21 March 2019

Mr. Mark Feather
General Manager, Policy and Performance
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

By email: DMO@aer.gov.au

Dear Mr. Feather

Default Market Offer Price Draft Determination

Alinta Energy Retail Sales Pty Ltd (Alinta) welcomes the opportunity to provide comment on the Australian Energy Regulator's *Draft Determination, Default Market Offer Price*.

Alinta is an active investor in 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, and in excess of 1.2 million electricity and gas customers including more than 600,000 in east coast markets, and is therefore well placed to provide comments on the Draft Determination.

Default Market Offer - Draft Determination

We recognize that the gap between consumers on attractive market offers and those remaining on high-priced standing offers (paying a "loyalty tax" - largely with the large incumbent retailers) is too wide and needs to be narrowed. In doing so, we also welcome the Federal Government's policy objective for the DMO to provide a fall-back position for customers, while still allowing for robust competition.

The Government's objective is consistent with the ACCC's recommendations for an adequate safety net within a competitive market in which new entrant and second-tier retailers can invest, differentiate and maintain pressure on the large incumbent retailers. This was also acknowledged by the ACCC in its submission to the AER Position Paper, stating that "to facilitate effective competition, retailers would need room to discount well below the DMO."[1]

The ACCC warned that if the DMO became a viable alternative for engaged consumers it

[1] ACCC (2018), Submission to AER on Default Market Offer Position Paper, p. 2.

would not be in long-term interest of consumers as "engaged consumers drive efficiency and innovation in the electricity sector by responding to new offerings from retailers."[2]

The AER has appropriately recognized the importance of not setting the DMO too low, by establishing a policy objective in the Draft Determination of "not dis-incentivising competition and market participation by customers and retailers."[3] However, Alinta is concerned that the Draft DMO has failed to deliver this policy objective, in particular for the South Australian and New South Wales markets.

Specifically, the draft DMO in these markets is at levels that would have a severe negative impact on retail competition, inadvertently establishing it as a viable alternative to market offers, and limiting the ability of second-tier retailers to compete against the dominant market position of the large incumbent retailers. There is a real risk that the market position of the large incumbent retailers will be entrenched in this scenario.

There are a number of opportunities available to the AER to adjust the DMO for the Final Decision to prevent these negative impacts:

1. Increase the wholesale cost adjustment to reflect increased wholesale costs subsequent to the publication of the AEMC's Residential Electricity Price Trend Review (December 2018)
2. Adjust the price attributed to conditional discount products in the calculation of the median market offer price to reflect the extent to which those conditions are met. This would better reflect the AER's claim that the median market offer is indicative of an efficient price.
3. Adjust the DMO to account for increased operating costs, for example as incurred as a result of the introduction of Five Minute Settlement and the establishment of a DMO
4. Set the DMO closer to the median standing offer than the median market offer to reflect the greater risk, based on the Draft Determination, of not meeting the AER's objective to not dis-incentivise competition and market participation by customers and retailers, particularly at the levels the draft DMO has been set for South Australia and New South Wales

Our detailed comments are set out below. Should you have any questions or require any additional information I may be contacted on (02) 9372 2653 or email: shaun.ruddy@alintaenergy.com.au

Yours sincerely,

Shaun Ruddy
Manager National Retail Regulation

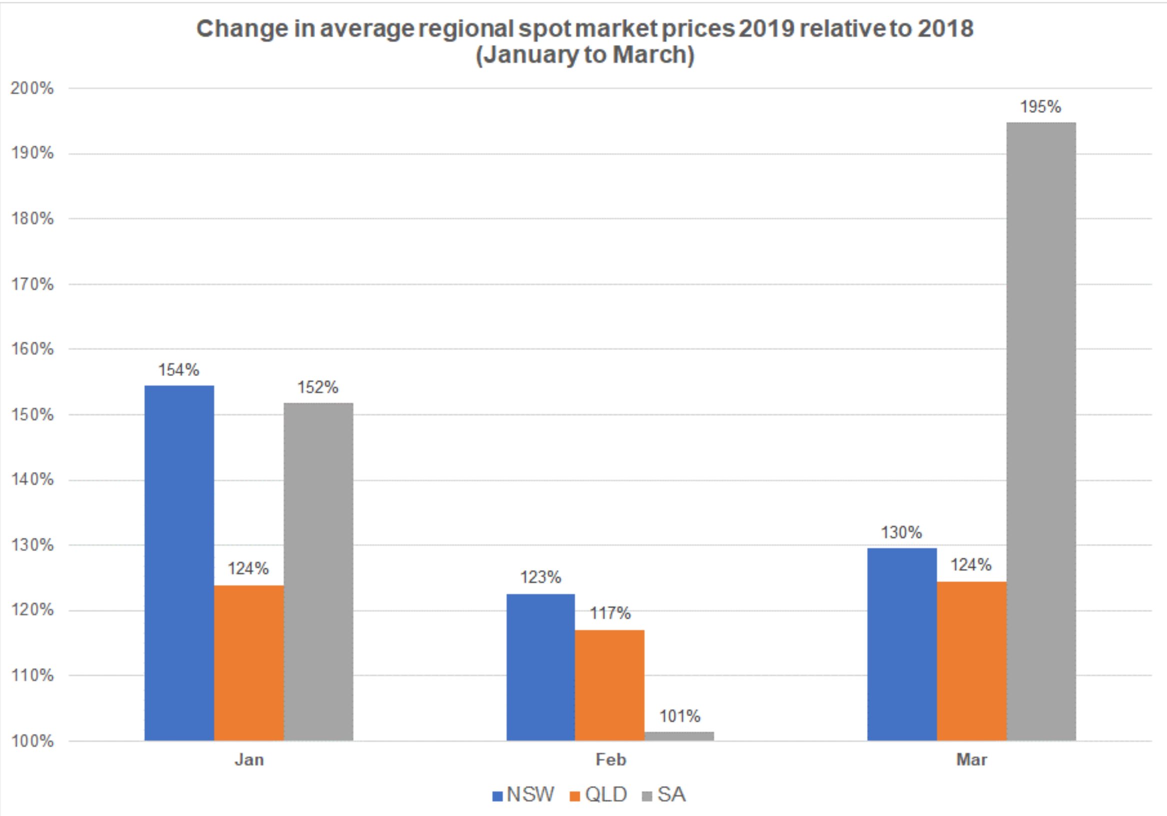
[2] ACCC (2018), op.cit.
[3] AER (2019), *Draft Determination - Default Market Offer*, page 41.

Default Market Offer Price Draft Determination

1. Wholesale costs adjustments

While the AER proposes to update the AEMC's Price Trends Review when additional information becomes available (for example, actual contract prices for 2019-20 at the end of March 2019)[4], Alinta believes reliance on the AEMC report at a time of high wholesale market volatility and continuing uncertainty around Government energy policy will expose retailers to significant risk under the DMO and that a higher allowance for wholesale market costs is necessary.

Our concerns with the risk of underestimating wholesale market costs is supported by the charts below. The first chart shows the relationship between average monthly reginal spot market prices (SMP) in relevant jurisdictions over the first three months of 2018 and 2019. In all regions, average monthly SMP was materially higher than the same month in the previous year. At the time of preparing this response, South Australia's March 2019 SMP is almost double the average monthly price in 2018 (at $157/MWh).



Source: AEMO data[5]

The second chart shows ASX swap price settlement levels indicating a clear upward trend to March 2019.

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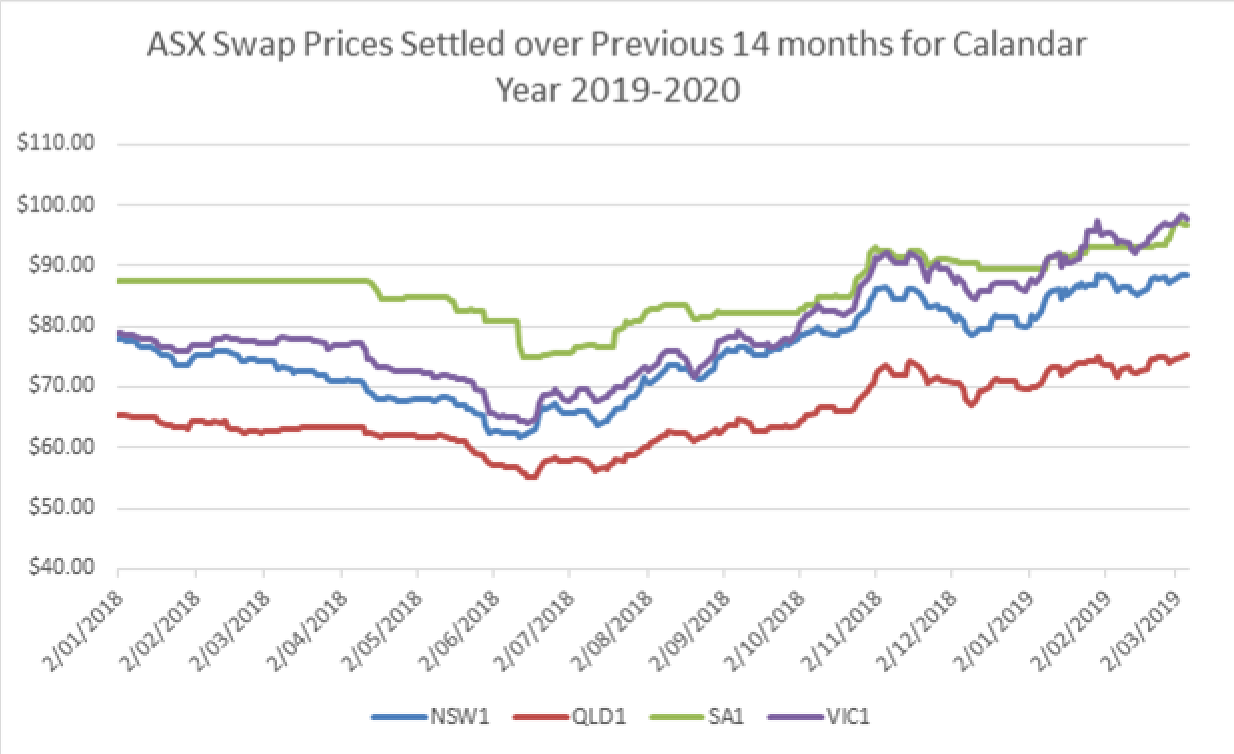
[4] AER, op. cit., page 54

[5] AEMO (2019), https://aemo.com.au/Electricity/National-Electricity-Market-NEM/Data-dashboard#average-price-table



These charts demonstrate that, despite views that increasing availability of renewable generation will temper spot market outcomes, actual outcomes in the spot market to date point to the significant volatility present in the market. Alinta recommends that the AER updates its view of wholesale market costs, given the sustained high (and increasing) prices being observed in 2019, to better reflect the risks and costs facing retailers.

The extent to which the market has moved from the data set used in the Draft Determination also demonstrates the asymmetrical risk retailers face in a price regulated environment, and why the AER should adopt a more conservative approach in setting the DMO as we discuss section 4 below.

2. Conditional discounts and the median market offer price

In our submission to the AER's position paper in December 2018, we highlighted the fact that conditional discounts are not always achieved, and basing the lower bound on a median market offer that assumes conditional discount terms are always met is flawed.[6] The AER's claim that this was a factor in choosing the mid-point between the median standing and median market price is not appropriate, as it is based on the assumption that the median market price is an efficient price. The calculated median market price is not an efficient price if it is based on the flawed assumption that all customers on that products meet the conditions.

[6] Alinta Energy (2018), Submission to AER Position Paper – Default Market Offer price, pages 7-8 https://www.aer.gov.au/system/files/Alinta%20Energy%20-%20AER%20Default%20Market%20Offer%20-%20Submission%20to%20Position%20Paper%20-%207%20December%202018_0.pdf

We again request that the AER apply a weighting to market offers featuring conditional discounts to accurately reflect the effective price of median market offers. The ACCC Retail Electricity Pricing Inquiry—Final Report found that, on average, 73% of residential customers meet the conditions necessary to obtain the full product discount. This would be an appropriate weighting for the AER to apply to conditional discount products in the calculation of the median market offer.

3. Increased operating costs

As an active user of NEM trading systems, settlement systems, forecasting tools and wide an array of other associated brokering products, the vast majority of NEM participant's (including Alinta Energy's) system infrastructure is currently being directly impacted by the implementation of five-minute settlement (5MS) and will subsequently require substantial upgrading.

Initial analysis highlights that the costs of 5MS systems upgrades will be substantial and will potentially span a lengthy time period. As part of the 2017 AEMC rule change process Russ Skelton & Associates (RSA) provided information on the potential costs of 5MS, concluding that "the present value of the total costs over 15 years of the implementation of 5MS would exceed $250 million".[7] These costs reflect both AEMO implementation costs, which will be reflected in increased market participant fees, and the internal implementation costs for market participants.

On the latter point it is also worth noting that:

- Participants are not able to access "off the shelf" energy trading and settlement systems to allow for 5MS.
- Demand for energy systems upgrades is not just coming from market participants who hold a physical position, but also the ASX, a wide array of brokers, the Australian Energy Market Operator (AEMO), the Australian Energy Regulator (AER), banking institutions and many others.
- The implementation of 5MS is a regulatory obligation with a relatively short timeframe for implementation, contributing to scarcity pricing.
- The designing, building, testing and operationalising of energy systems which can comply with five-minute settlement will require significant time and internal human resources from participants.

Implementing what is widely regarded as the most fundamental change the wholesale market has experienced in since the introduction of full-retail contestability within a tight-time frame, is adding significant costs to participants over the coming forward two-year planning cycle. The DMO should account for the significant cost associated with designing, building, testing and operationalising the largest wholesale market IT systems upgrade undertaken in the NEM.

[7] Australian Energy Council, Consultant Report by Russ Skelton & Associates, Directions Paper submission, pp. 22-23

More broadly, reform such as 5MS reflects the potential for any price regulator to understate business costs, and particularly in the energy sector which is undergoing an unprecedented increase in the underlying regulatory and compliance burden.

Indeed, the imposition of the DMO, and its associated advertising and product disclosure obligations, is yet another additional business cost that must eventually be recovered from consumers and should be accounted for through an increased retail cost allowance.

4. Setting the DMO closer to the median standing offer than the median market offer

Alinta generally supports the use of market data in the calculation of the DMO and recognises the difficulty inherent in balancing the competing objectives of where to set the DMO between the median Standing Offer and the median Market Offer.

However, a very small and declining proportion of customers (almost exclusively with the large incumbent retailers) are on standing offer tariffs, and several regulatory reforms, including the DMO as a price benchmark, will further reduce this customer segment.

In this context the greatest risk in balancing the competing DMO objectives is not that it will be set too high, such the reduction for some disengaged customers may not be as a high as it otherwise would be, but that it would be set too low, such that the vast majority of engaged customers become disengaged, which, as the ACCC recognises, is not in the long-term interests of consumers.

Indeed, this very risk has manifested in the DMO levels calculated in the AER's Draft Determination, whereby, in Alinta's view, the competitive markets in South Australia and New South Wales would be severely impacted. The extent of this impact is shown in the attached confidential appendix provided with this submission

5. DMO Review Mechanism

The energy market is currently going through an unprecedented level of market and regulatory reform. This reform has the potential to substantially alter the risk and cost associated with operating in the market.

We are concerned that there is no clearly defined review mechanism proposed that would be triggered where market changes have occurred during a DMO price determination period, that would have a significant impact on the assumed cost elements used in determining the DMO price.

Under the current method applied to determine the DMO price, point in time data (October 2018 Energy Made Easy pricing data) is being used. The use of point in time data does not provide the flexibility to redetermine the DMO in response to material events.