75th percentile of wholesale market outcomes, the AER has assumed risk limits for a prudent retailer that are lower than what is likely in reality and exposes retailers to increased spot market price risk. The 75th percentile amplifies the assumption that trading gains are locked in by retailers, which is inconsistent with an input into a regulated retail price benchmark under a cost build-up approach.

[1] Alinta Energy (2022), Directions consultation paper: Post-implementation review of Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019, page 2.

While we note the AER intends to have its WEC estimation method peer reviewed, Alinta Energy does not support the use of the 75th percentile at this time and believe strongly the 95th percentile should be retained for DMO4-6.

Alinta Energy also supports the retention of a 24-36 month assumed hedge book build period for a prudent retailer in determining WEC.

Retail costs

Alinta Energy supports the inclusion of smart meter costs and bad and doubtful debts in the retail cost component of the DMO. However, the use of and emphasis on reported ACCC data remains problematic as it is:

- Backward looking: It does not capture current costs faced by retailers (the costs of implementing the Consumer Data Right and the Better Bills Guideline will not be incorporated into DMO4).
- Weighted by the costs of larger retailers: while the AER suggest because smaller retailers are making competitive offers below the DMO, this does not mean that the DMO (influenced by large retailer operating costs estimates) is at a level that would sustain effective competition in the long term. The advantages of economies of scale do not seem to be recognised or adjusted for by relying solely on the reported ACCC data.
- Does not incorporate the costs of working capital or the full impact of the COVID pandemic. Working capital costs will increase as retailers make investments to comply with the CDR and Better Bills requirements.

For these reasons, Alinta Energy believes that a conservative approach to interpreting ACCC cost data should form part of the final determination of the DMO. To manage the deficiencies of relying on ACCC data discussed above, either a contingency should be added to these costs or the retail allowance adjusted upward to ensure smaller retailers in particular remain viable and can continue to invest and innovate for their customers. Applying flexibility to the determination of the DMO is in keeping with its role as a reference price, rather than a forensically determined regulated price. We acknowledge that there is no 'perfect' set of data or reference point that the AER can rely upon and that the aim of the setting of the DMO should not aim to replicate each element of the retail cost stack, as this departs from the role of the DMO as a reference price.

Finally, while we support the recognition of bad and doubtful debt expense in the calculation of the DMO, relying solely on publicly reported data (via annual reports) of very large listed retailers is certain to understate the actual cost faced by a prudent retailer. Again, a contingency for this should be considered by the AER in order to more reasonably estimate this ongoing cost facing retailers, particularly given the impacts of the COVID pandemic, the lag effect associated with bad debts and the impact of retailer compliance with the Statement of Expectations that applied during jurisdictional lockdowns that reduced retailers' ability to conduct credit related activities.

DMO retail allowance

We understand the setting of a retail allowance of 10 per cent for residential and 15 per cent for small business customers across all DMO jurisdictions is based upon the AER's examination of the range of observed retail allowances.

We are concerned that a uniform margin itself may not fully capture the competitive dynamics market conditions and risk profiles across jurisdictions.

If the retail allowance is to be adjusted, we consider there is scope to slightly increase its level in the draft determination to account for uncertainties and risks associated with the level of retail and wholesale costs discussed above. This would preserve the intent of the DMO as a reference price rather than a fully regulated price with inflexible settings. Furthermore, benchmarking the retail allowance to margins in price regulated markets would be inappropriate as it is again contrary to the policy objectives of the DMO.

Conclusions

Alinta Energy is concerned that the DMO is increasingly reflecting a regulated price model, inconsistent with its original objectives and intent. While the inclusion of previously excluded costs (bad and doubtful debts, metering, the cost of directions in South Australia) is welcome, the cost build-up approach lends itself to constant challenge as to the 'correct' level of each component, particularly the retail allowance.

To maintain consumer choice and effectively competitive markets, retailers need the certainty to invest and innovate and be provided with appropriate incentives to do so. This has been difficult in recent years as extensive and at times disruptive regulatory changes have been placed upon all retailers (and continue to be), while maintaining compliance with an ever growing regulatory regime.

We would strongly encourage the AER to adopt a flexible stance to the extent it can on the final determination of DMO4 and future determinations that will follow it. This includes maintaining the 95th percentile of estimated outcomes for wholesale market purchases, a contingency in retail costs to account for deficiencies in ACCC data and bad debt sampling from listed retailers only, or adjustment or contingency added to the retail allowance for residential and SME customers.

Alinta Energy welcomes further discussion with the AER as it works towards it final determination. Please contact David Calder (Manager, Regulatory Strategy) on 0448 169 226 in the first instance.

Yours sincerely,

Graeme Hamilton
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