



independent competition and regulatory commission

Draft Decision
**Retail Prices
for Non-contestable
Electricity Customers,
2009–2010**

Report 2 of 2009
April 2009

The Independent Competition and Regulatory Commission (the Commission) was established by the *Independent Competition and Regulatory Commission Act 1997* to determine prices for regulated industries, advise government about industry matters, advise on access to infrastructure and determine access disputes. The Commission also has responsibilities under the Act for determining competitive neutrality complaints and providing advice about other government-regulated activities. Under the *Utilities Act 2000*, the Commission also has responsibility for licensing utility services and ensuring compliance with licence conditions.

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For further information on this investigation or any other matters of concern to the Commission, please contact the Commission on 6205 0799.

Foreword

The Attorney-General has made a reference to the Independent Competition and Regulatory Commission (the Commission) to provide a price direction for the supply of electricity to non-contestable franchise ('transitional franchise tariff' or TFT) customers for the period from 1 July 2009 to 30 June 2010. The Minister's reference dated 23 December 2008 is made under sections 15 and 16 of the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act).

This reference makes the fifth price control arrangement for TFT customers following the introduction of full retail contestability (FRC). The four regulatory periods and the maximum regulated transition tariffs are listed below:

- A regulated maximum tariff was applicable to TFT customers for a period of three years from 1 July 2003 to 30 June 2006 (this included a 4.5% real increase in the first year and a 0.5% real increase for the remaining two years).
- The regulated maximum tariff applicable to TFT customers was extended for a period of one year from 1 July 2006 to 30 June 2007 (there was a zero real increase in this year).
- The regulated maximum tariff applicable to TFT customers was further extended for a period of one year from 1 July 2007 to 30 June 2008 (there was a 12.9% real increase in this year).
- The regulated maximum tariff applicable to TFT customers was extended once more for a period of one year from 1 July 2008 to 30 June 2009 (there was a 4.67% real increase in this year).

The current reference requires a regulated maximum tariff applicable to TFT customers for a further period of one year from 1 July 2009 to 30 June 2010.

In developing the price direction for the regulated maximum TFT applicable to customers eligible for these transition arrangements for the period from 1 July 2009 to 30 June 2010, the Commission is required to have regard to a number of matters, including:

- the requirements of section 20 of the ICRC Act
- the need to have a final report in sufficient time to allow ActewAGL Retail to make necessary administrative arrangements to its billing system and to provide information on the new tariff to customers.

This report sets out the Commission's draft decision and price direction and reasons for the conclusions reached. The Commission welcomes comments on the conclusions contained in this report and will take these into account when preparing the final decision and price direction.

Paul Baxter
Senior Commissioner
April 2009

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1 Introduction

This chapter:

- discusses the background to the regulation of retail prices for non-contestable franchise ('transitional franchise tariff' or TFT) electricity customers in the ACT
- summarises the current investigation's terms of reference
- provides an update on the state of the retail electricity market in the ACT
- sets out the Commission's proposed timeline for the current investigation
- provides information on how interested parties may make a submission on the draft decision and price direction.

1.1 Background

In the ACT, the retailing of electricity to customers consuming more than 160 megawatt hours (MWh) per year (predominantly large businesses) was made contestable from 1998. The electricity supply industry in the ACT was opened for retail competition to customers consuming more than 100 MWh/year (mainly medium-sized businesses) from 1 July 2001.¹

Following the Commission's recommendation that full retail contestability (FRC) be introduced for all customers in the ACT², the government opened the market for customers using less than 100 MWh/year (those customers with an annual electricity bill of less than about \$13,000) to competition from 1 July 2003.³ This allowed small businesses and households to select the electricity retailer of their choice.

While the government decided to open the market to all customers, certain transitional arrangements were maintained. These were intended to ensure that customers consuming less than 100 MWh/year were able to remain on non-negotiated contracts with the incumbent retailer, ActewAGL Retail, if they did not wish to enter into a negotiated contract with one of the electricity retailers licensed in the ACT.

In December 2002, the Commission received a reference from the Treasurer, instructing it to provide a price direction for the supply of electricity to franchise customers (i.e. those on non-negotiated contracts) for a transitional period from 1 July 2003 to 30 June 2006. The Commission's first price direction was made at the time of the initial opening of the retail electricity market to competition for small customers (those consuming less than 100 MWh/year). Thus, at the beginning of that price direction, all small customers were on the regulated retail tariff.

The initial reference to the Commission instructed it to provide a three-year price direction. The Commission termed the resulting tariff from that price direction the 'transitional franchise tariff' (TFT). Customers who chose to remain on the regulated tariff are called 'franchise customers', and customers who opted for a negotiated tariff with an alternative retailer or with the incumbent retailer are called 'non-franchise customers'.

¹ Utilities (Non-Franchise Electricity Customers) Declaration 2001 (Disallowable instrument 2001-93).

² ICRC, *Final report: Full retail contestability in electricity in the ACT*, July 2002.

³ Utilities (Non-Franchise Electricity Customers) Declaration 2003 (No. 1) (Disallowable instrument 2003-20).

The Commission's first price direction allowed a 4.5% real increase in the franchise maximum tariffs for the first year and a 0.5% real increase for each of the remaining two years.⁴ The Commission made this determination based upon a rigorous examination of the costs incurred by ActewAGL Retail in providing retail electricity services to franchise customers. That price direction also allowed for a variety of pass-through events, including changes in network operating costs.

During this first designated transitional period, the government undertook to consider whether these arrangements would need to be extended for an additional period. In that investigation, the Treasurer sought advice from the Commission on the need for the transitional arrangements to continue and, if so, the form of price protection that should apply to franchise contracts in future and the duration of such protection.

The Commission issued its final decision in April 2006. In that report, the Commission recommended that the TFT cease to exist. The Commission concluded that there was evidence that the retail market in the ACT was sufficiently competitive to support the removal of the TFT.

However, the Commission was concerned at that time that the removal of the TFT could affect the status of the standard customer contract that covered all franchise customers by default. Thus, the Commission determined that the TFT should continue for the period from 1 July 2006 to 30 June 2007 to allow the ACT Government to make any necessary legislative changes to preserve the conditions of the standard customer contract.

The Commission's final decision, released in April 2006, allowed for a consumer price index (CPI) increase in franchise revenue for the period from 1 July 2006 to 30 June 2007.⁵ Thus, customers could expect no real increase in prices at that time. The final decision did not contain a complete build-up of the costs of retail electricity services in the ACT. The Commission's analysis at that time was that the offer of only a CPI adjustment to franchise revenue was reasonable, and that the CPI increase for 2006–07 represented an appropriate balance between the retail margin to sustain a competitive market and a reasonable outcome for consumers.

Before the second regulatory period expired on 30 June 2007, the Commission received a further reference from the Attorney-General⁶, instructing the Commission to provide a price direction for the supply of electricity to franchise customers for a further transitional period from 1 July 2007 to 30 June 2008.⁷ In undertaking that review, the Commission reverted to an analysis based on a rigorous examination of the costs incurred by ActewAGL Retail in providing retail electricity services to franchise customers. This was required because of the length of time since the first cost study during early 2003, coupled with evidence of large changes in wholesale electricity charges, which were a major cost input for ActewAGL Retail.

In its final report in June 2007, the Commission allowed for a 12.9% real increase in the franchise maximum tariff for the period from 1 July 2007 to 30 June 2008.⁸ The Commission also noted its concern that the reference required the TFT to be set for a 12-month period only. Then current

⁴ ICRC, *Final determination: Investigation into retail prices for non-contestable electricity customers in the ACT*, Report 5 of 2003, May 2003.

⁵ ICRC, *Final report: Retail prices for non-contestable electricity customers*, Report 8 of 2006, April 2006.

⁶ Under the ACT Government's administrative arrangement orders, the Attorney-General assumed portfolio responsibility for the *Independent Competition and Regulatory Commission Act 1997* in 2006.

⁷ ICRC (Price Direction for the Supply of Electricity to Franchise Customers) Terms of Reference Determination 2007 (No. 1) (Disallowable instrument DI2007-96).

⁸ ICRC, *Final decision and price direction: Retail prices for non-contestable electricity customers*, Report 7 of 2007, June 2007.

market data showed a large increase in the electricity pool price resulting from supply–demand imbalances in the wholesale electricity market which, in turn, led to increases in energy purchase costs. The short reference period constrained the Commission in how it was able to allow cost changes resulting from that imbalance to be passed through to franchise customers by the incumbent retailer. This meant that the Commission was unable to transition any price changes over a longer period, as was decided in other jurisdictions—for example, the Independent Pricing and Regulatory Tribunal (IPART) in NSW and the Essential Services Commission of South Australia (ESCOSA)—at around the same time.

A further reference was received by the Commission on 7 February 2008 to determine any change to the TFT for the period from 1 July 2008 to 30 June 2009. In response, the Commission undertook another detailed build-up of the costs incurred by ActewAGL Retail in providing electricity to franchise customers. The final report was released in June 2008 and allowed for a real increase in the TFT of 4.67%.⁹

Table 1-1 summarises the changes (in real terms) to the TFT since its introduction in 2003–04.¹⁰

Table 1-1 Summary of real changes to the transitional franchise tariff

2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
4.5%	0.5%	0.5%	0%	12.9%	4.67%

1.2 Current investigation

The Attorney-General issued further terms of reference on 23 December 2008, requiring the Commission to provide a price direction for the supply of electricity to franchise customers for the period from 1 July 2009 to 30 June 2010.¹¹

In providing the price direction, the Commission is required to have regard to the requirement of section 20 of the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act), and it must produce its final report in sufficient time to allow ActewAGL Retail to make any necessary changes to its billing system and to provide information on the new tariff to customers.

The full terms of reference are set out in Appendix 1.

This report contains the Commission’s draft decision and price direction.

1.3 Overview of the market

The TFT does not apply to all electricity customers in the ACT. Rather, it applies only to those small customers (residential and non-residential customers who consume less than 100 MWh/year) who have not elected to enter into a negotiated contract with either the incumbent retailer, ActewAGL Retail, or an alternative electricity retailer. In total, there are 17 licensed retailers in the

⁹ ICRC, *Final Decision and price direction: Retail prices for non-contestable electricity customers*, Report 4 of 2008, June 2008.

¹⁰ Nominal increases can be calculated by increasing the real figure to allow for any increase in inflation.

¹¹ ICRC (Price Direction for the Supply of Electricity to Franchise Customers) Terms of Reference Determination 2008 (No. 2) (Disallowable instrument DI200-305).

ACT. Of the approximately 150,000 small customers in the ACT, nearly 31,000 (about 20% of customers) were on a negotiated contract at 30 June 2008.

1.4 Timeline

The Commission intends adopting the following timeline for the current investigation.

Activities	Dates
Release of the issues paper	Wednesday 11 February 2009
Submissions on issues paper	Friday 6 March 2009, 5.00pm
Release of draft decision	Friday 3 April 2009
Submissions on draft decision	Friday 8 May 2009, 5.00pm
Final decision and final price direction	Friday 5 June 2009
ActewAGL Retail implementation of tariff changes	From 1 July 2009

The release of the final decision and price direction by early June will allow ActewAGL Retail enough time to make necessary changes to its billing system and provide information to customers, as required by the terms of reference.

1.5 Making a submission on the draft decision

Submissions may be mailed to the Commission at:

The Independent Competition and Regulatory Commission
GPO Box 296
CANBERRA CITY ACT 2601

Alternatively, submissions may be emailed to the Commission at icrc@act.gov.au.

All submissions will be treated as public and will be published on the Commission's website unless the author of the submission indicates clearly that all or part of the submission is confidential and not to be made publicly available. Where confidential material is provided, the Commission prefers that this be under separate cover and clearly marked 'In Confidence'.

The secretariat may be contacted at the above addresses, by telephone on 6205 0799, or by fax on 6207 5887. The Commission's website is at www.icrc.act.gov.au.

1.6 Structure of the draft decision

The remainder of this report is structured as follows:

- Chapter 2 provides an overview of the methodology adopted by the Commission and sets out the draft decision.
- Chapter 3 summarises the submissions received on the issues paper.
- Chapter 4 discusses developments in other jurisdictions.

- Chapter 5 provides a detailed analysis of the efficient costs of providing retail electricity services.
- Chapter 6 examines the following non-technical matters
 - the social implications of the Commission’s decision
 - the possible inclusion of pass-through arrangements
 - matters related to continued price regulation.
- Chapter 7 contains the draft price direction.
- Appendix 1 contains a full transcript of the terms of reference.

2 Overview of methodology and draft decision

This chapter provides:

- a description of the methodology adopted by the Commission in determining the TFT, including a brief overview of the individual cost elements which contribute to the TFT
- a summary of how the cost elements have altered relative to those used in 2008–09, and the implications for the TFT
- an indication of how the Commission’s draft decision relates to outcomes in other jurisdictions.

2.1 Description of methodology and individual cost elements

The Commission determines the retail electricity price for the TFT by estimating the economically efficient cost base of an incumbent electricity retailer providing retail electricity supply services to a regulated customer segment. The Commission has developed a cost index with which it estimates the individual cost components incurred by ActewAGL Retail in providing electricity supply services to TFT customers and how those components track over time. Electricity prices are then adjusted to reflect movements in the index.

The individual cost elements which contribute to the TFT can be grouped into:

- energy costs:
 - energy purchase costs
 - energy trading and management costs
 - green costs
 - energy losses
 - National Electricity Market fees
- retail costs:
 - retail operating costs
 - retail margin
- network costs:
 - transmission and distribution network costs.

A brief description of the individual components follows.

Energy purchase costs

Energy purchase costs represent the costs incurred by the incumbent retailer in purchasing electricity from the market (that is, from electricity generators) to supply TFT customers.

Energy trading and management costs

Energy trading and management costs represent the costs incurred by the incumbent retailer in managing an energy trading desk. An energy trading desk is necessary to manage electricity purchases, which are typically bought using a forward-looking portfolio approach, and the associated financial risks.

Green costs

A range of obligations imposed by government affect the cost of electricity. These include the Australian Government's Mandatory Renewable Energy Target (MRET) scheme and the ACT Government's Greenhouse Gas Abatement Scheme (GGAS).

Energy losses

Electricity is usually generated far from where it is consumed. For example, only 2% of the electricity consumed in the ACT is produced within the territory. The remaining 98% is sourced from various generators along the east coast of Australia. The transportation of electricity through transmission and distribution networks inevitably results in some energy loss. That loss imposes a cost on the retailer, as it must purchase more electricity than it is able to sell.

National Electricity Market fees

The National Electricity Market (NEM) is the interconnected electricity grid that covers most parts of Queensland, New South Wales, the ACT, Victoria, Tasmania and South Australia. The NEM is managed by the National Electricity Market Management Company (NEMMCO), which is funded via user fees that are ultimately borne by customers. The fees cover a range of functions provided by NEMMCO which are necessary for the safe and reliable delivery of electricity to all consumers.

Retail operating costs

Retail operating costs are the costs incurred by the incumbent retailer in providing retail services to TFT customers. These costs include:

- billing services, including meter reading
- call centre costs
- customer information costs
- general operating overhead costs.

Retail margin

The retail margin represents the return the incumbent retailer earns on the investment it must make to provide retail services. Without a retail margin, the incumbent retailer would be unable to attract the funds needed to provide those services.

Transmission and distribution network costs

Transmission and distribution network costs cover the costs paid by the retailer to transport electricity over the transmission and distribution network.

Treatment of cost components

In estimating the individual cost components, the Commission draws on benchmark cost information available in the marketplace, other regulatory decisions within the retail electricity sector in Australia, and information provided by ActewAGL Retail.

Once the individual cost components are estimated, they are added together to produce an overall price (in \$/MWh). That price is then compared to the price calculated for the previous year, and an allowable percentage change in the TFT is determined.

However, the TFT is not a single tariff. Rather, it applies to a range of non-negotiated tariffs offered by ActewAGL Retail. Therefore, the Commission adopts what is referred to as a ‘weighted average price cap’. Under a weighted average price cap, ActewAGL Retail is able to rebalance the individual non-negotiated tariffs offered to franchise customers as long as the adjustment in the weighted average price does not exceed the percentage change in the overall price determined by the Commission.

The Commission then reviews the movement in the final suite of tariffs proposed by ActewAGL Retail to ensure that any adjustment in prices remains reflective of the movement in the TFT as calculated by the Commission.¹²

2.2 Summary of cost changes

Table 2-1 shows the movement in the individual cost elements between the Commission’s final decision for 2008–09 and its draft decision for 2009–10.

Table 2-1 Composition of TFT retail price for 2009–10 relative to 2008–09

	2008–09	2009-10	% Change
Energy purchase costs (\$/MWh)			
Electricity purchase cost (\$/MWh)	67.62 ^a	60.39	-10.69%
Energy contracting cost (\$/MWh)	0.72	0.75	4.35%
Green costs (\$/MWh)	4.87	5.12	5.17%
NEM fees (\$/MWh)	0.72	0.75	4.35%
Energy losses	4.86%	7.90%	62.55%
Total energy purchase cost (\$/MWh)	77.52	72.31	-6.72%
Retail operating costs (\$/MWh)	9.94	10.37	4.35%
Customer acquisition costs (\$/MWh)	–	–	
Total retail costs (\$/MWh)	9.94	10.37	4.35%
Network costs (\$/MWh)	56.06	66.34	18.34%
Total retail + network costs (\$/MWh)	143.52	149.02	3.84%
Retail margin (EBITDA, % of sales)	5.00%	5.00%	-
Total retail price (\$/MWh)	150.69	156.47	3.84%
X factor in CPI+X on MAR in \$/MWh		-0.49%	

a This figure differs from that contained in the 2008–09 final report as it has been updated for actual purchase cost information which was unavailable at the time of completing the inquiry.

¹² The Commission approves a schedule of tariffs attached to the standard customer contract; see, for example, Utilities (Variation of Terms – Standard Customer Contract) Approval 2008 (No. 1) - Notifiable Instrument NI2008-242.

As shown in Table 2-1, the changes in the cost elements with the largest affect on the TFT are:

- Electricity purchase costs
- Green costs
- Energy losses
- Network costs.

Electricity purchase costs decreased as a result mainly of the spike in purchase costs which occurred in mid-2007 working its way out of the Commission’s analysis. Green costs increased based on latest estimates of the costs incurred by ActewAGL Retail due to the Australian Government’s Mandatory Renewable Energy Target scheme and the ACT Government’s Greenhouse Gas Abatement Scheme. The increase in energy losses was due to the inclusion of an allowance for transmission network losses. Network costs have risen substantially from 2008–09 to 2009–10. This is due to an increase in distribution network charges as a result of the Australian Energy Regulator’s current inquiry into electricity distribution network charges in the ACT.

The remaining cost components were adjusted by CPI.

2.3 Outcomes in other jurisdictions

Regulated retail tariffs, which are similar to the TFT, exist in each state of the NEM except Victoria. In Victoria, retail price regulation has been removed following a finding that the market was competitive and that, therefore, price regulation was no longer required.

Of the remaining states, Queensland and NSW are the only jurisdictions undertaking reviews of regulated retail prices for 2009–10. The Queensland Competition Authority (QCA) released its draft decision for 2009–10 retail prices in December 2008.¹³ A final report from the QCA is expected 30 May 2009.¹⁴ In NSW, IPART released its draft report on 6 March 2009 and is expected to release its final report by 20 May 2009.¹⁵

Table 2-2 shows the proposed increase in retail prices from 2008–09 to 2009–10 in the ACT, Queensland and NSW.

The increase in the ACT is less than in Queensland and NSW for a number of reasons.

The 13.6% increase in Queensland is due to a 16% increase in electricity purchase cost estimates. The 16% increase is driven by an increase of 25% in the long-run marginal cost estimate of electricity purchase costs, which is based on a theoretical model, and an 8% increase in the market data-based estimate of electricity purchase costs. These two estimates are then given a 50:50 weighting which determines the overall increase of 16%. In addition, the regulatory approach adopted in Queensland assigns a higher overall weighting to

Table 2-2 Draft increases in retail prices: 2008–09 to 2009–10

Jurisdiction	% increase
ACT draft decision	3.8
Queensland draft decision	13.6
NSW draft decision ^a	18.9

a The NSW figure report is for Integral Energy. EnergyAustralia had an expected increase of 21.5% and Country Energy had an expected increase of 18.5%.

¹³ QCA, *Draft Decision, Benchmark Retail Cost Index for Electricity, 2009–10*, December 2008.

¹⁴ www.qca.org.au/electricity-retail/NEP0910/index.php.

¹⁵ IPART, *Market-based electricity purchase cost allowance—2009 review: Regulated electricity retail tariffs and charges for small customers 2007 to 2010, Electricity—Draft Report*, March 2009.

electricity purchase costs than in the ACT's approach. Furthermore, network costs have increased by 12%.

Of the 18.9% increase in NSW, 9.5% is due to increases in network costs, 3.5% is the result of the transitioning arrangements adopted over the length of the current three-year regulatory price path, and 5.9% is due to an increase in estimates of electricity purchase costs under the pricing model adopted by NSW. The overall increase of 18.9% is more than that expected in the ACT due partly to a larger increase in network costs in NSW than in the ACT. This is as a result of the Australian Energy Regulator's draft decision that additional distribution costs must be incurred in NSW relative to the ACT to ensure the appropriate maintenance and expansion of the network in that state. In addition, the methodology adopted in NSW to determine retail electricity prices had not initially factored in the spike in wholesale electricity prices that occurred during 2007. This differs from the approach adopted in the ACT, where the regulatory model is updated annually. As a result, a proportion of the increase in NSW can be considered a 'catch-up' relative to the ACT.

A more detailed discussion of the outcomes and approaches adopted in these and other jurisdictions is in Chapter 4.

3 Submissions on issues paper

In February 2009, the Commission released an issues paper setting out some of the key matters for consideration as part of this investigation. In response to the issues paper, the Commission received submissions from:

- ActewAGL Retail
- AGL Energy
- Care Financial Counselling Service
- Origin Energy
- SoftLaw Community Projects
- TRUenergy Australia.

These submissions are summarised below.

3.1 ActewAGL Retail

ActewAGL Retail provided two submissions to the Commission. The first was a letter which discussed in broad terms ActewAGL Retail's position on a range of matters raised in the issues paper. The second submission provided additional technical detail on ActewAGL Retail's position. Both submissions have been quoted throughout this report.

ActewAGL Retail argued for the removal of the regulated tariff and stated that:

... the move to full retail contestability in the ACT has delivered many benefits for consumers that are associated with a competitive retail electricity market. This has been successfully assisted through a transition period with a regulated retail tariff. However, continuing to regulate retail prices in a competitive market place threatens to deny consumers the benefits that flow from a truly competitive market, free from regulatory distortion.¹⁶

ActewAGL Retail noted the finding of the Australian Energy Market Commission (AEMC) that effective retail competition exists in Victoria and South Australia and endorsed the Commission's statement in the issues paper that the model for the removal of regulated prices adopted in Victoria could provide a starting point for the ACT.

On the current inquiry into retail prices, ActewAGL Retail stated that it:

... recommends important changes to the components that make up the decision variables of the TFT. In particular, the operation of the Commission's purchase cost/hedging model warrants review and enhancement. The model was first applied in 2007, and was used again in 2008. ActewAGL accepted the necessary simplicity of the model as it did provide certainty and consistency as part of the transition towards the removal of price regulation. However, given the ACT Government's intention to continue with the period of regulated prices in a fully competitive electricity market, it is now necessary to refine and adjust the model. This is necessary to more accurately reflect the commercial complexity and risks associated with forward purchasing energy requirements in an uncertain environment where there is the continuing spectre of ongoing price regulation'.¹⁷

¹⁶ ActewAGL Retail, submission 1 on issues paper, p. 1.

¹⁷ ActewAGL Retail, submission 1 on issues paper, p. 2.

ActewAGL Retail proposed a modification to the way electricity purchase costs are calculated such that the energy hedging assumptions be increased from the current assumption of 105% of forecast load.

In addition, ActewAGL Retail proposed a range of technical adjustments to the operation of the model.

In relation to the other cost elements, ActewAGL Retail argued that:

- retail operating costs be increased in line with the CPI but also include an allowance for customer acquisition and retention costs
- the approach adopted to the calculation of energy losses include an allowance for transmission losses.

ActewAGL Retail did not argue for any further changes to the methodology used in previous years. The determination of the cost elements for 2009–10 is discussed in Chapter 1.

ActewAGL Retail commented on the social impacts of changes to the TFT. Those comments are discussed in Section 6.1.

ActewAGL Retail also suggested that a range of pass-through events be included in relation to:

- the ACT Government's feed-in tariff
- unforeseen ACT and Australian Government environmental initiatives
- the possible introduction of a smart metering trial or rollout of smart meters
- a change in network tariffs during the 2009–10 financial year.

These events are discussed in Section 6.2.

3.2 AGL Energy

AGL Energy stated that it:

... continues to maintain its support for the removal of retail price regulation in those markets that are open to competition. It is therefore disappointing that the ACT Government has yet again requested the Commission to provide a price direction for electricity tariffs in the ACT for 2009–10 — nearly three years since the Commission undertook a review of, and found the electricity market to be competitive and subsequently recommended that removal of retail price controls.¹⁸

AGL argued that the:

removal of retail price regulation will encourage competition to develop further and allow electricity customers in the ACT to enjoy the significant benefits that arise from a fully competitive market, such as choice of retailer and potentially greater number of energy offers. Competition is the best mechanism for producing efficient prices, providing the price signals for new investment and providing incentives for the most efficient use of energy.¹⁹

Referring to the 2009–10 review, AGL stated that it 'generally supports the overall process adopted by the Commission' and that it is important that the TFT prices are set at cost-reflective

¹⁸ AGL, submission on issues paper, p. 1.

¹⁹ AGL, submission on issues paper, p. 1.

levels.²⁰ On this point, AGL stated that it ‘strongly recommends the inclusion of an allowance for acquisition costs as part of the efficient retail operating costs’.²¹

AGL stated that the:

... Commission has outlined in the Issues Paper that it has not included acquisition costs previously when setting prices as it was required to focus on determining a price direction for the supply of electricity to franchise customers, not a retailer competing for additional customers therefore assuming that a retailer does not incur this cost for franchise customers. On the contrary, AGL are of the view that with increased levels of competition, incumbent retailers will be required to compete for customers, including customers currently on franchise tariffs who may be considering transferring to a competition retailer—therefore incurring acquisition/retention costs. These costs will form part of the retailers cost base irrespective of whether they eventually sign up for a market tariff, remain on a TFT or revert from market tariff to TFT.²²

3.3 Care Financial Counselling Service

Care Financial Counselling Service (Care) provided a submission which focused on the social impacts of the Commission’s decision on retail electricity prices. Care stated that it recognised the Commission’s comment in the issues paper that it is guided by organisations such as the ACT Civil and Administrative Tribunal, Care Financial Counselling Service, the ACT Council of Social Service and other support agencies when giving effect to its obligations under section 20(2)(g) of the ICRC Act.

Care stated that the:

recognition of relevant community expertise, particularly in relation to issues impacting low income consumers is welcome. On a number of occasions however Care has expressed public concern that the Commission does not sufficiently understand or engage with the social impacts of its decisions on vulnerable customers.²³

In particular, in its submission to the 2008–09 Budget process, Care recommended a fundamental change to the Commission’s make-up and remit to ensure that it remained relevant and that its social policy obligations were given sufficient prominence. To date, the government has made no comment on that recommendation.

Care raised a number of specific concerns about the 2009–10 review of retail electricity prices. Those concerns are summarised below and discussed in detail in Section 6.1:²⁴

- Low income earners are particularly vulnerable to rising energy costs.
- Increasing cost pressures have been matched by decreasing real income in many low-income households.
- Rising costs of electricity can affect low-income consumers in multiple and compounding ways, including through the social isolation that accompanies a disconnection of supply, the potential health effects of inadequate heating or cooling, and going without other life essentials, such as medication or food.

²⁰ AGL, submission on issues paper, p. 1.

²¹ AGL, submission on issues paper, p. 1.

²² AGL, submission on issues paper, pp. 1–2.

²³ Care, submission on issues paper, p. 1.

²⁴ Care, submission on issues paper, pp. 2–3.

- The steady rise in moderate-income households suffering financial hardship appears to be continuing, despite recent interest rate cuts. The potential for loss of employment as a result of the economic downturn is an emerging area of concern.
- The Commission refers to the use of concessions to offset the impacts of price rises on low-income customers. Concessions are a useful tool, but in Care’s experience they are insufficient to deal with increasing ‘structural unfairness’.
- The Commission has repeatedly pointed to the benefits of increased competition as a driver of good consumer and economic outcomes. However, suggestions that price increases would have been greater without competition are of little value without hard data.
- Care recognises the need to focus on more and better energy-efficiency measures to counter the impacts of climate change. However, very few such measures provide genuine incentive, opportunity or adequate support to low-income households. For example, the proposed feed-in tariff will effectively exclude low-income households from participation because of the high initial financial outlay required, and low-income households will be disproportionately affected by any rise in electricity prices as a result of the feed-in tariff.

3.4 Origin Energy

Origin Energy argued that ‘if there are no significant barriers to entry and customers are free to make an adequately informed decision about their choice of retailer, retail price setting should be left to the market’.²⁵

On the current level of the TFT, Origin Energy noted that there had been a reduction in the number of customers on negotiated contracts in the ACT and that this ‘clearly suggests the offers available in the market are not sufficient to encourage customers to take up or remain on a negotiated contract.’²⁶ Origin Energy also noted the Commission’s comments in the issues paper regarding the possible distortions that may occur as a result of an inappropriately set TFT and that, because market offers tend to be based on a discount relative to the TFT, ‘it may be deduced the regulated price is not sufficient to encourage competitive offers’.²⁷ Furthermore, Origin Energy commented that many of the licensed but inactive retailers in the ACT were active in other jurisdictions and that this also indicated that the current market does not encourage retailers to enter the residential market in the ACT.

Origin Energy noted the reviews by the AEMC in Victoria and South Australia, which supported the removal of price regulation. The company noted that the removal of price regulation was to ‘occur in the context of an effective price and market monitoring scheme, price transparency and appropriate supporting arrangements for hardship customers’.²⁸

Origin Energy stated that it generally supports the cost build-up approach of the Commission, but requested that the Commission ‘review its previous position to exclude the cost for acquiring a new customer or retention costs’.²⁹ The company also stated that:

a retailers cost include the acquisition cost. Whilst these costs are excluded from the franchise price second tier retailers are unable to compete on a level playing field and/or incumbent retailers are

²⁵ Origin Energy, submission on issues paper, p. 1.

²⁶ Origin Energy, submission on issues paper, p. 1.

²⁷ Origin Energy, submission on issues paper, p. 1.

²⁸ Origin Energy, submission on issues paper, p. 2.

²⁹ Origin Energy, submission on issues paper, p. 2.

not able to retain scale. All other jurisdiction regulators have decided to make an allowance for customer acquisition costs as part of retail operating costs ... The consideration of acquisition costs is particularly important in a relatively small market like the ACT given that many of the costs are fixed and relate to the establishment of retail capability and retail brand in the community.³⁰

On social impacts, Origin Energy expressed support for the Commission's statement in the issues paper that the TFT was never intended to be a safety net measure for vulnerable customers and that, consequently, 'customers that require some assistance in paying electricity costs are best place addressed by government agencies that distribute targeted rebates or concessions to assist identifiable customers'.³¹ The company also noted that it is 'one of many national retailers that have targeted policies to assist customers that may be in temporary or permanent hardship and provide advice to all customers on energy efficient and energy conservation techniques'.³²

Origin Energy supported the inclusion of pass-through provisions for unforeseen events and argued for the inclusion of a general pass-through provision.³³

Origin Energy also commented on the introduction of the Australian Government's Carbon Pollution Reduction Scheme (CPRS), stating that:³⁴

ensuring full cost-recovery post the introduction of the CPRS will be extremely difficult while failure to do so will place a significant and unsustainable risk on retailer, consumers and, in time, the broader energy industry. Origin considers that the best option in these circumstances is for the market, rather than regulators, to determine price and drive efficiencies through the energy value chain.

While the proposed price direction covers the period prior to the expected introduction of the CPRS (that is, up to June 2010), the issue of the CPRS is still relevant to the current year. For instance:

- Irrespective of whether price regulation continues beyond 2009–10, it is essential that the 2009–10 year is used as a base year to establish prices on a cost-reflective basis, removing cross-subsidies and ensuring adequate retail margin;
- Similarly, we believe regulators need to place a policy focus on maximising competition in the retail market in the 2009–10 year based on a careful examination of both price and non-price barriers to competition;
- The expectation of the CPRS has already had an impact on the liquidity and dynamics of the forward contract market. The regulated pricing assessment process should examine carefully the effects these factors might have on pricing and price volatility for 2009–10.

3.5 SoftLaw Community Projects

SoftLaw Community Projects provided the following five comments:³⁵

1. There is little or no competition in the ACT energy market at the present time. Energy Australia has advised that they are not making offers to new customers, not even adding new services for existing customers and TRUenergy does not appear to be undertaking marketing activities.

In view of this, I suggest that the TFT should be set at as low a price as possible as it is the real price paid by the majority of customers. The idea of setting a higher price to create 'headroom' for competition is against the real interests of consumers.

³⁰ Origin Energy, submission on issues paper, pp. 2, 3.

³¹ Origin Energy, submission on issues paper, p. 3.

³² Origin Energy, submission on issues paper, p. 3.

³³ Origin Energy, submission on issues paper, p. 3.

³⁴ Origin Energy, submission on issues paper, pp. 3–4.

³⁵ SoftLaw Community Projects, submission on issues paper, p. 1.

2. The Commission intends to use the same methodology as in previous years—a building block approach. This is desirable for reasons of consistency and comparability. However this approach does have the danger of compounding errors year on year. I suggest that the Commission should look for ways of checking the final result against some external, objective measures such as the profit result of retailers or some other quantitative data supplied to the Commission by licensees.
3. The effects of the major electricity price spike in mid 2007 have now passed through. This price spike caused a major increase in the 2007–08 price and a further price increase in 2008–09. I would contend that the ‘Energy purchase cost’ element should now be significantly reduced for 2009–10.
4. The energy concession is not keeping pace with energy price rises. I suggest that the Commission needs to be far more specific about the need for concession increases when it addresses the social impacts of its Price Determinations.
5. At this stage, it is probably preferable to take a pass-through approach to the Feed in Tariff and the Carbon Pollution Reduction Schemes as the effects of these schemes are difficult to estimate at this stage. What the Commission could do, with some certainty, is to recommend Government action to prevent the financial costs of these schemes from falling on low income households.

3.6 TRUenergy Australia

TRUenergy stated that:

The level of competition in a retail energy market is directly related to the extent to which regulated prices are allowed to transition to market-based levels, facilitating the entry of new retailers and competitive activity. In the ACT, regulated electricity tariffs have been held below market-based levels, whereby the development of competition in the market remains well below that achieved in other Australian jurisdictions. For example, less than 22% of ACT customers are on a market contract, compared to over 60% in Victoria.

Of particular concern is the finding that in the past two years 4,000 additional customers have reverted to the regulated tariff, indicating that they could not obtain a better deal on a market contract. There is no better evidence in a contestable market that price setting arrangements have failed to transition regulated prices to market based levels.³⁶

TRUenergy supported the Commission’s comments in the issues paper that the significant role of the Commission in determining the price for both TFT and non-TFT customers (as most non-TFT contracts are a discount on the regulated tariff) is not sustainable or economically efficient and may in fact be reducing the long-term competitiveness of the market.

TRUenergy stated that:³⁷

The potential impact of price regulation on competitive activity is also confirmed by the January 2009 customer transfer statistics from NEMMCO, which show that high rates of competitive activity have been sustained only in Victoria, the sole jurisdiction to have removed price regulation.

Customer Transfer Rate – January 2009 (NEMMCO)	
Victoria	23.3%
Queensland	14.2%
South Australia	13.9%
New South Wales	11.1%

³⁶ TRUenergy, submission on issues paper, p. 1.

³⁷ TRUenergy, submission on issues paper, p. 1.

On the Commission’s methodology, TRUenergy stated that it ‘recommends the introduction of an allowance in retail costs for operating in a competitive market’.³⁸ The company suggested that the Commission examine the approach adopted in Queensland.

On the inclusion of pass-through arrangements, TRUenergy stated that ‘it is unclear why there is a need to specifically identify the circumstances in which the arrangements may be triggered’.³⁹ The company argued that ‘a more prudent approach would be to allow for a pass-through consideration in any circumstances in which there is a material change in the retailer’s cost base relative to the assumptions of the price path determination.’⁴⁰

³⁸ TRUenergy, submission on issues paper, p. 2.

³⁹ TRUenergy, submission on issues paper, p. 2.

⁴⁰ TRUenergy, submission on issues paper, p. 2.

4 Developments in other jurisdictions

This chapter summarises the developments in the retail electricity market in the states of the NEM and, where applicable, the approach adopted to the regulation of retail prices.

4.1 Queensland

Retail competition was introduced by the Queensland Government on 1 July 2007 for those who consume less than 100 MW/h per year. As in the ACT, those customers who do not elect to enter into a market contract may remain on a regulated tariff.

The regulated tariff in Queensland is calculated by the Queensland Competition Authority (QCA), which undertakes an investigation each year to adjust prices from 1 July. The broad approach adopted by the QCA is similar to that of the Commission, in that the QCA looks at the change in underlying costs of a retailer providing retail electricity services and determines an allowable percentage change that the retailer can apply to its regulated tariffs. The QCA determines the allowable percentage change via its Benchmark Retail Cost Index (BRCI).

The QCA was due to release its final decision on retail prices for 1 July 2009 to 30 June 2010 on 2 March 2009. However, on 25 February 2009 the QCA received a certificate of delegation from the responsible minister, extending the deadline for the final report until 30 May 2009.⁴¹

In granting the extension, the minister noted that:

... the QCA's decision on notified electricity prices for the current financial year is the subject of proceedings in the Supreme Court of Queensland, questioning the validity of the methodology used in determining the current notified prices.

I am aware that the current global economic turmoil will be making the task of setting the elements of the BRCI significantly more difficult than in previous years. Key economic data is changing on an almost daily basis.

For these reasons, and in the interests of providing 'as much certainty as possible in the decision making process that the QCA is involved in', the minister believed that 'it would be appropriate to extend the period available for consultation on the factors underlying the 2009–10 notified prices for as long as is reasonable'.

Therefore, the minister granted an extension for the due date of the QCA's final report to 30 May 2009, thereby allowing additional time for the QCA to consult. Table 4-1 shows the QCA's draft findings on the composition of the BRCI relative to its final decision in 2008–09.

⁴¹ www.qca.org.au/electricity-retail/NEP0910/index.php.

Table 4-1 QCA Final BRCI 2008–09 and Draft BRCI 2009–10

		QCA 08–09 final	QCA 09–10 draft	% change
Electricity purchase (\$/MWh)	LRMC (50%)	42.61	53.42	25%
	Purchase cost (50%)	52.91	57.34	8%
Total electricity purchase (\$/MWh)	Average	47.76	55.38	16%
20% NRET (\$/MWh)		1.35	1.91	41%
13% gas scheme (\$/MWh)		2.29	2.39	4%
Total green costs (\$/MWh)		3.64	4.3	18%
NEM fees (\$/MWh)		0.32	0.31	–3%
Ancillary services (\$/MWh)		0.39	0.37	–5%
Total (\$/MWh)		52.11	60.36	16%
Network costs (\$/MWh)	Distribution	45.3	50.8	12%
	Transmission	12.3	13.8	12%
Total network (\$/MWh)		57.6	64.6	12%
Retail operating costs (\$/cust)		80.96	84.03	4%
Acquisition costs (\$/cust)	Between retailers	20.08	20.26	1%
	To market with existing retailer	6.57	6.63	1%
Total retail cost per customer (\$/cust)		107.61	110.92	3%
Total retail costs (\$/MWh)		5.60	6.00	7%
Retail margin (%)		5%	5%	0%
BRCI		121.08	137.51	13.6%

BRCI = Benchmark Retail Cost Index; LRMC = long-run marginal cost

Source: Based on information contained in QCA, *Final Decision: Benchmark Retail Cost Index for Electricity: 2008–09*, May 2008 and QCA, *Draft Decision Benchmark Retail Cost Index for Electricity: 2009–10*, December 2008.

The methodology adopted by the QCA differs from the Commission’s approach in various ways. The main differences relate to:

- the methodology adopted for estimating electricity purchase costs
- the inclusion of customer acquisition and retention costs.

Estimating electricity purchase costs

The QCA adopts a two-step process to estimate electricity purchase costs. The first step involves estimating the cost of electricity for a hypothetical economically efficient combination of generating technologies for Queensland. The method used by the QCA to provide this estimate is sometimes referred to as a ‘long-run marginal cost’ (LRMC) approach. Under this approach, an estimate of electricity purchase costs is made based on forecasts of future demand and the cost of meeting that demand.

The second step involves estimating electricity purchase costs based on a combination of contract and spot market energy prices that a prudent retailer could be expected to pay over a two-year period. This approach has similarities with that of the Commission.

Once the two estimates are finalised, a simple average is taken and a final estimate is produced for use in the BRCI.

Customer acquisition and retention costs

In developing its BRCI, the QCA includes an allowance for customer acquisition and retention costs. In its decision for the period from 1 July 2009 to 30 June 2010, the QCA adopted a cost equivalent to \$1.45/MWh.⁴² This included an allowance for costs associated with customers switching between retailers, as well as an allowance for the cost of the incumbent retailer switching a customer from the regulated tariff to a market contract.

4.2 New South Wales

Retail competition was introduced in NSW on 1 January 2002. As in the ACT, Queensland and South Australia, customers retain the option of remaining on a regulated tariff. Since the introduction of retail competition, IPART has been responsible for determining the regulated tariff.

IPART undertook a major review of retail electricity prices in early 2007. The outcome of the review was a price path for the period from 1 July 2007 to 30 June 2010 for each of the three incumbent retailers: Country Energy, EnergyAustralia and Integral Energy.⁴³

In determining the price path, IPART undertook a cost build-up similar to that of the Commission. However, as with the methodology adopted by the QCA, there are technical differences between the two approaches in:

- the estimation of electricity purchase costs
- the inclusion of customer acquisition costs.

Estimating electricity purchase costs

In determining an appropriate estimate of electricity purchase costs, IPART considered a range of possible approaches.⁴⁴ These included:

- adopting an LRMC estimate using a methodology similar to that adopted by the QCA
- a modelling approach based on portfolio theory, whereby a retailer's costs are estimated by attempting to determine the efficient mix of electricity purchasing instruments (i.e. spot market purchases and other electricity purchase contracts)
- basing its estimates on market data such as d-cyphaTrade or data produced by the Australian Financial Markets Association.

IPART decided to adopt an approach based on portfolio theory because it considered that such an approach would provide a more cost-reflective estimate than LRMC. In early 2007, when this methodology was agreed, IPART also expressed concerns about the reliability of the data used in the calculation of the market data approach.

⁴² Based on a total allowance for customer acquisition and retention costs of \$53 million and an estimated load of 36,437,000 MWh.

⁴³ IPART, *Promoting retail competition and investment in the NSW electricity industry: Regulated electricity retail tariffs and charges for small customers 2007 to 2010, Final Report and Final Determination*, June 2007.

⁴⁴ IPART, *Promoting retail competition and investment in the NSW electricity industry*, pp 73–87.

Customer acquisition costs

IPART's terms of reference required it to consider the retail costs incurred by a 'mass market new entrant'.⁴⁵ IPART stated that it accepts that 'mass market new entrant retail costs include both retail operating costs and costs to acquire new customers'.⁴⁶

Table 4-2 shows the cost build-up and price path for Integral Energy (in 2006–07 dollars), as those factors are considered the most similar to ActewAGL Retail's.

Table 4-2 Integral Energy price path for 2007–08 to 2009–10 (2006–07 dollars)

	2007–08	2008–09	2009–10
Electricity purchase cost (\$/MWh)	57.8	56.7	52.2
Volatility allowance	1.1	1.1	1.1
Purchase cost subtotal	58.9	57.8	53.3
Energy contracting cost (\$/MWh)	–	–	–
Green costs (\$/MWh)	4.5	4.9	5.5
NEM fees (\$/MWh)	0.71	0.68	0.68
Energy losses (%)	9.10%	9.10%	9.10%
Total energy purchase cost (\$/MWh)	69.9	69.1	64.9
Retail operating costs (\$/customer/year)	75	75	75
Customer acquisition cost (\$/customer/year)	35	35	35
Adjustment for double counting	–5	–5	–5
Total retail costs (\$/customer/year)	105	105	105
Network costs	Pass-through	Pass-through	Pass-through
Retail margin	5%	5%	5%

Under the IPART methodology, network costs adjust each year and are passed through directly.

IPART's terms of reference instructed it to complete a review for the period from 1 July 2007 to 30 June 2010. However, during early 2007, when the IPART review was being conducted, there were significant increases in spot and contract electricity prices.

IPART was uncertain about the extent to which those increases would continue throughout the life of the price path and therefore about whether the increases should be included in the price direction. To address this issue, IPART elected to include an annual review mechanism which was restricted to examining electricity purchase costs each year of the three-year price path. If an annual review found that electricity purchase costs had altered by +/-10% compared with those forecast at the time of the price path determination, the price path would be adjusted to take that change into account.

The first annual review, undertaken by IPART in early 2008, concluded that electricity purchase costs had not altered by the +/-10% trigger amount. Therefore, the price path remained unchanged.

⁴⁵ IPART, *Promoting retail competition and investment in the NSW electricity industry*, p. 138.

⁴⁶ IPART, *Promoting retail competition and investment in the NSW electricity industry*, p. 93.

The second annual review of electricity purchase costs is currently underway. IPART released its draft report in March 2009. The draft report concluded that electricity purchase costs had increased by more than 10%. The draft report and associated documentation indicated that electricity purchase costs for Integral Energy (the NSW retailer considered most similar to ActewAGL Retail) for 2009–10 had increased from the estimate of \$52.2/MWh (when the price path was produced) to \$59.8/MWh (both in 2006–07 dollars). In 2009–10 dollars, this is an electricity purchase cost of \$65.0/MWh.⁴⁷

In addition to the change in tariffs due to the increase in electricity purchase costs, there are also cost increases in 2009–10 due to the pass-through of network costs and to the nature of the price path adopted by IPART. IPART estimated the nominal increase from 2008–09 to 2009–10 for a typical Integral Energy customer as 18.9%. The breakdown of the increase is shown in Table 4.3.⁴⁸

Table 4-3 Integral Energy price increase for 2008–09 to 2009–10

Network price increase	9.5%
Price increase due to transitioning in 2007 determination	3.5%
Impact of increased market-based electricity cost allowance from 2009 review	5.9%
Total percentage increase	18.9%

4.3 Victoria

Victoria has recently adopted an electricity retail market model that removes the role of a regulator in setting a TFT-equivalent price. The new regime requires electricity retailers to publish widely the prices that they offer individually. In addition, prices cannot change more frequently than once every six months. The decision to adopt this approach in Victoria was made in response to a finding by the AEMC that the market was effectively competitive and a consequent recommendation that the retail market barriers to FRC be removed.

If the responsible minister is concerned about the continuing effectiveness of competition in the retail electricity market, the minister can ask the AEMC to conduct a further review. Should the review find that conditions in the market have changed and that the market is no longer effectively competitive, a recommendation can be made that the minister once again regulate retail prices.

Studies similar to that undertaken in Victoria by the AEMC are to be carried out in other jurisdictions over the coming years. A review in the ACT is currently expected in 2010.

The decision to remove price regulation in Victoria followed the introduction of retail competition in January 2001.

The approach adopted in Victoria perhaps provides a starting point for considering the next step to facilitating FRC in the ACT. The current arrangements, in which the Commission plays such a significant role in determining the price for both negotiated and non-negotiated contracts in the market, is not sustainable or economically efficient, and may be reducing the long-term competitiveness of the market.

4.4 Tasmania

Retail competition is being introduced for larger users in Tasmania over the period from 1 July 2006 to 1 July 2009.⁴⁹ However, retail competition is yet to be introduced for small businesses and

⁴⁷ Frontier Economics, *Annual energy cost review: Final report*, February 2009, p. 24.

⁴⁸ IPART, *Market-based electricity purchase cost allowance—2009 review*, March 2009, p 12.

⁴⁹ www.power.tas.gov.au/domino/power.nsf/

residential customers in that state. The Office of the Tasmanian Energy Regulator (OTTER) has undertaken a cost–benefit analysis of the introduction of contestability for small and residential customers. The final report is with the Tasmanian Government, which is yet to make a decision.

Retail prices for small businesses and residential customers are determined in combination by the Tasmanian Government and OTTER. The government sets wholesale prices, while OTTER is responsible for determining a retail cost and margin. OTTER is also responsible for approving network charges (transmission and distribution charges) and other costs, which are passed through directly such as NEMMCO charges and green costs.⁵⁰

4.5 South Australia

In South Australia, retail competition for customers consuming less than 160 MWh per year was introduced on 1 January 2003. A regulated tariff is retained for customers who choose not to enter into a market contract. The Essential Services Commission of South Australia (ESCOSA) is responsible for determining the regulated tariff.

The most recent regulatory decision by ESCOSA covers the period from 1 January 2008 to 31 December 2010 and was released in November 2007.⁵¹ There have been no changes since then to the method of calculating the regulated retail tariff in South Australia, as opposed to the situation in NSW and Queensland, where annual reviews occur. Therefore, the comments made in the Commission’s 2008 final decision when describing the regulated retail tariff in South Australia remain unchanged. In ESCOSA’s final decision, energy purchase costs were expected to rise by a small amount from 2008 to 2009, and ESCOSA assumed a 4.1% reduction in real terms in retail operating costs from 2008 to 2009 due to expected efficiency gains in retail operating costs proposed by AGL SA.

⁵⁰ OTTER, *Investigation of Prices for Electricity Distribution Services and Retail Tariffs on Mainland Tasmania: Final Report and Proposed Maximum Prices*, September 2007.

⁵¹ ESCOSA, *2007 Review of Retail Electricity Price Path: Final Inquiry Report and Price Determination*, November 2007.

5 Analysis of efficient costs

This chapter discusses:

- the requirements of section 20 of the ICRC Act
- the methodology adopted by the Commission in determining the TFT
- the individual cost elements that contribute to the TFT.

The chapter concludes with a section that brings together the Commission's draft decision on each of the cost elements and sets out the proposed change in the TFT.

5.1 Section 20 criteria

The terms of reference state that the Commission must have regard to the requirements of section 20 of the ICRC Act. Section 20 provides a list of issues (sometimes considered as objectives) that the Commission needs to address in determining the weighted average price cap under which the TFT levels for 2009–10 will be developed.

Section 20 states that:

- (1) At the conclusion of an investigation on a reference authorising the commission to make a price direction in a regulated industry, the commission must decide on the level of prices for services in relation to the period specified in the reference and give a price direction accordingly to each person providing regulated services.
- (2) In making a decision under subsection (1), the commission must have regard to—
 - (a) the protection of consumers from abuses of monopoly power in terms of prices, pricing policies (including policies relating to the level or structure of prices for services) and standard of regulated services; and
 - (b) standards of quality, reliability and safety of the regulated services; and
 - (c) the need for greater efficiency in the provision of regulated services to reduce costs to consumers and taxpayers; and
 - (d) an appropriate rate of return on any investment in the regulated industry; and
 - (e) the cost of providing the regulated services; and
 - (f) the principles of ecologically sustainable development mentioned in subsection (5);
 - (g) the social impacts of the decision; and
 - (h) considerations of demand management and least cost planning; and
 - (i) the borrowing, capital and cash flow requirements of people providing regulated services and the need to renew or increase relevant assets in the regulated industry; and
 - (j) the effect on general price inflation over the medium term; and
 - (k) any arrangements that a person providing regulated services has entered into for the exercise of its functions by some other person.
- (3) Also, in making a decision under subsection (1), the commission must allow a declared fee under section 4C (Declared fees to be passed on to consumers) to be passed on in full to consumers of the service.

- (4) In a price direction, the commission must indicate to what extent it has had regard to the matters referred to in subsection (2).
- (5) For subsection (2) (f), *ecologically sustainable development* requires the effective integration of economic and environmental considerations in decision-making processes through the implementation of the following principles:
 - (a) the precautionary principle—that if there is a threat of serious or irreversible environmental damage, a lack of full scientific certainty should not be used as a reason for postponing measures to prevent environmental degradation;
 - (b) the inter-generational equity principle—that the present generation should ensure that the health, diversity and productivity of the environment is maintained or enhanced for the benefit of future generations;
 - (c) conservation of biological diversity and ecological integrity;
 - (d) improved valuation and pricing of environmental resources.

One of the objectives of the Commission’s analysis is to ensure that the retail services are delivered in a reasonably efficient manner (s. 20(2)(c)) to reduce the costs paid by consumers, without the exploitation of monopoly power (s. 20(2)(a)), which might otherwise raise costs for consumers. The costs it considers for ActewAGL Retail (s. 20(2)(e)), however, must also allow for an appropriate rate of return (s. 20(2)(d)) and a financially viable outcome for the service provider (s. 20(2)(i)).

There is tension between these objectives. In part, the Commission balances them by considering actual cost information provided by ActewAGL Retail and by building a cost base from benchmark data derived from public sources or from market data. In practice, the Commission relies heavily on the latter information to address the information asymmetry that can arise between the incumbent and the regulator.

Throughout this chapter, the Commission notes how it has considered the requirements of section 20 of the ICRC Act.

5.2 Methodology

The Commission determines the retail electricity price for the TFT by estimating the economically efficient cost base of an incumbent electricity retailer providing retail electricity supply services to a regulated customer segment. It does this by estimating the individual cost components incurred by ActewAGL Retail in the provision of electricity supply services to TFT customers. The individual cost components are discussed in detail in Section 5.3.

In estimating the individual cost components, the Commission draws on benchmark cost information available in the marketplace, other regulatory decisions within the retail electricity sector in Australia and information provided by ActewAGL Retail.

Once the individual cost components are estimated, they are added together to produce an overall price (in \$/MWh). That price is then compared to the price calculated for the previous year and an allowable percentage change in the TFT determined. This index-based approach can be thought of as similar to the way in which the Australian Bureau of Statistics (ABS) compiles the CPI. The ABS selects a basket of goods and assigns relative weightings to each of the items. The CPI then measures how the cost of the basket of goods fluctuates over time.

The TFT is not a single tariff. Rather, it applies to a range of non-negotiated tariffs offered by ActewAGL Retail. Therefore, the Commission adopts a ‘weighted average price cap’. Under the cap, ActewAGL Retail is able to rebalance the individual non-negotiated tariffs offered to franchise customers as long as the adjustment in the weighted average price does not exceed the percentage change in the overall price determined by the Commission.

The Commission then reviews the movement in the final suite of tariffs proposed by ActewAGL Retail to ensure that any adjustment in prices remains reflective of the movement in the TFT as calculated by the Commission. The final approved retail tariffs that constitute the TFT are then published by the Commission as a notifiable instrument.⁵²

5.3 Retail electricity cost elements

The individual cost components which contribute to the overall retail cost of electricity can be grouped into the following categories:

- energy costs
 - energy purchase costs
 - energy trading and management costs
 - green costs
 - energy losses
 - NEM fees
- retail costs
 - retail operating costs
 - retail margin
- network costs
 - transmission and distribution network costs.

The remainder of this section discusses each of these elements in detail. Each cost element is discussed in terms of:

- its definition
- the methodology adopted in the 2008–09 investigation
- any matters raised in submissions to the issues paper
- the proposed methodology to be adopted for the 2009–10 investigation
- the Commission’s draft decision
- how the Commission has considered the requirements of section 20 of the ICRC Act in reaching its decision.

⁵² The approved schedule of tariffs is attached to the standard customer contract. For example, see Utilities (Variation of Terms—Standard Customer Contract) Approval 2008 (No. 1), Notifiable Instrument NI2008-242.

5.3.1 Energy purchase costs

Definition

Energy purchase costs represent the costs incurred by the incumbent retailer in purchasing electricity from the market (that is, from electricity generators) to supply TFT customers.

2008–09 methodology

The Commission cannot readily and directly observe the actual cost of electricity to the incumbent retailer, as that cost comprises myriad contracts and supply arrangements that are negotiated at various points in time in advance or over the year for which the TFT is set.

The approach adopted by the Commission has been to estimate the cost of purchasing electricity, using publicly available market data on historical and future electricity prices combined with a range of assumptions aimed at mimicking the purchasing activities of an electricity retailer.

The key elements of the Commission’s methodology relate to the:

- source of data
- forward purchasing strategy
- load profile shape.

During 2008–09 (and 2007–08), the Commission sourced its data from d-cyphaTrade, an electricity trading house. The Commission purchased data from d-cyphaTrade on electricity futures and swap prices and used that information to estimate average peak, shoulder and off-peak electricity prices.

The Commission then assumed a forward purchasing strategy in which the retailer begins to build its portfolio 24 months in advance. It is assumed that the forecast load is hedged for each 6-month period of future delivery.

Table 5-1 shows the position assumed by the Commission for the incumbent retailer at 30 June 2008 (as used in the 2008–09 decision) and illustrates how forward purchases are built up over the preceding 24-month period. It is assumed that the retailer hedges to 105% of forecast load as at the beginning of the delivery period.

Table 5-1 Assumed forward purchasing strategy (for delivery 30 June 2008)

Purchase period (ending date)	June 2006	December 2006	June 2007	December 2008
Forecast load hedged by contract (%)	25%	25%	30%	25%

The load profile shape assumed by the Commission is shown in Table 5-2. The load profile shape is used to estimate the relative proportion of purchases of peak, shoulder and off-peak electricity.

Table 5-2 Assumed load profile shape

Approximate pricing profile	Hours/day	Time (%)
Peak	4.5	18.6%
Shoulder	7.6	31.6%
Off-peak time	11.9	49.8%
Total	24.0	100.0%

The Commission then calculated its estimate of the electricity purchase costs using the d-cyphaTrade data and the assumed forward purchasing strategy and load profile shape. Based on this methodology, the Commission estimated electricity purchase costs to be \$68.90/MWh for 2008–09.

Matters raised in submissions on the issues paper

Data source

In the course of retail electricity inquiries in Queensland and New South Wales, it has been suggested that the market data provided by d-cyphaTrade may not be representative. Alternative data sources have been suggested, such as the adoption of data provided by market brokers, the most well-known of which is ICAP.

These calls for an investigation of alternative data sources are in response to reduced volumes of trades in future years, especially peak period trades.

Hedging assumption

ActewAGL Retail argued that:

the current assumption in the purchase cost model that a retailer hedges to 105% of forecast load does not represent the behaviour of an efficient and prudent operator.⁵³

ActewAGL Retail stated that, in order to manage the volatility of demand, it enters into two types of hedging contracts: swaps and caps. Swaps are used to purchase a defined amount of energy at a certain time and at a certain price. Caps are then purchased as a form of ‘insurance’ for those times when the retailer has not purchased enough energy to meet demand and would therefore have to buy energy on the spot market. Given that those times are likely to be periods of peak demand on the whole network (and, subsequently, high price), the caps are taken out to limit the exposure to the spot price, which can reach a maximum of \$10,000/MWh.

ActewAGL Retail proposed that:

the purchase cost be increased to better represent the prudent costs for managing risk and meeting the demand or energy for this regulated market segment.⁵⁴

Proposed 2009–10 methodology

The Commission has adopted an ‘index’-based approach to determining the change in the TFT from one year to the next, notwithstanding that the index is calculated using price per MWh

⁵³ ActewAGL Retail, submission 2 on issues paper, p. 8.

⁵⁴ ActewAGL Retail, submission 2 on issues paper, p. 10.

estimates. The methodology developed by the Commission looks at the relative changes in the cost components and is similar to the approach adopted by the ABS when determining the CPI.

The Commission first formally developed the index for use in determining the appropriate change in tariffs from 2006–07 to 2007–08. In developing the index, the Commission analysed its earlier three-year decision from 1 July 2003 to 30 June 2006 and the following decision, which applied during the 2006–07 financial year. In this analysis, the Commission investigated the cost components upon which it had made those decisions and ensured that all relevant cost components (with appropriate weightings) were included in the 2007–08 index.

ActewAGL Retail has proposed an adjustment to the hedging assumption used in the calculation of the index to determine the change in the TFT from 2008–09 to 2009–10. The purpose of developing an index is to track the changes in its components from one year to the next. Under such an approach, in order to maintain the integrity of the index, it is necessary that there be consistency in the cost components and the way they are determined.

However, that is not to say that, once developed, an index must remain unchanged. For example, an alternative data source could be adopted if it were shown to be more appropriate. Similarly, the cost components need not remain static. For example, the basket of goods considered by the ABS in developing the CPI is updated to reflect changes in consumer purchasing patterns. If it can be shown that there is a technical problem in the operation of the model used to calculate the index, the model should be updated.

There are four possible circumstances in which a change may be necessary:

- A relevant cost component of the index has failed to be included. If so, there is a legitimate claim for the inclusion of an additional component in the index.
- Conditions have changed, rendering the current cost components of the index no longer representative of the 'true' basket. If so, it may be necessary to update the cost components. It must also be demonstrated that the proposed change is material.
- There is a problem with the underlying data used to construct the model. In this case, an alternative data source may be adopted if it can be shown that the alternative source is superior and that the change between the sources results in a material difference.
- There is a technical problem with the way in which the index is calculated. If so, there is a legitimate claim to adjust the methodology.

The Commission's preferred approach to adjusting the model is as follows:

- Construct an updated model that incorporates the adjustments.
- Populate the updated model with the data for 2007–08, 2008–09 and 2009–10.
- Determine the 2009–10 total retail price.
- Determine the percentage change between the 2008–09 total retail price, as determined under the old model, and the 2009–10 total retail price, as determined under the updated model.
- Calculate the X factor using the Fisher equation: $(1 + \text{percentage change}) / (1 + \text{CPI}) - 1$.

For electricity purchase costs, there is a question regarding the appropriateness of the use of d-cyphTrade data compared with ICAP data. In addition, ActewAGL Retail proposed an adjustment to the assumed hedging arrangements of the forward purchasing strategy.

Data source

In Queensland it has been argued by AGL in its submissions to the QCA inquiry that there are preferable data sources to d-cyphaTrade on the grounds that the futures market as reported by d-cyphaTrade is relatively thin.⁵⁵ It has been argued that this is especially the case for peak futures contracts and that the prices reported by d-cyphaTrade might be skewed by the low volume of trades. The claim about the thinness of the market for future years is a concern, given that the model developed by the Commission relies on peak and base contract information over the coming 24-month period.

The Commission has investigated the d-cyphaTrade data and notes that the ‘open interest’, which is a measure of the number of contracts in the market, is low for NSW peak futures and cap contracts for 2010 onwards—that is, there are adequate market data available for the coming 12-month period, but the volumes drop away significantly thereafter. However, the Commission notes that the thinness of the market does not apply to base contracts, which are well represented through to the end of 2010, as required under the Commission’s modelling (which relies on prices for the coming 24-month period). Table 5-3 shows open interest for NSW, Victoria, Queensland and South Australia peak and off-peak futures and caps contracts at 23 March 2009.

Table 5-3 Futures and caps, open interest at 23 March 2009

	NSW		Vic.		Qld.		SA	
	Peak ^a	Base ^b	Peak	Base	Peak	Base	Peak	Base
Q12009	231	2,837	459	2,686	263	2,844	20	272
Q22009	166	2,813	180	2,326	50	2,244	18	120
Q32009	183	2,921	125	1,991	45	2,393	0	115
Q42009	232	2,555	137	2,218	118	2,639	5	125
Q12010	12	1,140	35	1,449	60	1,419	0	6
Q22010	3	894	27	959	0	665	0	2
Q32010	1	564	12	714	0	741	1	1
Q42010	1	588	12	726	0	736	0	1
Q12011	0	25	0	210	0	226	0	0
Q22011	0	15	0	210	0	249	0	0
Q32011	0	15	0	170	0	205	0	0
Q42011	0	15	0	170	0	205	0	0
Q12012	0	0	0	0	0	0	0	0
Q22012	0	0	0	0	0	0	0	0
Q32012	0	0	0	0	0	0	0	0
Q42012	0	0	0	0	0	0	0	0
Total	829	14,382	987	13,829	536	14,566	44	642

a Peak = futures

b Base = futures + caps

The Commission notes how the level of open interest has altered over time. Table 5-4 shows the open interest in the market at 26 March 2007, about the time at which the Commission developed the index.

⁵⁵ CRA International, *Final Second Report: Calculation of the Benchmark Retail Cost Index 2009–10*, December 2008, pp. 97–98 and AGL submission to QCA inquiry, *Comments on 2nd Draft CRA Report*, 13 November 2008, p. 5.

Table 5-4 Futures and caps, open interest at 26 March 2007

	NSW		Vic.		Qld		SA	
	Peak ^a	Base ^b	Peak	Base	Peak	Base	Peak	Base
Q12007	205	1,304	674	692	230	920	85	441
Q22007	210	880	493	1,036	70	561	0	386
Q32007	130	1,053	510	845	90	589	0	311
Q42007	131	947	520	890	50	795	0	230
Q12008	209	814	630	705	115	705	20	206
Q22008	77	912	295	680	80	710	0	136
Q32008	52	712	210	600	70	605	0	82
Q42008	57	682	195	655	105	635	0	77
Q12009	5	475	155	247	0	450	0	20
Q22009	5	415	40	255	5	430	0	20
Q32009	0	310	35	225	0	330	0	20
Q42009	0	310	35	215	0	340	0	20
Q12010	0	195	0	35	0	160	0	0
Q22010	0	195	0	35	0	160	0	0
Q32010	0	195	0	0	0	160	0	0
Q42010	0	195	0	0	0	160	0	0
Total	1,081	9,594	3,792	7,115	815	7,710	105	1,949

a Peak = futures

b Base = futures + caps

As shown in Table 5-3 and Table 5-4, the level of open interest in futures and caps has declined between 2007 and 2009, especially in NSW. The Commission is aware of a number of possible reasons for the drop-off in the volume of contracts:

- There may be uncertainty about future weather conditions. For example, the recent drought led to an increase in wholesale purchase price volatility during 2007. This was partly due to shortages in the volumes of water used for electricity generation in turbines and for cooling. The shortages and the resulting increased price volatility may have had an adverse impact on some generators, affecting their willingness to offer forward purchase contracts. In addition, retailers may have become more wary about entering into longer term contracts, given the high level of volatility seen over recent years.
- There may be uncertainty in the market as a result of the Australian Government's proposed Carbon Pollution Reduction Scheme which may be affecting the willingness of generators to offer contracts and retailers to purchase these contracts.
- There is ongoing uncertainty about the potential sale of generation and retail businesses in NSW. It is possible that this uncertainty may be affecting the offers that generators are willing to make to the market and that retailers are willing to purchase.
- Generators and retailers may have found that it is more efficient to offer and purchase peak futures contracts only 12 months in advance, as opposed to 24 months.
- A greater number of trades may be occurring bilaterally and, as such, are not being reported on the market.

The Commission is unable to draw any definitive conclusions to explain the drop-off in open interest as reported by d-cyphaTrade. However, before altering the data source from d-cyphaTrade to ICAP, it is necessary to establish that the ICAP data do not suffer from the same problems.

The d-cyphaTrade and ICAP data both incorporate trades as reported on the Sydney Futures Exchange. However, the ICAP data also incorporate additional trades as brokered directly by ICAP, and therefore potentially have a greater volume of trades compared with d-cyphaTrade data. In general terms, the d-cyphaTrade data can be considered a subset of the ICAP data, as the ICAP data include the d-cyphaTrade data plus ICAP's own trade data.

The Commission has a number of reservations about the ICAP data. ICAP includes a number of off-market trades, but the price and volume of those trades are unknown and unverifiable. In addition, ICAP reports only average prices. Therefore, there is a lack of detail and transparency associated with the ICAP data.

Furthermore, the Commission understands that the reduction in the level of open interest as shown in Table 5-3 and Table 5-4 is not restricted to the trades as they occur on the Sydney Futures Exchange and are subsequently reported by d-cyphaTrade. As discussed above, a range of matters have led to a structural adjustment in the electricity purchase market, reducing the volume of futures and cap contracts. This structural change has affected the volume of trades facilitated by ICAP and subsequently reported in its data. While a potentially greater volume of trades is represented in the ICAP data, that data have also suffered from a reduction in the volume of futures and cap trades.

Therefore, the issue becomes how to best address the reduction in the overall level of futures and cap trades in the market, as opposed to whether to adopt d-cyphaTrade or ICAP data. The Commission notes that there is still a large level of open interest reported by d-cyphaTrade for the coming 12-month period (that is, Q1 2009, Q2 2009, Q3 2009 and Q4 2009). At this time, the Commission is also more comfortable with continuing the use of the d-cyphaTrade data, given its use in previous years and its concerns about the transparency of the ICAP data.

Therefore, the Commission's preferred approach for the draft decision is to continue to use the d-cyphaTrade data, but to adjust the model so that the futures price is based on the data available for the coming 12 months, as opposed to the coming 24 months as previously used. There is no need to adjust the approach adopted for base contracts, as the market remains 'thick' and therefore representative of the market price for electricity.

To adjust the model for use in the draft decision, the Commission will effectively repopulate the index from 2006–07 onwards using d-cyphaTrade data for the coming 12 months of futures prices and 24 months of base prices, and roll forward the model to determine an appropriate adjustment from 2008–09 to 2009–10.

As noted above, the matter of the appropriateness of d-cyphaTrade data has also been raised in other jurisdictions. In Queensland, AGL submitted that there were alternative, more appropriate, sources than d-cyphaTrade for estimating electricity purchase costs, such as the market information provided from a number of electricity market brokers (such as that provided by ICAP). The QCA did not have enough time to assess the claim before the release of its draft report, and opted to retain the d-cyphaTrade data but investigate the alternative sources prior to the final report.⁵⁶

⁵⁶ CRA International, *Final Second Report: Calculation of the Benchmark Retail Cost Index 2009–10*, December 2008, pp. 97–98 and AGL submission to QCA inquiry, *Comments on 2nd Draft CRA Report*, 13 November 2008, p. 5.

In the recent draft report by IPART into the market-based electricity purchase cost allowance for 2009–10, it stated that:

At the time of its 2007 determination IPART decided to base its decision on expert advice rather than publicly available information on future electricity wholesale prices, such as that provided by d-cypha. This is because, at the time, trading in future contracts was a relatively small proportion of physical demand and there were doubts about whether d-cypha indexes adequately represented electricity wholesale prices. Since then trading in electricity future contracts has expanded considerably and d-cypha indexes are more likely to be representative of future electricity wholesale prices.⁵⁷

However, to maintain consistency with the approach determined in 2007, IPART maintained its methodology based on a portfolio theory estimation of electricity purchase costs. Despite this, it is interesting to note IPART's increased confidence in the d-cyphaTrade data.

Hedging assumption

ActewAGL Retail has argued that the current hedging assumption of 105% of forecast load does not accurately reflect a prudent electricity retail purchasing strategy. Rather, ActewAGL Retail submitted that it estimates the necessary cost to cover a prudent retailer is significantly higher.

There is a legitimate claim to adjust the Commission's index and modelling if it can be demonstrated that a relevant cost component has been omitted. Based on the claim from ActewAGL Retail that a prudent purchasing strategy would see a retailer incur costs in excess of 105% of the energy purchase cost, the Commission has undertaken a preliminary investigation of a range of market sources as well as seeking additional information from ActewAGL Retail. The Commission intends undertaking a more detailed investigation prior to the final report. Based on these preliminary investigations, the Commission accepts the argument from ActewAGL Retail that the current assumption of 105% may not reflect accurately the operations of a prudent retailer. However, it is important to note that the Commission's approach to modelling is not to try to replicate the behaviour of ActewAGL Retail but rather to develop an index which tracks the movements in costs of a prudent operator.⁵⁸

The Commission's preliminary investigations indicated that the hedging approach adopted by electricity retailers varies depending on whether the retailer is purchasing for peak or off-peak time periods as well as varying depending on the time of year for which these purchases are being made. The Commission understands that the different approaches, and subsequently different costs incurred, between servicing base and peak loads is related to the expected volatility of the load.

Peak periods apply only to high demand hours on business days, while base load covers all other times. Base load can be forecast with a greater degree of certainty relative to peak loads. As such, an electricity retailer can make forward purchases with a higher level of confidence and therefore does not have to incur as many additional costs related to managing volatility as it does when purchasing for peak periods. Based on the Commission's preliminary investigations, it considers that a modelling assumption of 105% of the energy purchase costs is appropriate to compensate ActewAGL Retail for uncertainty regarding base load purchases.

⁵⁷ IPART, *Market-based electricity purchase cost allowance—2009 review: Regulated electricity retail tariffs and charges for small customers 2007 to 2010, Electricity—Draft Report*, March 2009, p. 2.

⁵⁸ This is not to suggest that ActewAGL Retail is not prudent, but rather that the Commission must look at this issue from an independent position rather than simply accept ActewAGL Retail's claimed hedging arrangements as those that should apply to the setting of the TFT.

Peak periods cover times of greater uncertainty and volatility in electricity demand than base periods. For example, it is difficult to forecast summertime peaks associated with afternoon air-conditioner use days in advance, let alone months or years in advance. As such, an electricity retailer is likely to incur additional costs associated with managing this risk. The Commission investigated the extent of these additional costs and its preliminary view is that an adjustment to the model to incorporate a cost allowance of 120% for peak electricity purchases is a fair representation of the costs likely to be incurred by a prudent retailer.

In addition, and as noted above, the Commission has reconsidered the reliability of the d-cyphaTrade data. The Commission concluded that while base contract information was available for the coming 24-month period, there was a need to adjust the period for which the Commission draws peak contract information such that it only covers the coming 12-month period. Taking into account this adjusted assumption and the Commission’s preliminary findings regarding hedging strategies, the assumed forward purchasing strategy of a prudent retailer for use in the Commission’s model is shown in Table 5-5.

Table 5-5 Assumed forward purchasing strategy (for delivery 30 June 2009)

Purchase period (ending date)	June 2007	December 2007	June 2008	December 2008
Peak forecast load hedged by contract (%)			80%	40%
Base forecast load hedged by contract (%)	25%	25%	30%	25%

The Commission intends investigating further the assumptions regarding appropriate hedging assumptions in preparing the final report.

Draft decision

The Commission’s draft decision is to continue to use d-cyphaTrade data. However, to address concerns about the thinness of the peak futures market in coming years, it will adjust its model so that the model includes only peak data for the coming 12-month period. Base contract information will continue to be taken from the coming 24-month period. An adjustment to the hedging assumption will be made, to increase it from 105% to 120% for peak period purchases. No adjustment will be made to the base period purchase hedging assumption. The Commission will investigate further these hedging assumptions before the final report.

The adoption of these assumptions results in an estimate of electricity purchase costs of \$60.39/MWh. This estimate will be updated prior to the final report to take into account the latest market data, given that approximately two months of additional data will be available.

Section 20 requirements

The Commission has adopted an approach based on independent and verifiable market data and a range of assumptions based on industry standards to provide a reasonable estimate of the cost of purchasing wholesale energy from a competitive market pool. In developing this approach, the Commission has developed a methodology which it considers provides a balance between the social imperatives of the provision of reliable electricity to TFT customers (ss. 20(2)(b),(g)), the reduction of market power through the setting of the lowest efficient prices in an open market pool (ss. 20(2)(a), (c), (h), (i) and (k)), and the need for the financially sustainable continuation of the TFT offer by the incumbent retailer in the ACT (ss. 20(2)(d), (e), (i) and (j)).

5.3.2 Energy trading and management costs

Definition

Energy trading and management costs represent the costs incurred by the incumbent retailer in managing an energy trading desk. An energy trading desk is necessary to manage electricity purchases, which are typically bought using a forward-looking portfolio approach, and the associated financial risks.

2008–09 methodology

In the 2007–08 draft decision, the Commission examined market data and concluded that an allowance of \$0.70/MWh was reasonable to recover costs associated with energy hedging, contracting and management. The Commission did not receive any comments in response to the draft decision and subsequently adopted \$0.70/MWh for the final 2007–08 decision.

In preparing the 2008–09 decision, the Commission proposed to simply adjust the 2007–08 figure to account for inflation. Based on that approach, the Commission included an allowance of \$0.72/MWh in the 2008–09 draft decision. Once again, the Commission received no responses addressing the calculation of the allowance for energy hedging, contracting and management. Therefore, the Commission adopted a value of \$0.72/MWh in the final decision for 2008–09.

Matters raised in submissions on the issues paper

No submission's were received which proposed an adjustment to the 2008–09 methodology.

Proposed 2009–10 methodology

The Commission proposes to adopt the methodology whereby the allowance for energy trading and management costs is adjusted by CPI. The Commission has calculated a CPI figure of 4.35% using the following formula, populated using the ABS All Groups Index for the weighted average of eight capital cities:

$$CPI_t = \frac{CPI_{March(t-2)} + CPI_{June(t-2)} + CPI_{Sept(t-1)} + CPI_{Dec(t-1)}}{CPI_{March(t-3)} + CPI_{June(t-3)} + CPI_{Sept(t-2)} + CPI_{Dec(t-2)}} - 1$$

The formula produces a CPI figure of 4.35% to apply in 2009–10. This results in an allowance of \$0.75/MWh (0.72×1.0435).

Draft decision

The Commission's draft decision is to adopt an allowance of \$0.75/MWh for energy trading and management costs.

Section 20 requirements

The recovery of costs associated with energy hedging, contract and management requirements meets the economic efficiency objective in s. 20(2)(c), as well as the cost-recovery provisions of s. 20(2)(e).

5.3.3 Green costs

Definition

Green costs cover a range of obligations, imposed by governments, that affect the cost of electricity. These include the Australian Government's Mandatory Renewable Energy Target (MRET) scheme and the ACT Government's Greenhouse Gas Abatement Scheme (GGAS).

Green costs can also cover other costs, such as costs incurred as part of the ACT Government's feed-in tariff scheme.

The ACT Government's solar feed-in tariff regime commenced on 1 March 2009 and has the potential to impose a 'green cost' on ActewAGL Retail. The feed-in tariff regime is initially aimed at households and small businesses and is capped at systems up to 30 kilowatts (kW). Those with a system capacity up to 10 kW will receive 50.05 cents per kilowatt hour (kWh), while those with a capacity between 10kW and 30 kW will receive 40.04 cents per kilowatt hour.⁵⁹ However, in announcing the scheme, the minister foreshadowed a possible increase in eligibility to give larger producers the opportunity to take advantage of the scheme. An announcement clarifying this possibility is expected by June 2009.⁶⁰

While the retail business is responsible for purchasing the electricity from the eligible households and small businesses, the scheme has been designed in such a way that the costs are passed through to the distribution business and subsequently included in distribution charges.

Given that costs incurred by the retailer are to be recovered from the distribution business, there is likely to be little direct impact on retailers. However, ActewAGL Retail has proposed the inclusion of a pass-through arrangement to cover any costs it is unable to recover. The pass-through claim is discussed in Section 6.2.

2008–09 methodology

2008–09 green costs were based on information provided by ActewAGL Retail and subsequently verified by the Commission.

At the time of finalising the 2008–09 price path, the ACT Government had yet to finalise its feed-in tariff arrangements, so the extent of any costs likely to be incurred by ActewAGL Retail was unknown. Therefore, the Commission included a pass-through event to cover a situation in which the scheme is introduced during the 2008–09 financial year and imposes costs on ActewAGL Retail.

The trigger event allowed for a review of the determination if the costs incurred were more than \$250,000. As the scheme was only introduced from 1 March 2009 and the costs of the scheme are passed through to the distribution business, no claim has been made.

⁵⁹ Department of the Environment, Climate Change, Energy and Water, *Fact Sheet: Proposed ACT electricity feed-in tariff scheme*, released 10 February 2009.

⁶⁰ Speech by Minister Corbell announcing the feed-in tariff scheme, 10 February 2009.

Matters raised in submissions on the issues paper

ActewAGL Retail submitted that it:

has estimated its Green Costs are made up of a cost to meet liability under the Mandatory Renewable Energy Target (MRET) and a cost to meet liability under the Greenhouse Gas Abatement Scheme (GGAS).⁶¹

ActewAGL Retail provided a spreadsheet to the Commission which set out its estimates of its green cost obligations under the MRET and GGAS initiatives.

Proposed 2009–10 methodology

The Commission has verified the ActewAGL Retail estimate of green costs and proposes to adopt those values.

Draft decision

The Commission's draft decision is to adopt an allowance for green costs of \$5.12/MWh.

Section 20 requirements

The Commission considers that an allowance for green costs is consistent with s. 20(2)(e), which requires the Commission to have regard to the principles of ecologically sustainable development. In addition, including an allowance for green costs on a cost-recovery basis (s. 20(2)(e)) ensures that consumers are protected from the potential misuse of monopoly power (s. 20(2)(a)).

5.3.4 Energy losses

Definition

Electricity is typically generated far from where it is consumed. For example, only 2% of the electricity consumed in the ACT is produced within the territory; the remaining 98% is sourced from various generators along the east coast of Australia.

The transportation of electricity through transmission and distribution networks inevitably results in some energy loss. That loss imposes a cost on the retailer, as it must purchase more electricity than it is able to sell.

2008–09 methodology

Before the beginning of each financial year, NEMMCO publishes a report in which it identifies loss factors, which are then used to determine the cost of the losses.

In 2008–09, energy losses of 4.86% were included in the Commission's final decision.

⁶¹ ActewAGL Retail, submission 2 on issues paper, p. 10.

Matters raised in submissions on the issues paper

ActewAGL Retail submitted that an allowance should be included for distribution as well as transmission losses. This approach differs from that adopted in previous years, where an allowance had only been granted for distribution losses.

ActewAGL Retail submitted:

The distribution loss factors and transmission loss factors for 2009/10 are not yet available. There are two transmission loss factors for the ACT: one for energy supplied at 132 kV from Canberra and the other for the 66 kV supply from Queanbeyan. As the bulk of the supply to TFT customers in the ACT is through the 132 kV supply point, it is proposed to use the transmission loss factor for that supply point.⁶²

Proposed 2009–10 methodology

In previous years, the Commission has established an energy loss cost component based solely on distribution losses. The Commission has considered ActewAGL Retail's proposal that an allowance be granted which includes transmission losses as well as distribution losses. Such an approach would be an alteration of the Commission's index. A component for transmission losses would be an additional cost component; it could be included on the grounds that it had previously failed to be included (as discussed in relation to hedging costs in Section 5.3.1).

The Commission has now confirmed that the electricity prices it uses are based on the price at the West Sydney reference node. Therefore, it is reasonable that transmission losses be included to account for the transmission losses associated with transporting electricity from western Sydney to the ACT.

The Commission proposes to include an allowance for transmission losses from 2009–10 as a one-off addition to the cost base. A 'catch-up' for previous years is not considered appropriate, as the matter has only now been brought to the Commission's attention and is only relevant in future years.

As noted by ActewAGL Retail, the loss factors for 2009–10 have yet to be finalised. Therefore, the Commission proposes to base the figures to be included in the draft decision on estimates of the loss factors for 2009–10. Those figures will then be updated before the release of the final report, following the finalisation of the relevant figures for 2009–10 by NEMMCO.

The Commission proposes to include an allowance for electricity losses based on a combination of distribution and transmission losses, calculated as $(1 + \text{distribution losses}) \times (1 + \text{transmission losses})$. This methodology results in a loss allowance of 7.90% (1.0478×1.0298).

Draft decision

The Commission proposes to include an allowance for electricity losses of 7.90%, which will be updated in the final report to take into account 2009–10 transmission and distribution loss factors to be notified by NEMMCO.

Section 20 requirements

The Commission notes that the recovery of these energy losses meets the objectives of ss. 20(2)(d), (e), (h) and (i) by ultimately requiring customers to pay for the energy they consume.

⁶² ActewAGL Retail, submission 2 on issues paper, p. 10.

As this approach to energy losses in the distribution and transmission system is mandated in the NEM framework, it also meets the objectives of s. 20(2)(k).

5.3.5 National Electricity Market fees

Definition

The NEM is the interconnected electricity grid that covers most parts of Queensland, NSW, the ACT, Victoria, Tasmania and South Australia. The NEM is managed by NEMMCO, which is funded via user fees that are ultimately borne by customers. The fees cover a range of functions provided by NEMMCO that are necessary for the safe and reliable delivery of electricity to all consumers.

2008–09 methodology

In 2008–09, the Commission adopted the NEM fees as determined by IPART in its 2007 decision, suitably adjusted for inflation. This resulted in an allowance of \$0.72/MWh.

Matters raised in submissions on the issues paper

ActewAGL Retail proposed that the NEM fees for 2009–10 be based on those adopted in 2008–09 following an adjustment for inflation.⁶³

Proposed 2009–10 methodology

The Commission proposes to adopt the methodology in which the allowance for NEM fees is adjusted by the CPI. The Commission has calculated a CPI figure of 4.35%. This results in an allowance of \$0.75/MWh (0.72×1.0435).

Draft decision

The Commission proposes to adopt NEM fees of \$0.75/MWh.

Section 20 requirements

The Commission recognises that the recovery of NEM fees meets the objective of ss. 20(2)(d), (e) and (i). The payment of ancillary services fees assists NEMMCO in providing for safe and reliable delivery of electricity to all consumers, which supports the objectives of s. 20(2)(b).

5.3.6 Retail operating costs

Definition

Retail operating costs are the costs incurred by the incumbent retailer in providing retail services to TFT customers. These costs include:

- billing services, including meter reading
- call centre costs
- customer information costs
- general operating overhead costs.

⁶³ ActewAGL Retail, submission 2 on issues paper, p. 10.

2008–09 methodology

The Commission adopted an estimate of \$85 per customer for retail operating costs for 2003–04 in its price direction for the period from 2003–04 to 2006–07.⁶⁴ In subsequent years, the \$85 figure has been adjusted for inflation; in 2008–09, \$97.12 per customer was adopted as a reasonable estimate of retail operating costs.

Once an estimate of retail operating cost per customer has been determined, it must be translated into a cost per MWh so that it may be included in the Commission’s cost build-up. The translation is made using data provided by ActewAGL Retail on the number of customers on the TFT arrangements, total electricity usage and a growth factor. For 2008–09, the Commission adopted a retail operating cost of \$9.94/MWh.

As part of the 2008–09 determination, the Commission considered but rejected the inclusion of customer acquisition costs.

Matters raised in submissions on the issues paper

ActewAGL Retail stated that it:

proposes that the estimate of retail operating costs be increased by CPI in 2009/10, but it is essential that an allowance also be made for customer acquisition ...⁶⁵

In addition, ActewAGL Retail argued that:

the ACT is the only jurisdiction in which [customer acquisition costs] are not recognised as legitimate retail market costs based on external benchmarks, and their continued exclusion will only continue to undermine the benefits of competition ...⁶⁶

AGL stated that it ‘generally supports the overall process adopted by the Commission’ and that it is important that the TFT prices be set at cost-reflective levels.⁶⁷ On this point, AGL stated that it ‘strongly recommends the inclusion of an allowance for acquisition costs as part of the efficient retail operating costs’.⁶⁸

In addition, AGL stated that the:⁶⁹

Commission has outlined in the Issues Paper that it has not included acquisition costs previously when setting prices as it was required to focus on determining a price direction for the supply of electricity to franchise customers, not a retailer competing for additional customers therefore assuming that a retailer does not incur this cost for franchise customers. On the contrary, AGL are of the view that with increased levels of competition, incumbent retailers will be required to compete for customers, including customers currently on franchise tariffs who may be considering transferring to a competition retailer—therefore incurring acquisition/retention costs. These costs will form part of the retailers cost base irrespective of whether they eventually sign up for a market tariff, remain on a TFT or revert from market tariff to TFT.

⁶⁴ ICRC, *Final determination: Investigation into retail prices for non-contestable electricity customers in the ACT*, May 2003, p. 22.

⁶⁵ ActewAGL Retail, submission 2 on issues paper, p. 10.

⁶⁶ ActewAGL Retail, submission 2 on issues paper, p. 12.

⁶⁷ AGL, submission on issues paper, p. 1.

⁶⁸ AGL submission on issues paper, p. 1.

⁶⁹ AGL submission on issues paper, pp 1–2.

Origin Energy stated that it generally supports the cost build-up approach of the Commission but requested that the Commission ‘review its previous position to exclude the cost for acquiring a new customer or retention costs’.⁷⁰ The company also stated that:

a retailers cost include the acquisition cost. Whilst these costs are excluded from the franchise price second tier retailers are unable to compete on a level playing field and/or incumbent retailers are not able to retain scale. All other jurisdiction regulators have decided to make an allowance for customer acquisition costs as part of retail operating costs ... The consideration of acquisition costs is particularly important in a relatively small market like the ACT given that many of the costs are fixed and relate to the establishment of retail capability and retail brand in the community.⁷¹

Commenting on the Commission’s methodology, TRUenergy stated that it ‘recommends the introduction of an allowance in retail costs for operating in a competitive market’.⁷² TRUenergy suggested that the Commission examine the approach adopted in Queensland.

Proposed 2009–10 methodology

Two matters involving retail operating costs must be considered:

- How are retail operating costs to be determined?
- Is it appropriate to include an allowance for customer acquisition costs?

Retail operating costs

The Commission proposes to adopt the approach suggested by ActewAGL Retail, in which the 2008–09 cost per MWh is increased by the inflation rate. This results in an estimate of retail operating costs of \$10.37 per MWh (9.94×1.0435).

Customer acquisition costs

In previous investigations, the Commission has chosen not to include an allowance for customer acquisition costs because it was not convinced that ActewAGL Retail should be incurring significant costs in attracting customers to the regulated tariff. Furthermore, the Commission has noted that there is no requirement in its terms of reference to make an allowance for customer acquisition costs, as is the case in other jurisdictions such as NSW and Queensland.

Indeed, this does not preclude ActewAGL Retail from incurring costs to inform customers about the TFT. In the Commission’s 2003 decision on the TFT, an allowance for ‘sales and marketing, being primarily the costs of communicating the TFT arrangements’ was included in the list of costs making up retail operating costs.⁷³ The Commission’s 2003 final decision on retail prices is the basis for the current level of the allowable efficient retail operating costs. The Commission has adopted an indexing approach to retail operating costs since that time, and the marketing costs have been indexed and included in the TFT value for each year the Commission has set the rate. The 2003 decision included marketing costs as part of the efficient retail operating costs. Those costs were allowed so that ActewAGL Retail could inform customers about the TFT arrangements.

It is important to distinguish between legitimate costs for a regulated retail electricity provider and those costs that may occur in a competitive market. For example, the Commission does not reduce

⁷⁰ Origin Energy, submission on issues paper, p. 2.

⁷¹ Origin Energy, submission on issues paper, pp. 2, 3.

⁷² TRUenergy, submission on issues paper, p. 2.

⁷³ ICRC, *Final determination: Investigation into retail prices for non-contestable electricity customers in the ACT*, May 2003.

the efficient retail operating costs by taking away any economies of scope that are gained by operating a retail electricity subsidiary and a retail gas subsidiary, and potentially a retail water and wastewater subsidiary. On the contrary, the Commission is concerned about the efficient costs of operating a retail electricity business, and has therefore allowed the recovery of costs that would apply to an efficient stand-alone electricity retailer.

While the Commission has historically allowed some marketing costs in its build-up of efficient retail operating costs, it has not previously allowed for customer acquisition costs. The TFT should not be considered as the price that a competitive retailer sets in the market. The Commission does not envisage that ActewAGL Retail will be actively promoting the TFT in a marketing campaign, either to attract customers who have previously left the TFT to return to the TFT or to encourage customers not to leave the TFT. This is part of the fundamental ‘market disconnect’ created when a regulated tariff is set by the regulator in a market where competitive firms also potentially compete.

ActewAGL Retail has provided no new information that demonstrates the necessity of including customer acquisition costs for regulated retail services, or the extent to which it incurs such costs. In addition, the ACT Government has made no amendment to the Commission’s terms of reference from last year that would require the Commission to take account of customer acquisition costs.

The Commission is conscious of the submissions from the retailers which make the argument, directly or indirectly, that the lack of customer acquisition costs is having a negative affect on the level of competition in the ACT retail electricity market. However, the Commission must also consider the incentives behind those submissions. All retailers, including the incumbent regulated retailer, stand to gain from increases in the regulated retail tariff. Competitors gain from increased headroom in which to position their retail offers in the marketplace. The regulated retail business, which is also a participant in the competitive side of the market through its own tariff offers, gains if the regulated retail tariff is increased, because its return per regulated retail customer will also increase.

The Commission has stated previously that it considers vigorous competition to be the most appropriate way to protect the long-term interests of consumers. Therefore, it takes seriously the possibility that the lack of an allowance for customer acquisition costs is stifling competition between retailers and subsequently harming consumers’ long-term interests.

There are currently 17 licensed electricity retailers in the ACT:

- ActewAGL Retail
- Australian Power and Gas Pty Ltd
- AGL Sales Pty Ltd
- AGL Sales Queensland Electricity Pty Ltd
- Aurora Energy
- Country Energy
- Dodo Power and Gas Pty Ltd
- EnergyAustralia
- ERMPower Retail Pty Ltd
- Integral Energy Australia

- Jackgreen Pty Ltd
- Origin Energy Electricity Ltd
- Powerdirect
- Red Energy
- SUN Retail
- TRUenergy Pty Ltd
- TRUenergy Yallourn Pty Ltd.

However, the Commission understands that few of these retailers are currently active in servicing the small customer (residential and non-residential) market.

ActewAGL Retail noted a reduced level of customer ‘churn’ in the ACT. ActewAGL argued that the level of churn had been reduced, and speculated ‘that this is at least partly driven by a TFT which is below a sustainable, commercial electricity market price’.⁷⁴ Mass market customer churn is the number of customers who switch from one retailer to another, and includes all customers (that is, residential and non-residential and small and large customers). It does not show ActewAGL Retail customers who have switched from the TFT to a negotiated contract with ActewAGL Retail, as those customers have not switched retailers and are therefore not included in the NEMMCO data.

The Commission has updated its graph of mass market customer churn, as contained in the 2008–09 final report (Figure 5.1).

After an increase in customer switching between about July 2006 and July 2007, the number of switches has returned to a range between 200 and 400 a month. Care is needed in interpreting these figures, as they include all switches between retailers (residential, non-residential, large or small customers). However, the level of churn seems to suggest that customers are continuing to switch between retailers.

Additional information on the level of customer activity can be gained from an examination of the number of small customers (i.e. customers who may access the TFT) who have entered into negotiated contracts. Table 5-6 shows the number of small customers (residential and non-residential) and their type of contract at the end of each financial year since the introduction of contestability on 1 July 2003.

Approximately 30,000 residential and 1,000 non-residential customers were on negotiated contracts at 30 June 2008. This represents approximately 20% of small customers. However, the proportion of customers on negotiated contracts decreased between 2006–07 and 2007–08.

Origin Energy submitted that the decrease in the number of customers on negotiated contracts ‘clearly suggests the offers available in the market are not sufficient to encourage customers to take up or remain on a negotiated contract’.⁷⁵

⁷⁴ ActewAGL Retail, submission 2 on issues paper, p. 12.

⁷⁵ Origin Energy, submission on issues paper, p. 1.

Figure 5.1 Mass market customer churn to February 2009

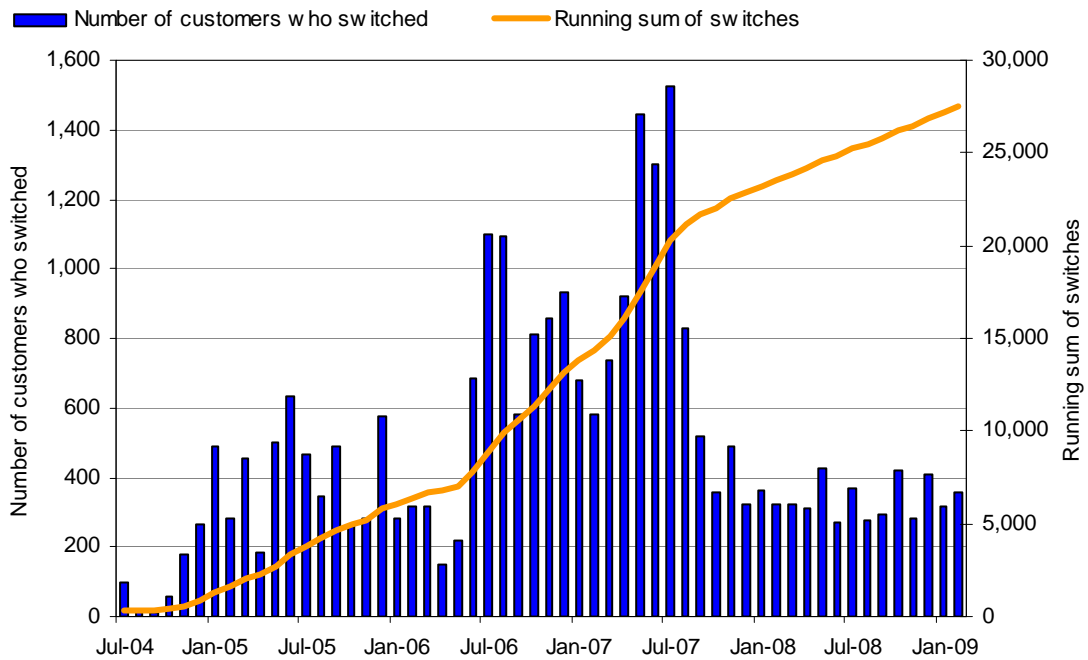


Table 5-6 Customer category and contract

Year (as of 30 June)	2004-05	2005-06	2006-07	2007-08
Non-negotiated contract (TFT)				
• Residential	113,454	106,992	102,853	107,490
• Non-residential	10,114	9,402	10,518	10,504
Negotiated contract (non-TFT)				
• Residential	17,029	27,987	34,163	30,092
• Non-residential	1,251	1,714	1,133	902

Source: Based on data collected from electricity retailers for use in the Commission's performance reports.

The Commission considers that there has been a reasonable amount of customer activity but notes that the proportion of customers who have switched to negotiated contracts is lower in the ACT than in other jurisdictions.

However, care must be taken in concluding that the lower level of churn is a direct result of the non-inclusion of an allowance for customer acquisition costs and, subsequently, a relatively low retail tariff that does not offer enough room for alternative retailers to enter the market.

A range of possible contributing factors may be resulting in the relatively low rate of churn in the ACT. These include the high level (and perceived high level) of brand loyalty among ACT customers towards ActewAGL Retail. As the sole incumbent, ActewAGL Retail has had significant time to build its brand loyalty. In addition, much of that brand loyalty was established during the time that electricity services were provided by a wholly government-owned entity, most recently known as ACTEW.⁷⁶ This high level of brand loyalty may be affecting the willingness of

⁷⁶ Electricity services are now provided by ActewAGL Retail, which is half-owned by the ACT Government and half-owned by AGL.

customers to switch retailers. In addition, the high level of brand loyalty may be affecting the willingness of retailers to enter the market.

The way retail competition was introduced in Victoria provides an interesting contrast. In Victoria, the incumbent electricity retailer was split into three competing businesses, each of which had to adopt a new name, thereby diluting any brand loyalty and potentially increasing the willingness of customers to switch retailers. Victoria has a significantly higher switching rate than the ACT, and has one of the most active retail electricity markets in the world.

A further possible contributing factor is that customers may be unaware of their ability to enter into a negotiated contract or might be unwilling to invest the necessary time to make such a decision. The significant number of customers remaining on the TFT, despite the savings available from switching, could indicate this. Other customers may have considered switching to a negotiated contract but chosen to remain on the TFT.

While it is difficult to make unequivocal statements about whether the absence of an allowance for customer acquisition costs is having a negative affect on the level of competition, it is likely that there are a range of contributing factors.

The Commission does not consider it appropriate to allow the inclusion of an allowance for customer acquisition costs in an attempt to increase the level of competition in the market. While it acknowledges that vigorous competition is in the best long-term interests of consumers, it must also be guided by the various requirements of section 20 of the ICRC Act. These include matters such as the protection of consumers against abuses of monopoly power, the cost of providing regulated services and the social impact of its decisions. In balancing the objectives of the Act, the Commission does not consider that the potential longer term benefits to consumers from including an allowance for customer acquisition costs (on the basis that it may increase competition) outweigh the potential negative short-term implications of the increased cost. This is especially the case, given customers' apparent apprehension about switching to negotiated contracts.

This point was highlighted in the submission from SoftLaw Community Project, which stated:⁷⁷

There is little or no competition in the ACT energy market at the present time. Energy Australia has advised that they are not making offers to new customers, not even adding new services for existing customers and TRUenergy does not appear to be undertaking marketing activities.

In view of this, I suggest that the TFT should be set at as low a price as possible as it is the real price paid by the majority of customers. The idea of setting a higher price to create 'headroom' for competition is against the real interests of consumers.

On a further matter related to the competitiveness of the ACT market, the Commission notes its finding in April 2006 that the ACT retail electricity market exhibited the characteristics of a competitive market and its recommendation that retail price regulation be removed.⁷⁸ The Commission notes that the Ministerial Council on Energy has instructed the AEMC to review the effectiveness of retail competition in electricity and gas in the NEM jurisdictions.⁷⁹ A review was scheduled for NSW in 2009 and the ACT in 2010. In late 2008, the AEMC advised that the retail review for NSW will take place in 2011 instead of 2009. At this time, the review date for the ACT continues to be 2010.

⁷⁷ SoftLaw Community Projects, submission on issues paper, p. 1.

⁷⁸ ICRC, *Final Report, Retail prices for non-contestable electricity customers*, April 2006.

⁷⁹ The retail gas market has not been subject to retail price regulation since 2002.

The Commission considers that the findings of the AEMC review may well endorse the Commission's finding and result in the removal of price regulation in the medium term. This will enable competing retailers to make competitive market-based offers to consumers.

At this time, the Commission has not been provided with adequate information to justify the inclusion of a customer acquisition cost on the grounds that ActewAGL Retail incurs actual costs in acquiring or retaining customers on the regulated tariff. The Commission's terms of reference do not specify that it is to include an allowance for customer acquisition costs, and the Commission does not consider it appropriate to include an allowance for such costs in an attempt to increase the level of retail competition.

Therefore, the Commission does not include an allowance for customer acquisition costs in the draft decision.

Draft decision

The Commission proposes to adopt an allowance for retail operating costs of \$10.37/MWh based on a CPI adjustment from the 2008–09 figure as proposed by ActewAGL Retail.

No allowance is considered appropriate at this time for customer acquisition costs.

Section 20 requirements

The Commission considers that the allowance granted for retail operating costs is a reasonable balance between the need to allow cost recovery (s. 20(2)(e)) and the need to require the incumbent to operate efficiently (s. 20(2)(c)). In addition, the Commission has had regard for the social impacts of its decisions (s. 20(2)(g)) by not including a customer acquisition cost on the basis that such a cost is necessary to encourage competition.

5.3.7 Retail margin

Definition

The retail margin represents the return the incumbent retailer earns on the investment it must undertake to provide retail services. Without a retail margin, the incumbent retailer would be unable to attract the funds needed to provide those services. In addition, the existence of a retail margin together with an allowance for other legitimate costs of providing the retail service allows room for other retailers to enter the market and competitively offer alternative electricity supply contracts, assuming they can operate more efficiently or achieve other economies (including savings on the retail margin) that can be passed through to customers in the form of lower prices.

2008–09 methodology

In 2008–09, the Commission increased the retail margin from 4% of retail sales value to 5%. It adopted that approach based on an analysis of the return necessary to provide retail electricity services and the retail margin granted in other jurisdictions.

Matters raised in submissions on the issues paper

ActewAGL Retail noted the decision by the Commission to adopt a retail margin of 5% in 2008–09 and stated that it welcomed the decision. It noted that retailers in other jurisdictions have argued that a retail margin of 5% was below a competitive outcome. However, ActewAGL Retail

acknowledged that other regulators had maintained a margin of 5% and contended that a margin ‘of at least 5% be applied to total retail costs and this should be maintained as a minimum for the 2009–10 period, consistent with the margin applied to comparable entities in other states.’⁸⁰

Proposed 2009–10 methodology

The Commission considers a retail margin of 5% to be appropriate. The Commission notes that this is the retail margin adopted in other jurisdictions, and that it increased the retail margin from 4% to 5% in 2008–09.

Draft decision

The Commission proposes to maintain a retail margin of 5% on the total retail costs of ActewAGL Retail.

Section 20 requirements

The Commission believes this approach meets the objectives of s. 20(2)(d), to allow an appropriate return on investment, and s. 20(2)(i), to meet the borrowing, capital and cash flow requirements of the business.

5.3.8 Transmission and distribution network costs

Definition

Transmission and distribution network costs are the costs paid by the retailer to transport electricity over the transmission and distribution networks.

2008–09 methodology

The costs charged by transmission and distribution network owners are determined by the Australian Energy Regulator (AER). These costs are unavoidable, and so are passed directly through into retail prices.

In 2008–09, the Commission adopted a cost of \$56.06/MWh based on information received from ActewAGL Retail and derived from the regulated tariffs produced by electricity transmission and distribution reviews.

Matters raised in submissions on the issues paper

ActewAGL Retail noted the AER’s draft decision on distribution prices for 2009–10 provides for a real increase of 13.82%. It stated that ‘the Commission’s decision regarding retail costs cannot be influenced by factors such as distribution costs, over which ActewAGL has no control’.⁸¹

Proposed 2009–10 methodology

The AER’s draft decision for a real increase of 13.82% in 2009–10, when combined with the annual transmission network adjustment, translates into an estimate of network costs of \$66.34/MWh. The Commission proposes to adopt this figure but notes that it will need to be updated for the final report after the AER’s release of final distribution costs.

⁸⁰ ActewAGL Retail, submission 2 on issues paper, pp. 12–13.

⁸¹ ActewAGL Retail, submission 2 on issues paper, p. 13.

As noted in Section 5.3.3, the ACT Government has introduced a feed-in tariff scheme, the costs of which are to be recovered from consumers through electricity distribution charges. Any future modification to this scheme could alter distribution costs.

The possibility of altering the current feed-in tariff scheme was foreshadowed by the Minister for Energy at the launch of the scheme, when he noted that the ACT Government was reviewing the scheme with a view to adjusting the existing 30 kW cap to give larger producers the opportunity to take advantage of the feed-in tariff rates. An announcement clarifying this possibility is expected by June 2009.⁸² Questions arise about the timing of possible changes to the scheme and the way changes to distribution charges are implemented by the AER. This matter is discussed in relation to possible pass-through arrangements in Section 6.2.

Draft decision

The Commission proposes to adopt the estimate of network costs of \$66.34/MWh, while noting that the figure will need to be updated in the preparation of the final report after the AER's release of the final determination of distribution costs.

Section 20 requirements

The Commission believes that allowing the recovery of actual costs incurred meets the objective of s. 20(2)(a) by protecting consumers from abuses of monopoly power, while at the same time accepting that the recovery of network cost pass-throughs is a legitimate activity for the retailer and meets the objectives of ss. 20(2)(c), (d), (e), (i) and (k).

5.4 Draft decision on cost elements

Table 5.7 sets out the Commission's draft decision on the cost components used to determine the change in the TFT.

⁸² Speech by Minister Corbell announcing the feed-in tariff scheme, 10 February 2009.

Table 5.7 Composition of TFT retail price for 2009–10 relative to 2008–09

	2008–09	2009–10	% Change
Energy purchase costs (\$/MWh)			
Electricity purchase cost (\$/MWh)	67.62 ⁸³	60.39	-10.69%
Energy contracting cost (\$/MWh)	0.72	0.75	4.35%
Green costs (\$/MWh)	4.87	5.12	5.17%
NEM fees (\$/MWh)	0.72	0.75	4.35%
Energy losses	4.86%	7.90%	62.55%
Total energy purchase cost (\$/MWh)	77.52	72.31	-6.72%
Retail operating costs (\$/MWh)	9.94	10.37	4.35%
Customer acquisition costs (\$/MWh)	–	–	
Total retail costs (\$/MWh)	9.94	10.37	4.35%
Network costs (\$/MWh)	56.06	66.34	18.34%
Total retail + network costs (\$/MWh)	143.52	149.02	3.84%
Retail margin (EBITDA, % of sales)	5.00%	5.00%	–
Total retail price (\$/MWh)	150.69	156.47	3.84%
X factor in CPI+X on MAR in \$/MWh		-0.49%	

⁸³ This figure differs from that contained in the 2008/09 final report as it has been updated for actual purchase cost information which was unavailable at the time of completing the inquiry.

6 Non-technical matters

This chapter considers non-technical matters, including:

- social implications
- pass-through arrangements
- issues involved in continued price regulation.

6.1 Social implications

The Commission is required under section 20(2)(g) of the ICRC Act to address matters relating to the social implications of its decisions for vulnerable customers. This section provides a summary of submissions that addressed the social implications of the TFT decision. The summary of submissions is followed by a discussion of the matters raised.

Summary of submissions

ActewAGL Retail stated:

ActewAGL notes that the Commission has reiterated its statement that ‘the TFT was never intended to be a safety net measure for more vulnerable customers.’

ActewAGL believes that the best way for the Commission to take account of the social impact of its decision regarding the TFT is to implement measures that will best accelerate competition in the ACT, thereby improving the benefits to consumers that flow from a truly competitive market, free of regulatory constraints and distortions.

ActewAGL has proposed a number of measures to achieve this in the submission, including adjusting the hedging model to better account for the risk facing retailers in purchasing energy in the current market and the inclusion of customer acquisition costs to bring the ACT in line with other jurisdictions.

In accord with the Commission, ActewAGL supports the use of targeted concession arrangements as the best means of supporting vulnerable customers to manage their electricity accounts. Where the Government is able to identify particular social equity or affordability issues, these should be addressed through direct, transparent government payments, not through price controls, which have the potential to inhibit competition and have other unintended consequences. Electricity customers are also afforded protection under consumer protection laws and ActewAGL’s customer hardship programs. Further ActewAGL offers a range of flexible payment options to assist its customers, such as “Even Pay” and “Budget Pay” which effectively smooth a customers billing cycle for seasonal load, assisting households to effectively budget for energy purchases.⁸⁴

AGL argued that the:

removal of retail price regulation will encourage competition to develop further and allow electricity customers in the ACT to enjoy the significant benefits that arise from a fully competitive market, such as choice of retailer and potentially greater number of energy offers. Competition is the best mechanism for producing efficient prices, providing the price signals for new investment and providing incentives for the most efficient use of energy.⁸⁵

Origin Energy supported the Commission’s statement in the issues paper that the TFT was never intended to be a safety net measure for vulnerable customers and that, consequently, ‘customers

⁸⁴ ActewAGL Retail, submission 2 on issues paper, pp. 13-14.

⁸⁵ AGL, submission on issues paper, p. 1.

that require some assistance in paying electricity costs are best place addressed by government agencies that distribute targeted rebates or concessions to assist identifiable customers.’⁸⁶ Origin Energy also noted that it is ‘one of many national retailers that have targeted policies to assist customers that may be in temporary or permanent hardship and provide advice to all customers on energy efficient and energy conservation techniques’.⁸⁷

Care stated that it recognised the Commission’s comment in the issues paper that it is guided by organisations such as the ACT Civil and Administrative Tribunal, Care, the ACT Council of Social Service (ACTCOSS) and other support agencies when giving effect to its obligations under section 20(2)(g) of the ICRC Act.

Care stated that the:

recognition of relevant community expertise, particularly in relation to issues impacting low income consumers is welcome. On a number of occasions however Care has expressed public concern that the Commission does not sufficiently understand or engage with the social impacts of its decisions on vulnerable customers.

In particular, in its submission to the 2008–2009 Budget process Care recommended a fundamental change to the Commission’s make-up and remit to ensure that it remained relevant and that its social policy obligations were given sufficient prominence. Government has to date made no comment on this recommendation.⁸⁸

On the 2009–10 review of retail electricity prices, Care stated:

a) Care’s service delivery experience suggests that low income consumers are particularly vulnerable to rising energy costs [analysis of Care Inc. data 1 July to 31 December 2008 showed utility debt represented approximately 22% of presenting issues for clients]. Increases in electricity prices since 2007 have been compounded by a variety of additional cost pressures, including food, housing, medical and fuel. Low income consumers generally lack the capacity to respond to significant increases in the price of energy (and other) basics. They have little, if any, money for discretionary spending and overwhelmingly live in accommodation that is poorly constructed, badly insulated and contains outdated appliances; all of which make this group extremely sensitive to price rises.

b) Increasing cost pressures have been matched by decreasing income in real terms in many low income houses. The Commonwealth Government has in part recognised the problem by commissioning a review of pension incomes. Care and its core client group eagerly await the outcomes of this review but note that recipients of allowance incomes (such as Newstart) are not included in the review.

c) Rising costs of electricity can affect low income consumers in multiple and compounding ways including; the social isolation that accompanies a disconnected supply, the potential health effects of inadequate heating or cooling, to going without other life essentials such as medication or food. Care regularly sees low income consumers forced to make choices between essentials such as food and energy. Care acknowledges many factors may contribute to disadvantage. Energy however, is vital to maintain quality of life, particularly in a jurisdiction such as the ACT where winter temperatures are severe and the costs associated with heating are amongst the highest in the country.

d) The steady rise in moderate income households suffering financial hardship appears to be continuing despite recent interest rate cuts. The emerging area of concern is the potential for loss of employment as a result of the economic downturn. As with interest rate rises on top of surging debt levels, the effects of increased unemployment and under-employment are likely to hit households that are the least equipped to deal with financial hardship. Care has experienced in recent years, an

⁸⁶ Origin Energy, submission on issues paper, p. 3.

⁸⁷ Origin Energy, submission on issues paper, p. 3.

⁸⁸ Care, submission on issues paper, p. 1.

increase in the depth and breadth of hardship in the general community; this puts pressure on support systems; both within government and across the community sector.

e) The Commission makes reference to the use of concessions to offset the impacts of price rises on low income customers. Concessions are a useful tool but in Care's experience they are insufficient to deal with what is in fact an issue of increasing structural unfairness. Whilst the Commission has repeatedly pointed to the benefits of increased competition as being a driver of good consumer and economic outcomes, there is little hard evidence to support a conclusion that ordinary and low income households are better off. Suggestions that price increases would have been greater without competition are of little value without hard data.

f) More broadly, Care recognises the need to focus on more and better energy efficiency measures to counter the impacts of climate change. Very few of these measures, however, provide genuine incentive, opportunity or adequate support to low income households. For example, the proposed Feed-In Tariff will effectively exclude low income households from participation due to the high initial financial outlay; and low income households will be disproportionately affected by any rise in electricity prices as a result of the Feed-In Tariff. Given such changes to energy markets; appropriate, considered regard for the social impacts of decisions that affect vulnerable and disadvantaged consumers is of even greater importance.⁸⁹

SoftLaw Community Projects provided comments on a range of matters. Those comments with specific reference to the social implications of the Commission's review included:

The energy concession is not keeping pace with energy price rises. I suggest that the Commission needs to be far more specific about the need for concession increases when it addresses the social impacts of its Price Determinations.⁹⁰

Discussion

When making decisions on matters such as electricity and water pricing, the Commission is required to consider the social impacts of its decisions under section 20(2)(g) of the ICRC Act. In those considerations, the Commission is guided by organisations such as the ACT Civil and Administrative Tribunal, Care Financial Counselling Service, ACTCOSS, SoftLaw Community Projects and other support and advocacy agencies.

In this decision on regulated retail electricity prices, the Commission notes the comments by Care, which argue that low-income consumers are 'particularly vulnerable to rising energy costs'⁹¹ and that 'low income consumers generally lack the capacity to respond to significant increases in the price of energy (and other) basics'.⁹²

The Commission is conscious of the adverse impact of rising electricity costs on low-income and vulnerable consumers, such as those identified by Care.⁹³ Adverse impacts could include:

- the social isolation that accompanies a disconnected supply
- the potential health effects of inadequate heating or cooling
- going without other life essentials, such as medication or food.

However, as noted previously by the Commission, the TFT is not intended to be a 'safety net' to be used for social or targeted support to smaller consumers. Setting the regulated retail tariff, which any customer regardless of their income can access, at a level to ensure that low-income and

⁸⁹ Care, submission on issues paper, pp. 2–3.

⁹⁰ SoftLaw Community Projects, submission on issues paper, p. 1.

⁹¹ Care, submission on issues paper, p. 2.

⁹² Care, submission on issues paper, p. 2.

⁹³ Care, submission on issues paper, p. 2.

vulnerable customers can afford their electricity bills creates several market distortions. If the price of electricity reflects the ability of the most disadvantaged electricity customers to afford their purchases, then full cost recovery for the provision of retail electricity services is unlikely. This would result in signals to utility service providers that distort their investment and electricity purchasing decisions, and would require large government subsidies to support the service. Competition in other sectors of the electricity market, especially for large customers, implies that there can be no cross-subsidies between customer classes. That is, large customers should not (and cannot under current market structures) be required to cross-subsidise small customers. Finally, setting the regulated retail tariff too low would encourage excessive use of electricity, which has negative environmental consequences.

Submissions from ActewAGL Retail and Origin Energy explicitly supported the view that the TFT was never intended to be a safety net.⁹⁴ In addition, ActewAGL Retail argued:

the best way for the Commission to take account of the social impact of its decision regarding the TFT is to implement measures that will best accelerate competition in the ACT, thereby improving the benefits to consumers that flow from a truly competitive market, free of regulatory constraints and distortions.⁹⁵

AGL stated that the:

removal of retail price regulation will encourage competition to develop further and allow electricity customers in the ACT to enjoy the significant benefits that arise from a fully competitive market, such as choice of retailer and potentially greater number of energy offers. Competition is the best mechanism for producing efficient prices, providing the price signals for new investment and providing incentives for the most efficient use of energy.⁹⁶

The Commission supports the view that competition is the best way of supporting the long-term interests of consumers. However, it notes the following comment from Care:

Whilst the Commission has repeatedly pointed to the benefits of increased competition as being a driver of good consumer and economic outcomes, there is little hard evidence to support a conclusion that ordinary and low income households are better off. Suggestions that price increases would have been greater without competition are of little value without hard data.⁹⁷

The Commission considers the benefits of competition to be more than simply lower prices. Competition also compels businesses to develop alternative products and provide differing levels of customer service. However, the Commission notes that in electricity retail services, compared with other product markets, there are limited opportunities for businesses to offer alternative products and provide alternative levels of service. Despite this, the Commission considers competition to be in the best interests of consumers.

A recent report by the United Kingdom's Office of Gas and Electricity Markets (OFGEM) provides an interesting snapshot of the state of the retail electricity market in that country. Retail price regulation in the United Kingdom was removed in 2002. OFGEM monitors the operation of the market and provides regular reviews. Some of the main findings of the most recent OFGEM review of the market include:

A record number of customers are switching suppliers—this is driving energy suppliers to offer more competitive prices, improve customer service and innovate by offering new products both to retain existing customers and win new customers.

⁹⁴ ActewAGL Retail, submission 2 on issues paper, p. 13; Origin Energy, submission on issues paper, p. 3.

⁹⁵ ActewAGL Retail, submission 2 on issues paper, pp. 13–14.

⁹⁶ AGL, submission on issues paper, p. 1.

⁹⁷ Care, submission on issues paper, pp. 2–3.

... the best suppliers are seeing significant increases in their market share by delivering superior service at competitive prices.

Companies that are not delivering on price or service have been punished by significant customer losses and churn. Suppliers who have charged uncompetitive prices in the regions where they used to have a monopoly have seen higher than average market share losses. In 7 of the 14 regions, electricity incumbents now have less than 50% of the market. Where the incumbent has retained market share it is usually because they have offered competitive prices.

Another finding is that suppliers are beginning to develop new products aimed at encouraging customers to save energy. These products give more choice and are a small but important step towards delivering a low carbon economy.

For the energy market to work well, customers need to be well informed, involved and active.⁹⁸

The Commission considers that the findings of OFGEM lend weight to the view that competition is the best way to support the long-term interests of consumers. However, the Commission is also conscious that there is a clear need to provide support mechanisms for low-income and vulnerable consumers. On this point, the Commission restates its support for targeted government concession programs as the most appropriate way to support low-income and vulnerable customers. This view on targeted support programs was also supported by ActewAGL Retail and Origin Energy.

Origin Energy stated that ‘customers that require some assistance in paying electricity costs are best place addressed by government agencies that distribute targeted rebates or concessions to assist identifiable customers.’⁹⁹ The company also noted that it is ‘one of many national retailers that have targeted policies to assist customers that may be in temporary or permanent hardship and provide advice to all customers on energy efficient and energy conservation techniques’.¹⁰⁰

The Commission supports the use of targeted concession arrangements such as those offered by the ACT Government (and arrangements such as those cited by Origin Energy). Such arrangements, rather than global price restrictions, are the best way of providing assistance to vulnerable customers.

On the use of targeted concession arrangements, the Commission notes the comments of Care:

The Commission makes reference to the use of concessions to offset the impacts of price rises on low income customers. Concessions are a useful tool but in Care’s experience they are insufficient to deal with what is in fact an issue of increasing structural unfairness.¹⁰¹

SoftLaw Community Projects also discussed concession programs and noted:

The energy concession is not keeping pace with energy price rises. I suggest that the Commission needs to be far more specific about the need for concession increases when it addresses the social impacts of its Price Determinations.¹⁰²

During the 2008–09 review, the Commission identified government concessions as an important issue. In its final report it noted that on 1 April 2008 the Minister for Disability, Housing and Community Services, Katy Gallagher, tabled the report *Review of ACT Government Concessions* in the Legislative Assembly, together with the government’s response to the report. The Commission noted that an interdepartmental committee had been formed and was addressing

⁹⁸ OFGEM, *Domestic Retail Market Report*, June 2007, pp. 1–2.

www.ofgem.gov.uk/Markets/RetMkts/Compet/Documents1/DRMR%20March%202007doc%20v9%20-%20FINAL.pdf

⁹⁹ Origin Energy, submission on issues paper, p. 3.

¹⁰⁰ Origin Energy, submission on issues paper, p. 3.

¹⁰¹ Care, submission on issues paper, p. 2.

¹⁰² SoftLaw Community Projects, submission on issues paper, p. 1.

matters arising out of the report, including programs to assist low-income households and individuals.

A final announcement of the finding of the interdepartmental committee has yet to be made, although the government has announced some changes to its subsidy programs for water and wastewater services.

The Commission believes that the correct way to address this issue is to take a more holistic approach. As noted by OFGEM, even in a situation where competition is very active (as in the United Kingdom), there is a need for customers to be well informed, involved and active if the energy market is to work well. The element of information and education needs to be linked to any financial subsidy and support programs if the particular requirements of low-income households and individuals are to be met.

The Commission is aware of a wide range of existing government programs designed to improve the overall energy-efficiency and energy-use awareness of ACT consumers, and lower-income households and individuals in particular. For example, the ACT Government has committed \$20 million over the next 10 years for improving the energy efficiency of public housing. This includes improving energy efficiency through wall and ceiling information and draught seals as well as high-efficiency hot water systems and heating appliances for new and existing dwellings. The ACT Government also allocated \$1 million in additional emergency relief funding as part of the 2008–09 Second Budget Appropriation. Of this \$1 million, \$850,000 was allocated to Regional Community Services and existing ACT funded emergency relief providers such as St Vincent de Paul, the Salvation Army and Uniting Care Kippax to help vulnerable Canberrans with bills, groceries and other essentials

In its submission to the ACT budget for 2009–10, ACTCOSS made the following recommendation on this matter:

Accelerate and expand programs to retrofit public housing properties to improve energy and water efficiency.¹⁰³

While such programs are part of the solution to the problem of ‘structural unfairness’ identified in the Care submission, they do not necessarily address all the issues raised by Care, which referred to pension schemes, Newstart and a range of other programs that are the responsibility of the Australian Government.

Addressing and solving such problems is beyond the ability of the Commission. In the Commission’s pricing inquiries, the focus needs to be on how best to link pricing outcomes with the wider range of policy initiatives. The first objective must be to ensure that the price paid for electricity reflects the efficient costs of providing the service. In a market that is open to competition from other electricity retailers, it is not possible to create a series of cross-subsidies in electricity tariffs, through which the electricity supply needs of one segment of consumers are partly or wholly funded by other consumers.

However, the Commission agrees that the social welfare requirements of a society showing signs of ‘structural unfairness’ go beyond better education and information on the broad range of funding and demonstration programs available from government. What is required for those households and individuals in need are direct funding programs that take into account the prices of

¹⁰³ ACTCOSS, *Submission to ACT BUDGET 2009 Prioritising people: A person-centred approach to today’s challenges*, February 2009, p. 27.

the essential services involved. As noted by SoftLaw Community Projects, the Commission needs to be far more specific about the need for concession increases, notwithstanding that in the past the Commission has publicly called for appropriate upgrading of government-funded subsidies for targeted welfare recipients.

The Commission notes that the current concession arrangements provide for a maximum rebate of \$194.87 on electricity bills in the ACT. This compares favourably with rebates in other jurisdictions (for example, \$112.00 in NSW, \$118.20 in Queensland and \$120.00 in South Australia). However, the typical ACT household's electricity bills are higher than in other states because it has a larger heating requirement during winter than other Australian urban households. The typical NSW customer uses 5,600 kWh per year, compared to 8,000 kWh per year for the typical ACT customer.¹⁰⁴ Thus, the concession offered in the ACT is less generous than indicated by a simple comparison.

In addition, the concession is applied differently for electricity supply, compared to water and wastewater services. The water and wastewater concession is linked directly to the fixed charge, so when the fixed charge increases there is a proportional increase in the water and wastewater services concession. However, the electricity concession is based on a per kilowatt hour rate, which varies between the summer and winter months. The actual rate per kilowatt hour does not automatically change when electricity prices change. Rather, it remains constant unless and until the ACT Government takes a direct decision to alter the per kilowatt hour rate. Furthermore, the maximum payment available under the scheme is \$194.87, regardless of the household's total electricity bill.

There has been only one adjustment in the level of the energy rebate since 2004.¹⁰⁵ The maximum attainable rebate at 1 July 2004 was \$189.11. This was increased as of 1 July 2008 to \$194.87 to compensate consumers for the introduction of the Network Facilities Infrastructure Tax (discussed further below). Therefore, there has been a gradual decline in the real value of the concession, as electricity charges have increased by around 35% since 2004–05.

Care alluded to the declining real value in concessions when it referred to increasing structural unfairness in the electricity market. The Commission is aware that those customers who receive concessions and other support programs are particularly vulnerable to price rises, and are potentially those least able to adjust their level of consumption in response. To at least partly address this matter, the Commission considers that there are strong grounds for linking the value of the electricity rebate to increases in the retail price of electricity.

The increase in the value of the energy concession in 2008, when the cap on the concession was increased from \$189.11 to the current value of \$194.87, was to compensate for the introduction of the ACT Government's Network Facilities Infrastructure Tax. The Commission considers that there are parallels between the introduction of a new tax and the introduction of the ACT Government's feed-in tariff scheme, as they both impose an unavoidable additional cost on electricity customers.

¹⁰⁴ Based on Commission analysis of ACT consumption and IPART, *Market-based electricity purchase cost allowance—2009 review: Regulated electricity retail tariffs and charges for small customers 2007 to 2010, Electricity—Draft Report*, March 2009, p. 2.

¹⁰⁵ Prior to 1 July 2004, there was a separate electricity rebate (paid by the ACT Government) and gas rebate (paid by ActewAGL Retail). These were combined into a single energy rebate on 1 July 2004 which is paid by the ACT Government. The energy rebate is paid only on electricity consumption as it is assumed that all gas customers are also electricity customers.

As an indication of the likely cost of the feed-in tariff arrangement, the Commission notes the submission from ActewAGL Distribution to the AER, which asks for an allowance of almost \$50 million over the coming five years to offset the cost of the ACT feed-in tariff scheme. This is the equivalent to a charge for a typical household of around \$28 per year if allocated evenly over the five years.¹⁰⁶

However, ActewAGL Distribution's submission (discussed in detail in Section 6.2) indicates that it expects the tariff payments component of the scheme to rise over time from \$3.4 million in 2009–10 to \$15.3 million in 2013–14 (see Table 6-1 in the following section).

A number of cost estimates for the impact of the feed-in tariff scheme on household electricity bills are currently being quoted. In debate in the Legislative Assembly, the ACT Greens have argued that the cost is likely to be in the order of \$35 per customer per year over the coming years.¹⁰⁷ The government has given an estimated cost of around \$1,074/kWh for a single kilowatt installed by a household.¹⁰⁸ Based on an assumed 2 kW per installation and 3,900 installations over the next five years (15 installations per week), this would be equivalent to a cost of around \$24 per year for a typical household consuming 8,000 kWh.

While the difference in these estimates may reflect differing assumptions about potential take-up rates, the cost is likely to continue increasing over time as additional households join the scheme. Therefore, there is an urgent need to address the way the value of concessions is calculated. To the extent that low-income households cannot afford to participate in the scheme, there is an argument that the concession for electricity should be adjusted annually to address this growing cost.

ACTCOSS made this point in its submission to the ACT Budget for 2009–10:

ACTCOSS is concerned about the introduction of the feed-in tariff and its disproportionate impact on low income households. The energy concession should be reviewed each year to ensure that it is increased to match cost impacts of the feed-in tariff.¹⁰⁹

In reaching the conclusions about retail electricity prices for 2009–10 in this draft decision, the Commission has considered a range of matters. The Commission is confident that it has reached a reasonable outcome that balances the needs of consumers with the need to ensure the continuing viability of electricity retailers and retail competition in the ACT. In making this decision, the Commission has been especially mindful of the social impacts of its decision. Accordingly, the Commission will recommend that the ACT Government amend the electricity concession rates to index both the kilowatt hour rate and the cap on the concession payment to movements in the TFT. Furthermore, the Commission will recommend that the government consider making a further cost allowance in its concession arrangements to account for costs associated with the feed-in tariff.

6.2 Pass-through arrangements

This section:

- provides a definition of pass-through arrangements

¹⁰⁶ \$50 million divided by five years divided by total usage of 2,831,000 MWh multiplied by a typical household usage of 8,000 kWh per year.

¹⁰⁷ ACT Legislative Assembly Hansard, 26 February 2009, p. 1123, speech by Mr Rattenbury.

¹⁰⁸ ACT Legislative Assembly Hansard, 26 February 2009, p. 1125, speech by Mr Corbell.

¹⁰⁹ ACTCOSS, *Submission to ACT BUDGET 2009 Prioritising people: A person-centred approach to today's challenges*, February 2009, p. 27.

- discusses the pass-through arrangements from 2008–09
- summarises the submissions received on pass-through arrangements
- sets out the Commission’s draft decision on pass-through arrangements for 2009–10.

Definition

Pass-through arrangements are often included in regulatory decisions to allow for an adjustment to prices if unforeseen events occur during the life of a price path. If a pass-through ‘trigger’ event occurs, a new investigation can be undertaken to update the prices or an automatic adjustment may be made.

Pass-through arrangements typically apply to events that are unforeseen, or whose extent is uncertain, and which are beyond the ability of the regulated entity to control. Therefore, the need for triggers increases with the length of the price path. For a price path of only 12 months, as with the TFT, such an arrangement is less necessary.

2008–09 pass-through arrangements

At the time of finalising the 2008–09 price determination, there was uncertainty about the possible introduction of an emissions trading scheme by the Australian Government and a feed-in tariff arrangement by the ACT Government. Therefore, the Commission included pass-through mechanisms applying specifically to those two possibilities.¹¹⁰

Matters raised in submissions on the issues paper

ActewAGL Retail suggested that a range of pass-through events be included in the 2009–10 price path. These were in relation to:

- the ACT Government’s feed-in tariff
- unforeseen ACT and Australian Government environmental initiatives
- the possible introduction of a smart metering trial or rollout of smart meters
- a change in network tariffs during the 2009–10 financial year.

ActewAGL Retail provided the following supporting arguments for the inclusion of these four pass-throughs.

Feed-in Tariff

On 1 March 2009, the ACT Government introduced a feed-in tariff (FiT) scheme to apply to renewable energy produced by small generation systems and fed back into the electricity network. Under the FiT Scheme, customers are paid for the gross output of their generation installation for a period of 20 years. The rate to be paid over the 20 years is generally determined by the date of connection of the generation unit. The FiT rate can be set by the ACT Government each year, with a default formula in the FiT scheme legislation if the ACT Government does not set a rate. The ACT Government has set the current FiT rate until 30 June 2010.

This scheme has potentially large financial and administrative implications for ActewAGL. ActewAGL must ensure it is no worse off as a consequence of the policy. The costs imposed on it could include not only the cost of the tariff but any costs it was required to incur to help implement, manage, administer, report, publicise or advise on the scheme. This would include any cash flow or

¹¹⁰ ICRC, *Final Decision and Price Direction: Retail prices for non-contestable electricity customers*, Report 4 of 2008, June 2008, pp. 55–57.

holding costs incurred as a result of the timing of payments to customers and the re-imburement from the networks business.

As well, ActewAGL Retail understands that ActewAGL Distribution has sought the inclusion of the FiT in its electricity network prices that are to be determined by the AER. ActewAGL Retail is assessing how it will be separately impacted by the introduction of the FiT, including increased exposure to the spot market. ActewAGL Retail will endeavour to assess the financial implications of the scheme and advise the Commission during the course of this review.

Given the ACT Government's expectation to announce Stage 2 of the scheme in June 2009, ActewAGL believes that the cost pass through mechanism regarding the FiT that was incorporated into the 2008/09 final decision should be maintained so that any incremental costs can be recovered in full once the details and the financial implications are known.

Environmental initiatives

The ACT and Commonwealth Governments are continuing to actively consider policies to manage carbon emissions. ActewAGL notes the Commission's statement that 'the need for the inclusion of pass-through arrangements in the price direction for 2009–10 may ... have been reduced' as 'the Commonwealth Government has stated that the Carbon Pollution Reduction Scheme will commence from 1 July 2010.' However, ActewAGL is also aware that the ACT Government is considering a range of separate and related initiatives and that there is sufficient uncertainty regarding environmental initiatives and potential implications for electricity costs during the 2009/10 financial year that a broader pass through mechanism be developed to apply in 2009/10 to recover any costs that may arise from these new unforeseen and unknown initiatives during the period.

Smart Metering

The [Ministerial Council on Energy] has released an exposure draft of legislation amending the National Electricity Law (NEL) to support the national smart metering framework. The proposed amending legislation creates a power for jurisdictional Ministers to make a determination requiring the relevant distribution business to undertake a smart metering pilot or trial, or full rollout in a particular jurisdiction. The intention of the legislation is to create a mechanism whereby distribution businesses can ensure cost recovery of smart metering pilots, trials and rollouts where jurisdictional Governments deem that these actions are necessary. The proposed amendments are intended to come into effect on 1 July 2009.

While the proposed legislation focuses on distribution business cost recovery, retail businesses will also incur significant costs where smart metering pilots, trials and rollouts are mandated. In particular, retail businesses face significant billing system and data management costs incurred to support new functionality available through smart metering. These costs can arise through the operation of a pilot or trial where full end-to-end business processes are being tested.

The proposed amendments to the NEL do not address retail cost recovery as retail pricing in jurisdictions where retail regulation is still in place remains the responsibility of jurisdictional Governments.

ActewAGL considers that it is appropriate that the 2009/10 determination reflect the possibility that the ACT Government will issue a smart metering trial, pilot or rollout determination under the amended law during the price determination period. ActewAGL therefore proposes that a smart metering determination made under the NEL be included as a pass through event in the 2009/10 determination.

This event should cover both a change in network tariffs in the period resulting from a network pass through event in respect of smart metering, as well as the pass through of retail costs associated with the trial.

Distribution Network Tariff Change

Mechanisms under the National Electricity Rules, in particular pass through mechanisms, create scope for network tariffs to change during a regulatory year. ActewAGL Retail considers that it should not bear the risk of a potential change in network tariffs and should not be required to carry

these costs for any remaining period of that year. Therefore, ActewAGL will require an ability to pass through these costs during the financial year.¹¹¹

Origin Energy supported the inclusion of pass-through provisions for unforeseen events and argued for the inclusion of a general pass-through provision. The company argued that it is important that retail businesses not be exposed to unexpected increases in costs.¹¹²

SoftLaw Community Projects stated:

At this stage, it is probably preferable to take a pass-through approach to the Feed in Tariff and the Carbon Pollution Reduction Schemes as the effects of these schemes are difficult to estimate at this stage. What the Commission could do, with some certainty, is to recommend Government action to prevent the financial costs of these schemes from falling on low income households.¹¹³

TRUenergy stated that ‘it is unclear why there is a need to specifically identify the circumstances in which the arrangements may be triggered.’¹¹⁴ TRUenergy argued that ‘a more prudent approach would be to allow for a pass-through consideration in any circumstances in which there is a material change in the retailer’s cost base relative to the assumptions of the price path determination.’¹¹⁵

Proposed 2009–10 methodology

The terms of reference for the current inquiry require the Commission to determine a price path for 12 months. A 12-month price path has less need for pass-through provisions compared to a longer price path because costs can be forecast more accurately over a shorter term. Therefore, the Commission is inclined to limit pass-through arrangements for the current price path. The Commission also has concerns about the potentially high regulatory and administrative costs of reviewing and possibly adjusting prices more often than once a year.

However, at the time of finalising the 2008–09 price path, the Commission included two pass-through provisions—one for costs associated with the ACT Government’s feed-in tariff and the other for potential costs associated with the Australian Government’s Carbon Pollution Reduction Scheme. Both schemes were envisaged when the price path was being finalised. The fact that these two pass-through arrangements are related to environmental initiatives indicates the importance government is attaching to environmental matters and the pace at which policy is being developed and implemented.

The inclusion of these two pass-through provisions in the 2008–09 price direction reflected uncertainty about the feed-in tariff and the emissions trading scheme at that time. Since that time, the Commission has gained a better understanding of the likelihood of either of these events occurring. In assessing whether similar pass-through arrangements are needed in the 2009–10 price path, the Commission must consider what is likely to occur, its probability, when it might occur and whether the cost impost is likely to be significant.

The remainder of this section discusses the four pass-through events proposed by ActewAGL Retail.

¹¹¹ ActewAGL Retail, submission 2 on issues paper, pp 14-15.

¹¹² Origin Energy, submission on issues paper, p. 3.

¹¹³ SoftLaw Community Projects, submission on issues paper, p. 1.

¹¹⁴ TRUenergy, submission on issues paper, p. 2.

¹¹⁵ TRUenergy, submission on issues paper, p. 2.

Feed-in tariff

The ACT Government's feed-in tariff scheme was announced on 10 February 2009.¹¹⁶ The feed-in tariff regime is initially aimed at households and small businesses and is capped at 30 kW. Those producing up to 10 kW will receive 50.05 cents per kilowatt hour (c/kWh), while those producing between 10kW and 30 kW will receive 40.04 c/kWh.¹¹⁷

Under the scheme, retail electricity businesses pay scheme participants the designated rate per kilowatt hour for electricity produced. The retailer then recovers the cost of purchasing this electricity from the distribution business, which in turn recovers its costs via distribution charges. The end result is that all electricity customers face increased distribution charges and subsequently increased retail prices. Any increase in distribution charges is captured in the transmission and distribution network costs component of the Commission's cost index.

ActewAGL Retail has stated that there may be costs which it is unable to recover from the distribution business. It suggests that these may include costs it is 'required to incur to help implement, manage, administer, report, publicise or advise on the scheme. This would include any cash flow or holding costs incurred as a result of the timing of payments to customers and the reimbursement from the networks business.'¹¹⁸

ActewAGL Retail has stated that it will assess the implications of the feed-in tariff scheme during the course of this review and advise the Commission on the potential financial implications of the scheme.¹¹⁹ The Commission proposes to wait for that advice before forming a judgment on the appropriateness of including the suggested pass-through.

The Commission notes ActewAGL Retail's comments on the ACT Government's intention to announce Stage 2 of the feed-in tariff scheme in June 2009. Under Stage 2, it is proposed that the scheme be extended to allow for the inclusion of larger participants. The Commission considers that the advice provided by ActewAGL Retail regarding the cost of Stage 1 of the feed-in tariff scheme will give an indication of the potential costs of Stage 2 and therefore of the need for a pass-through for the scheme.

ActewAGL Distribution recently made a revised regulatory proposal to the AER¹²⁰ in response to the AER's draft decision in November 2008.¹²¹ In the revised proposal, ActewAGL Distribution included its best estimates of the costs the distribution business expects to incur over the next five years for the operation of the feed-in tariff (both Stage 1 and Stage 2). Table 6.1 shows ActewAGL Distribution's expected operating costs.

¹¹⁶ Speech by Minister Corbell announcing the feed-in tariff scheme, 10 February 2009.

¹¹⁷ Department of the Environment, Climate Change, Energy and Water, *Fact Sheet: Proposed ACT electricity feed-in tariff scheme*, released 10 February 2009.

¹¹⁸ ActewAGL Retail, submission 2 on issues paper, p. 15.

¹¹⁹ ActewAGL Retail, submission 2 on issues paper, p. 15.

¹²⁰ ActewAGL Retail Distribution, *Determination 2009-14: Revised regulatory proposal to the Australian Energy Regulator*, January 2009.

¹²¹ Australian Energy Regulator, *Draft Decision: Australian Capital Territory distribution determination 2009-10 to 2013-14*, November 2008.

Table 6-1 ActewAGL Distribution, expected feed-in tariff operating costs (\$ million, 2008–09 dollars)

	2009–10	2010–11	2011–12	2012–13	2013–14	Total
Standard control						
Tariff payments	3.4	6.8	10	12.7	15.3	48.2
Network operations expenditure	0.1	0.1	0.1	0.1	0.1	0.6
Alternative control						
Maintenance and repair	0.1	0.1	0.1	0.1	0.1	0.5

In addition, there will be almost \$3 million in capital expenditure over the five-year price path.

ActewAGL Distribution expects to incur total costs of \$49.3 million from the operation of the feed-in tariff over the next five years, and has asked the AER to allow those costs to be recovered in network charges. The final decision for distribution services in the ACT will not be released until May 2009, and the Commission will not prejudge the AER’s decision. However, if the AER accepts this expenditure as an allowable cost, the costs will be recovered through distribution charges and will increase the total network costs for 2009–10 in the Commission’s build-up of efficient costs.

ActewAGL Distribution has estimated the tariff payments for the next five years. The expected cost rises steadily from \$3.4 million in 2009–10 to \$15.3 million in 2013–14, reflecting the increased take-up by households of the feed-in tariff option. The Commission notes that, if the increased take-up continues past 2014, the cost of the feed-in tariff scheme will be significantly higher in the future, as new entrants each year add to the total cost that must be recovered through electricity retail prices in the ACT.

The way distribution charges are adjusted for cost imposts on the distribution business is discussed below in relation to ActewAGL Retail’s proposal to include a pass-through for distribution network tariff changes. However, at this time the Commission is not inclined to accept a pass-through provision for the feed-in tariff. The Commission expects to be guided by the AER’s final decision for ACT distribution services (to be released in May 2009). The Commission’s deeper understanding of the nature and regulatory arrangements of the feed-in tariff, acquired over the past 12 months, indicates a reduced need to include a pass-through arrangement in the 2009–10 price determination.

Environmental initiatives

How likely the Australian and ACT governments are to introduce environmental initiatives that impose a cost on ActewAGL Retail is not known. However, there have been substantial developments since the Commission released its 2008–09 decision in May 2008. Since then, the Australian Government has confirmed a 1 July 2010 starting date for the emissions trading scheme. Therefore, the Commission does not consider there to be a need to include pass-through for that event.

The Commission has concerns about the lack of clarity of the proposed pass-through event and the potential ambiguity about what qualifies as an ‘environmental initiative’. The Commission notes that the pass-throughs included in the 2008–09 decision were defined tightly and referred to specific events.

Smart metering

The responsible minister has the power to require the distribution business to undertake a smart metering trial. However, as pointed out by ActewAGL Retail, the costs of such a trial are imposed on the distribution business as opposed to the retail business. Therefore, as is the case with the potential costs of the feed-in tariff, only those costs that ActewAGL Retail would be unable to recover from the distribution business should be considered.

The Commission understands that ACTEW Corporation has been approached by the ACT Government to undertake a smart water metering trial. In response, ActewAGL Distribution undertook a net benefit study and concluded that there would be benefits from expanding the study to include other utility services (gas and electricity). The ACT Government accepted that suggestion.¹²² ActewAGL Distribution then commenced its multi-utility integrated metering infrastructure (MIMI) project. The costs of the project are split between ACTEW (40%), ActewAGL Distribution (electricity) (40%) and ActewAGL Distribution (gas) (20%).

The Commission allowed the recovery of these relevant costs in its recent water decision, as did the AER in its recent electricity distribution draft decision. The AER stated:

The AER notes the benefits of undertaking project MIMI that ActewAGL has identified in its regulatory proposal. In particular, the project will improve ActewAGL's understanding of the costs and potential benefits associated with electricity smart metering. It will report on expected costs and savings in a business case, report on market acceptance and customer behavioural responses, and identify any change management and communication challenges in a full deployment of smart meters across the ACT.¹²³

Given the current MIMI trial and its inclusion of smart electricity metering, the Commission considers the likelihood of the ACT Government requesting a further electricity specific smart metering trial to be minimal. The Commission considers that the logistics and timetable for a possible rollout of smart meters would be worked out with all affected parties well in advance. The Commission is unaware of any current proposal for a rollout, and does not consider a rollout likely during 2009–10.

Therefore, the Commission does not consider it necessary to include a pass-through mechanism to cover costs associated with a smart metering event.

Distribution network tariff change

As noted by ActewAGL Retail, the National Electricity Rules allow for the pass-through of changes to distribution tariffs during a regulatory year. This creates the possibility that distribution charges might be altered and that ActewAGL Retail would have to absorb the cost for the remainder of the regulatory year, in the absence of an allowance for retail prices to adjust correspondingly. However, the Commission can find no indication that the AER intends to adopt any form of pass-through arrangements, other than passing through additional costs that meet the requirements of the AER's pass-through provisions on a yearly basis. Therefore, the Commission is not convinced of the need to consider mid-year adjustments to the TFT.

¹²² Australian Energy Regulator, *Draft Decision: Australian Capital Territory distribution determination 2009–10 to 2013–14*, November 2008, p. 185.

¹²³ Australian Energy Regulator, *Draft Decision: Australian Capital Territory distribution determination 2009–10 to 2013–14*, November 2008, p. 190.

The AER will release its final decision before the Commission finalises the pass-through arrangements for the TFT for 2009–10. The Commission understands that the final report will discuss the AER’s approach to the pass-through of costs incurred by the distribution business in relation to the feed-in tariff scheme. The AER final report will also indicate whether the AER intends to allow an adjustment to distribution charges during a regulatory year for this or any other possible event. Therefore, the Commission will reassess the necessity to include a pass-through for changes in distribution network tariffs at that time.

Draft decision

The Commission will reassess the need to include pass-through arrangements before its final report. However, at this time, its preferred option is to include no pass-through arrangements.

The Commission seeks additional information from ActewAGL Retail about any financial implications of the feed-in tariff and welcomes additional details of ActewAGL Retail’s proposed environmental initiatives pass-through. The Commission is not convinced of the need to include a smart metering event. The Commission will reassess the need to include a pass-through arrangement for changes in distribution network tariffs following the release of the AER’s final decision.

6.3 Continued price regulation

The Commission is concerned about the continued regulation of retail electricity prices in the ACT. Typically, competitive market offers consist of discounts below the TFT. Thus, the Commission’s decisions in setting the TFT are reflected in the prices offered to franchise and (after a discount) non-franchise customers. Therefore, there are potentially significant impacts if the Commission sets an incorrect TFT.

Setting a regulated tariff in a market that also promotes competitive pricing creates a delicate balancing problem for a regulator. If the TFT is set too high, franchise customers will pay too much for their electricity. A high TFT would encourage competitive electricity retailers to offer larger discounts on the TFT. While that might increase the rate of transfer from the TFT to competitive offers, customers remaining on the TFT would be paying well above competitive market rates for their electricity. If, for whatever reason, low-income and vulnerable customers were over-represented among those remaining on the TFT, that could create the appearance of structural unfairness. Currently, rental customers may be less likely to enter into market contracts because of the contracts’ typically long duration and high contract termination fees.

Conversely, setting the TFT price too low could result in retailers temporarily withdrawing from the competitive market or, in extreme cases, leaving the industry altogether. This would reduce the competitiveness of the market and be contrary to the best interests of consumers.

Victoria offers an interesting example of how this matter might be addressed. Victoria has recently adopted an electricity retail market model that removes the role of a regulator in setting a TFT-equivalent price. The new regime requires electricity retailers to publish widely the prices they individually offer. In addition, prices cannot change more frequently than once every six months. The decision to adopt this approach in Victoria was made in response to an AEMC finding that the market was effectively competitive and a consequent recommendation that the retail market barriers to FRC be removed.

If the responsible Victorian minister is concerned about the continuing effectiveness of competition in the retail electricity market, the minister can ask the AEMC to conduct a further review. Should the review find that the market is no longer effectively competitive, a recommendation can be made that the minister once again regulate retail prices.

Studies similar to that undertaken in Victoria by the AEMC are to be carried out in other jurisdictions over the coming years. A review in the ACT is currently expected in 2010.

The approach adopted in Victoria is perhaps a starting point for considering the next step to facilitate FRC in the ACT. The current arrangements, whereby the Commission plays such a significant role in determining the price for negotiated and non-negotiated contracts in the market, is neither sustainable nor economically efficient, and may be reducing the long-term competitiveness of the market.

A related matter is the regulatory approach adopted in the ACT. The ACT Government appears to have adopted a process whereby it issues terms of reference for updates of the TFT on an annual basis. One consequence of continually resetting the TFT for one year is that the Commission is unable to adopt a methodology to smooth year-to-year fluctuations in price.

Instead, based on the consistent application of the Commission's current TFT regulatory model, fluctuations in the cost build-up components necessarily flow through directly into the next year's TFT prices. Volatility in the cost components, which subsequently influences price, may affect low-income and vulnerable customers disproportionately because they often have limited ability to limit their use of electricity in response to significant price shifts.

On this matter, the Commission notes the developments in the United Kingdom's retail electricity market. In 2003, the first retailer introduced a fixed price tariff, under which a customer can lock in a price for coming years in a similar manner to fixing a home loan interest rate. By 2007, all retailers offered fixed price offers, which were popular because retail electricity prices were rising. In March 2007, 6 million electricity customers were on a fixed price tariff.¹²⁴

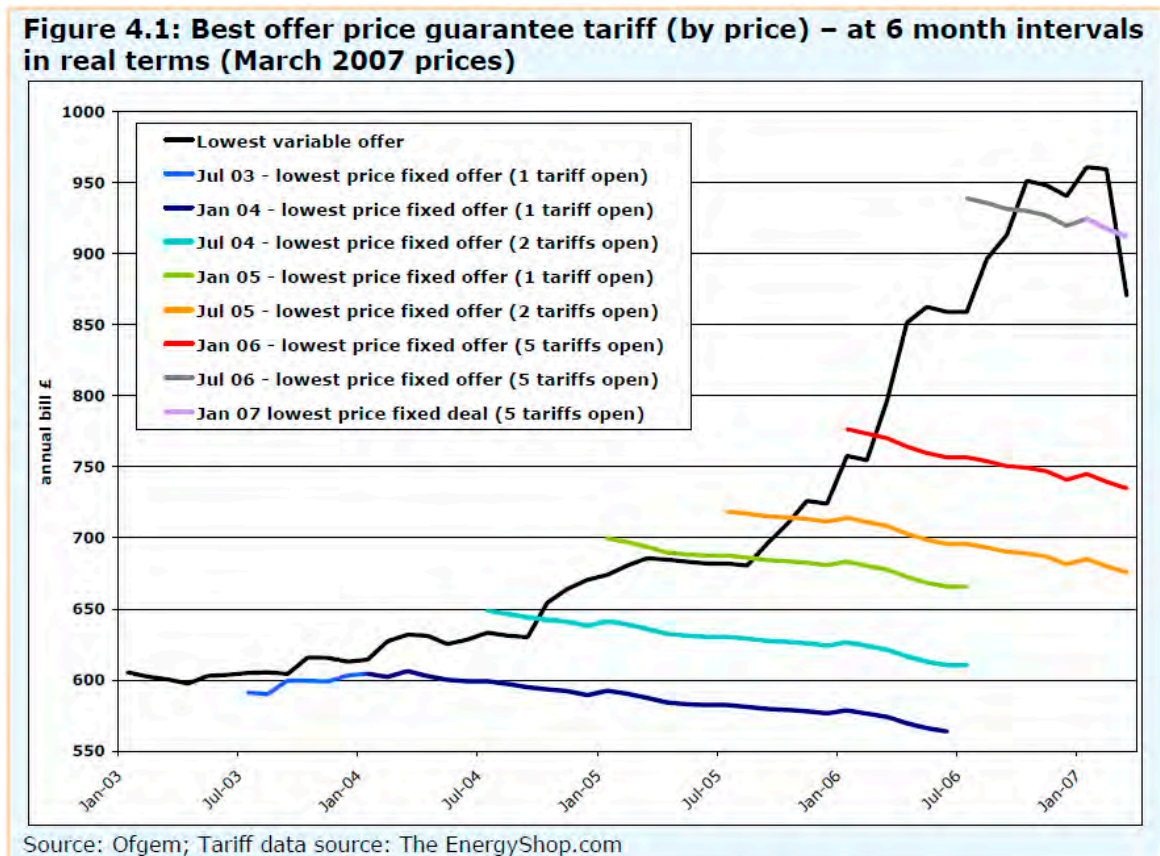
Figure 6.1 shows how selected fixed price offers compared with the best variable price offers in the United Kingdom from 2003 to 2007.¹²⁵

¹²⁴ OFGEM, *Domestic Retail Market Report*, June 2007, pp. 12–14.

www.ofgem.gov.uk/Markets/RetMkts/Compet/Documents1/DRMR%20March%202007doc%20v9%20-%20FINAL.pdf

¹²⁵ OFGEM, *Domestic Retail Market Report*, June 2007, p. 13.

Figure 6.1 UK fixed price tariff vs. variable tariff



Source: 2007 OFGEM Domestic Retail Market Report, Figure 4.1.

As can be seen from Figure 6.1, customers who adopted fixed price offers at a time of rising variable prices faced lower electricity prices over time. Interestingly, competition between retailers led to the development of a product that addressed one of the disadvantages identified in the regulatory methodology of the ACT.

The Commission considers that the removal of price regulation is in the best long-term interests of all consumers. If a competitive retail market were allowed to flourish without the intrusion of a distorting regulated retail tariff, new pricing strategies and billing arrangements such as those in the United Kingdom would be developed. Competition could also hasten the adoption of time-of-use pricing, which would send price signals to consumers about the true cost of electricity and reduce the need for additional generating capacity. However, the Commission is not blind to the potential problems that might occur in the transition to a fully deregulated and competitive retail electricity market. As the Commission stated in its 2006 reports on the need for a regulated retail tariff in the ACT, there should be an extensive information campaign to educate consumers on the workings of the new electricity market and continuing safeguards to protect the most vulnerable consumers.

The Commission considers that the adoption of a regulatory arrangement similar to that in Victoria would be in the long-term best interests of consumers in the ACT. This would involve removing the TFT, implementing a monitoring scheme, and limiting price changes by retailers to twice yearly. The Commission would also like to see the review by the AEMC brought forward to 2009. This would allow enough time for those changes to be made before the need to reset the TFT on 1 July 2010, should the AEMC conclude that the market is effectively competitive.

7 Draft price direction

This chapter contains the Commission's draft price direction for the TFT for the period from 1 July 2009 to 30 June 2010.

1 Period of the direction

The provisions below will apply to the period from 1 July 2009 to 30 June 2010.

2 Variation to price of retail electricity services

The maximum price that may be charged by ActewAGL Retail for the provision of electricity services to franchise customers during the period must be calculated according to the following formula:

$$\sum_{i=1}^n \sum_{j=1}^m P_{ij}^t Q_{ij}^R \leq \sum_{i=1}^n \sum_{j=1}^m P_{ij}^{t-1} Q_{ij}^R \times (1 + \text{CPI}) \times (1 + X)$$

Where:

P_{ij}^t is the proposed 2009–10 price for component j of the regulated retail tariff i

P_{ij}^{t-1} is the actual 2008–09 price charged by ActewAGL Retail for component j of the regulated retail tariff i

Q_{ij}^R is the reference quantity for component j of the regulated retail tariff i defined as the actual quantity (in both customer numbers or MWh) as reported by ActewAGL Retail for the 12-month period ending 31 March 2009

CPI = 4.35%

X = -0.49 %

Appendix 1 Terms of reference

Australian Capital Territory

Independent Competition and Regulatory Commission (Price Direction for the Supply of Electricity to Franchise Customers) Terms of Reference Determination 2008 (No 2)

Disallowable instrument DI2008–305

Made under the

Independent Competition and Regulatory Commission Act 1997 (the Act), Section 15 (Nature of industry references) and Section 16 (Terms of industry references)

Reference for investigation under Section 15

Pursuant to subsection 15(1) of the Act, I refer to the Independent Competition and Regulatory Commission (the ‘Commission’) the provision of a price direction for the supply of electricity to franchise customers for the period 1 July 2009 to 30 June 2010.

Terms of reference for investigation under section 16

Under the Act, section 16(1), I require that the Commission consider the following matters in relation to the conduct of the investigation:

1. In undertaking the review, the Commission should have regard to the requirement of section 20 of the Act.
2. The Commission must produce its final report in time sufficient to allow ActewAGL Retail to make any necessary changes to its billing system and to provide information on the new tariff to customers.

Simon Corbell MLA

Attorney-General

23 December 2008

Abbreviations and acronyms

ABS	Australian Bureau of Statistics
ACT	Australian Capital Territory
ACTCOSS	ACT Council of Social Service
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
BRCI	Benchmark Retail Cost Index
Care	Care Financial Counselling Service
Commission	Independent Competition and Regulatory Commission (ACT)
CPI	consumer price index
CPRS	Carbon Pollution Reduction Scheme
ESCOSA	Essential Services Commission of South Australia
FRC	full retail contestability
GGAS	Greenhouse Gas Abatement Scheme (ACT) Greenhouse Gas Reduction Scheme (NSW)
IPART	Independent Pricing and Regulatory Tribunal (NSW)
kW, kWh	kilowatt, kilowatt hour
MIMI	multi-utility integrated metering infrastructure
MRET	Mandatory Renewable Energy Target
MW, MWh	megawatt, megawatt hour
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company
OFGEM	Office of Gas and Electricity Markets (United Kingdom)
OTTER	Office of the Tasmanian Energy Regulator
QCA	Queensland Competition Authority
TFT	transitional franchise tariff