

STANDING OFFER PRICES FOR THE SUPPLY OF ELECTRICITY TO SMALL CUSTOMERS FROM 1 JULY 2017

ACTEWAGL RETAIL RESPONSE TO
ISSUES PAPER FRAMEWORK AND
APPROACH FROM THE INDEPENDENT
COMPETITION AND REGULATORY
COMMISSION

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ActewAGL

for you

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1. Introduction

In June 2016, the ACT Treasurer issued a terms of reference requiring the Independent Competition and Regulatory Commission (the Commission) to determine a price direction for standing offer prices for the supply of electricity to small customers. The terms of reference stipulated that the price direction will be for the next regulatory period of 1 July 2017 to 30 June 2020. On 24 October, the Commission released an Issues Paper setting out its proposed approach to setting retail electricity prices for the next regulatory period. The Commission invites stakeholders to make submissions in response to the Issues Paper by 30 November 2016.

Consistency and predictability of the regulatory framework are vital to provide certainty to consumers and retailers. Regulation that sets retail prices too low imposes unnecessary risk on retailers and deters new entry of competitors which prevents ACT consumers benefiting further from the wide range of benefits that competition can deliver.

For these reasons, ActewAGL Retail (ActewAGL) supports the continued use of the Commission's pricing model for setting retail electricity prices for the next regulatory period, provided that some adjustments are made.

ActewAGL has a number of concerns with some components of the model which if not adjusted would result in prices that do not properly compensate ActewAGL for the costs and risks of providing a standing offer product and hence are inconsistent with the legislative objective of promoting effective competition.

In particular:

- ActewAGL continues to disagree with the uplift factor used in the model; and
- ActewAGL believes the Commission needs to revisit its decision to exclude customer acquisition and retention costs from total retail costs. Excluding these costs results in setting prices below levels that properly compensate ActewAGL for commercially benchmarked costs of supply. The Commission is the only Australian regulator to exclude these costs in setting retail prices.

ActewAGL also requests amendments to the cost pass-through provisions in the Price Direction and identifies a potential cost pass-through application for the Power of Choice regulatory reforms to recover additional unavoidable costs that will arise within the regulatory control period 2017-2020.

2. Competition Continues to Increase in the Electricity Market

There are a number of indicators of the presence of competition in the ACT electricity market. The continuation of retail price regulation, whilst competition is growing, is unnecessary and introduces regulatory risk.

Evidence that competition continues to increase in the ACT

ActewAGL considers that competition continues to increase in the retail electricity market in the ACT and that electricity retail price control regulation should be removed in the ACT as it was with retail gas pricing nearly 15 years ago.¹

Competition is the most effective means for delivering long-term benefits to consumers. For this reason, the promotion of competition is one the key objectives of most regulatory regimes², including the regime under which the ACT electricity retail prices are regulated. The competition objective in the ICRC Act is “to promote effective competition in the interest of consumers.”³ This is the overarching objective that applies to all sections of the Act, including the Part 4 Price Directions objective at section 19L. The competition objective acknowledges that outcomes from effective competition are superior to regulated outcomes.

The potential benefits of competition underlie the rationale for opening the ACT electricity market to competition in 2003. Energy Australia, previously TRU Energy, has been competing in the ACT electricity market for over a decade, Origin Energy entered the ACT electricity market in 2014 and more retailers are entering such as Next Business Energy.

Competition has resulted in a range of new market energy offers for residential and small business customers, with a substantial increase in the proportion of customers investigating energy offers⁴. In its 2015/16 report on the performance of the retail energy market, the Australian Energy Regulator (AER) reported there were 48 market offers and 15 standard offers for residential customers and 30 market offers and 17 standard offers for small business customers in the ACT. In addition there were 16 dual fuel market offers.⁵

¹ ActewAGL's view on retail competition and price regulation are detailed in its submissions to the AEMC's annual Retail Competition Reviews, See for example, ActewAGL Retail 2015, Submission in Response to the Approach Paper: 2016 Retail Competition Review, December.

² The AEMC website states that “All aspects of our work reflect the view that effective competition at wholesale and retail levels, together with appropriate regulation for network services is the best way to deliver efficient, reliable and safe energy for consumers”. <http://www.aemc.gov.au/About-Us/About-the-AEMC>. The ACCC website states “The ACCC promotes competition and fair trade in markets to benefit consumers, businesses, and the community.” <https://www.accc.gov.au/about-us>. The ESC website states “In working to achieve our objective, the ESC, where relevant, must have regard to existing and potential competition within the industry” <http://www.esc.vic.gov.au/corporate/about-us/what-we-do/>. The IPART website states “While the factors that we have regard to vary according to our powers, they typically include factors such as encourage competition where possible.” <https://www.ipart.nsw.gov.au/Home/About-IPART/Our-role>

³ Section 7 of the ICRC Act 2016.

⁴ AEMC 2016, Retail Competition Review, Final Report, June, p. 22.

⁵ AER 2016, Annual Report on the Performance of the Retail Energy Market 2015-16 p.17

Further evidence of increasing competition can be seen in the reduction of ActewAGL's market share. The AER reported that over the financial year 2015/16 ActewAGL's market share declined by 3%.⁶

Given the competition objective in the ICRC Act and presence of competitive activity in the ACT, it is unclear why the Commission suggests that introducing competition may not benefit consumers.

Competition is a means to achieving the objective of realising benefits in the long-term interests of consumers and not an ultimate objective in itself, it is not always economically beneficial to introduce competition in some markets.”⁷

Level of regulated price

ActewAGL remains committed to its long standing position that competition will deliver superior outcomes for consumers and will remove the asymmetric risk of setting prices too low that is inherent in price regulation. Actual and potential competition provides sufficient discipline on ActewAGL to deliver efficient pricing to consumers and deregulation is likely to encourage additional competition in the ACT.

While the Commission controls prices through this regulatory determination process, setting the retail price of electricity too low puts at risk the achievement of other benefits of competition such as innovation in product differentiation and customer services, responsiveness to technology changes and efficient levels of investment.

ActewAGL is concerned that the Commission's current approach to determining retail prices results in prices below the efficient level that would allow full commercial cost recovery for an efficient mass market new entrant.

In particular, the 'swap only' uplift factor evaluated by the Commission falls short of the full hedging costs borne by prudent and efficient retailers and excluding customer acquisition and retention costs from retailing costs results in artificially low prices.

In summary, it is ActewAGL's view that competition continues to increase in the ACT retail electricity market and therefore retail price regulation is no longer warranted. However, given that retail regulation is to continue for a further three years, ActewAGL encourages the Commission to regulate retail prices in a manner that allows proper compensation of efficient costs.

⁶ Ibid p.14

⁷ ICRC 2016, Issues Paper, p31.

3. Regulatory approach and pricing model

This section provides ActewAGL's view on each of the features of the regulatory approach proposed by the Commission in the Issues Paper. The Commission's proposal is to use the same approach to pricing retail electricity services as used in previous regulatory reviews. Overall, the continuation of the current approach is supported, however several components of the model require review. ActewAGL also provides responses to the Commission's specific questions below about the price model.

3.1 Regulatory Approach

3.1.1 Length of the regulatory period and annual calibrations

ActewAGL notes that the length of the regulatory period has been set to three years in the terms of reference. While the three year period provides certainty for retailers and consumers, it also increases the importance of the annual recalibration process and pass-through arrangements to:

- adjust for unforeseen events;
- update estimates where required; and
- correct for settings that may need to be adjusted during the regulatory period.

3.1.2 Weighted average price cap

ActewAGL continues to support the application of the weighted average price cap. The weighted average price cap allows ActewAGL the commercial flexibility to set individual tariffs to better reflect customer's different preferences within an overall price cap.

3.1.3 Cost pass-through arrangements

ActewAGL agrees with the Commission in relation to the importance of retaining the arrangements for cost pass through as a key component of the regulatory approach for electricity pricing for small customers. The Minister's terms of reference for this price review require the Commission to consider "the direct impact on electricity costs of government policies and pass through of costs and savings to regulated prices."⁸

The cost pass through arrangements are a useful mechanism to address the cost impacts from regulatory and taxation events implemented from government or other policy administrative changes that arise from time to time and that impact retailers' costs to supply electricity services. Without such a mechanism, regulated retailers would be unable to recover the efficient commercial costs of supply.

ActewAGL suggests amending some aspects of the cost pass through arrangements as follows.

⁸ Andrew Barr MLA Treasurer, June 2016 ICRC (Price Direction for the Supply of Electricity to Small Customers on Standard Retail Contracts) Terms of Reference Determination 2016 p.2

A regulatory change event is described in the current Price Direction as a decision made by a government or a regulator in the period starting in May of the first year of the regulatory control period and ending on the last day of the regulatory control period. This timeframe poses a problem for regulatory changes that are released on a date that is well in advance of implementation dates.⁹ A more appropriate approach would be reference in the Price Direction to the timeframe in which the costs are incurred, or can be reliably forecast, by the retailer.

The Price Direction should also specifically allow compensation for cost pass-through applications in the final year of the regulatory control period such that the price increase associated with the additional revenue requirements can be levied in the subsequent regulatory control period. The 2014 Price Direction in section 9.1 confines the Commission to consideration of a pass-through event as part of the annual recalibration process as described in section 8. Accepting pass-through applications in the final year means that a price increase associated with the additional revenue requirements can be levied in the first year of the subsequent regulatory control period, if this is established as a reset principle.

3.2 Pricing Model

ActewAGL supports the continued use of the Commission's pricing model provided that some adjustments are made. The model is simple, transparent and replicable and provides a consistent and predictable approach to price regulation in line with the AEMC's recommendation¹⁰.

ActewAGL, however does have several concerns with a number of the inputs into the Commission's model, which are set out in the sections below.

3.2.1 Energy purchase cost

The Commission's Issues Paper, seeks input on two issues relevant to estimating the energy purchase cost (EPC).

Issue 1: Is it appropriate for the Commission to return to using exchange traded ASX forward price data averaged over a 23-month period in calculating energy purchase costs?

Given the removal of the carbon price from 1 July 2014, ActewAGL agrees with the Commission that the use of over the counter (OTC) contract data is no longer necessary. ActewAGL believes it is appropriate for the Commission to return to using exchange traded ASX forward price data for calculating the forward price. ActewAGL also agrees with the Commission's proposal to return to the full 23 month averaging period as it better reflects the purchasing profile of a prudent retailer.

ActewAGL notes the significant rise in the forward price for wholesale electricity in 2017/18, which will be captured in the Commission's pricing model. While

⁹ This is often the case for regulatory changes that have significantly far reaching consequences justifying inclusion of transitional arrangements so that firms have time to put in place the necessary changes.

¹⁰ AEMC 2013, Advice on Best Practice Retail Price Methodology, Final Report, September.

wholesale electricity prices have been rising since 2014, the most dramatic increases have occurred since April 2016 for a number of reasons including:

- Increasing demand from Queensland where the growing LNG export operation in Gladstone has seen the Queensland market go from supplying lower cost power to NSW to importing more energy to meet the demands of large scale gas liquefaction. As export demand increases gas prices, the subsequent cost of producing gas fired electricity increases wholesale electricity prices further.
- Emerging demand in Victoria where there are concerns over energy security and supply as ageing brown coal generation is retired. This increases prices in NSW as Victoria seeks to import more energy from black coal generation in the NSW Hunter Valley.

The disruption in the NEM and the reversal of the supply and demand balance in NSW has seen contract prices increase by almost 50%.

Issue 2: The Commission welcomes comments on its current approach to estimating hedging costs.

While ActewAGL recognises the complexities involved in estimating the uplift factor in a market characterised by significant price and demand volatility, the Commission's current approach to calculating the uplift factor underestimates the efficient costs incurred by retailers.

In response to ActewAGL's previous concerns on the model, the Commission has held the view that the EPC model is doing exactly what it was designed to do and is providing a conservative EPC for ActewAGL¹¹. ActewAGL does not believe the EPC model produces conservative results.

The Commission's model is based on a swap only hedge, as this approach is simple and in the Commission's view provides a reasonable estimate of hedging costs. Prudent and efficient retailers layer a combination of base swaps, peak swaps and caps to hedge a load. Retailers use these more complex structures to manage forward price risks. In practice retailers don't use a simple swap only hedge approach.

To demonstrate this, ActewAGL has assessed actual uplift factor outcomes over the period 2005/06¹² to 2015/16 for the Commission's swap only approach compared to a retailer's layered hedge approach with overall hedge coverage set equal to that of the Commission's model.

As can be seen from Figure 1 below, the uplift factors for the Commission's swap only hedge are bounded within the range of 0.61 to 1.44 while a retailer's layered hedge structure delivered outcomes in a much narrower range of 0.87 to 1.35.

¹¹ ICRC 2014, Final Report, Standing offer prices for the supply of electricity to small customers, 1 July 2014 to 30 June 2017, Report 4 of 2014, June.

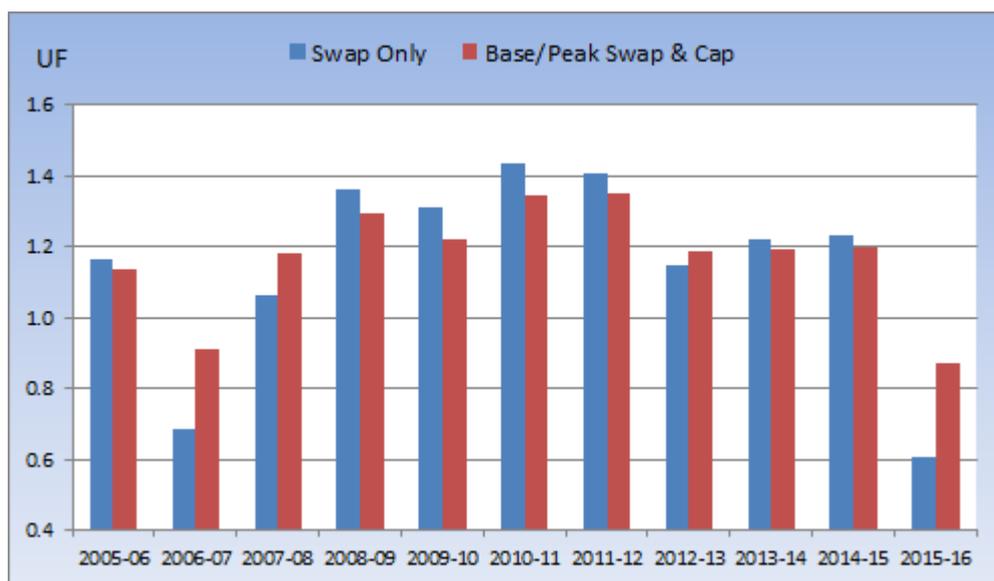
¹² The comparison is undertaken for the period from 2005/06 rather than 2003/04 because ASX price data for cap products commenced in 2005/06.

Retailers seek to limit price uncertainty that comes from the highly volatile spot market. Layered hedges are demonstrably better at limiting price uncertainty than the swap only hedge structure allowed for under the Commission’s uplift factor model.

The risk management strategy provided by a layered hedge structure comes at a small premium compared to the swap only approach. Comparing actual uplift factors for 2005/06 through 2015/16 the long run average uplift factor is 2.2% higher than the swap only approach.

In ActewAGL’s view, the Commission should acknowledge that retailers use more complicated hedge structures than the simple swap only hedge approach currently evaluated by the existing uplift factor equation. An allowance of at least 2% should supplement the Commission’s existing (swap only) calculation of the uplift factor to adequately compensate retailers for the additional long run cost that is being incurred by retailers using the prudent and efficient layered hedge structure.

Figure 1: Historic Actual Uplift Factor: Swap only hedge vs layered hedge



3.2.2 Customer acquisition and retention costs

In the Issues Paper, the Commission re-iterates its position against the inclusion of an allowance for customer acquisition and retentions costs (CARC). The Commission’s view is that such an allowance is not warranted in the ACT because there is a reasonable probability that any benefits will be small or long delayed or non-existent, and therefore of little current value.¹³ The Commission welcomes comments on its position.

¹³ ICRC 2016 Issues Paper p.31

Issue 3: The Commission welcomes comments on its position that a competition allowance is not justified in the ACT.

ActewAGL disagrees with the Commission's position on CARC for the same reasons detailed in previous submissions.¹⁴ ActewAGL's view is summarised below.

- The Commission fails to acknowledge the link between the level of competition in the ACT and regulated retail prices. The Commission appears more concerned with the possibility that the inclusion of CARC may result in higher prices in the short-term rather than the longer-term benefits that competition can deliver in the form of innovation, cost efficiencies, improved customer service and greater product differentiation that better reflects customer needs.¹⁵
- CARC are legitimate costs that would be incurred by a prudent and efficient mass market electricity retailer operating in a competitive market. The exclusion of such costs results in total costs being set below efficient levels, which is at odds with the objective of promoting competition and the delivery of subsequent benefits to consumers.
- ActewAGL and other retailers operating in the ACT incur acquisition and retention costs and therefore the Commission's position to exclude these costs would result in total retail operating costs being set below a commercial level in the ACT.

ActewAGL also notes that the Office of the Tasmanian Economic Regulator (OTTER)¹⁶, in its most recent pricing determination for Aurora Energy, allowed a provision for customer acquisition and retention costs. While OTTER did not separately identify the value it assigned to CARC from other retailing costs, it did state that:

“The Economic Regulator is allowing Aurora Energy to recover CARC such as costs relating to defensive campaigns and advertising costs which would be incurred should a new retailer or retailers enter the Tasmanian residential electricity market.”¹⁷

OTTER set total retailing costs, inclusive of CARC, at \$138.45 per customer.¹⁸ This compares with the Commission's current retailing cost allowance for ActewAGL of \$117.53 per customer for 2015/16 and \$119.31 per customer for 2016/17.¹⁹

The inclusion of CARC by OTTER is consistent with the approach adopted by other Australian regulators including IPART, QCA and ESCOSA prior to the removal of

¹⁴ ActewAGL Retail, Issues Paper response to the ICRC, Retail prices for franchise electricity customers from 1 July 2014, 15 November 2013, p. 20

¹⁵ The Allen Consulting Group, Calculating the CARC for an efficient full-market electricity retailer in the ACT, April 2012, p. 14

¹⁶ Office of the Tasmanian Economic Regulator, Investigation to determine maximum standing offer prices for small customers on mainland Tasmania, Final Report, May 2016, p.56

¹⁷ *ibid*, p. 58

¹⁸ *Op.cit.* In addition, the Office of the Tasmanian Economic Regulator states that “If, as a result of a new retailer entering the Tasmanian residential electricity market, Aurora Energy sustains a material change in costs or is materially adversely affected by the change in circumstances, the Pricing Regulations provide Aurora Energy with the ability to seek the Economic Regulator's approval to either adjust (see Section 7.6.2 of this Report), or amend (see Section 3.3 of this Report) the 2016 Standing Offer Determination”. p.57

¹⁹ ICRC. June 2016, Final decision Retail electricity price recalibration 2016-17 p.18

retail price regulation. The Commission is the only Australian regulator to exclude CARC from total retailing costs.

To ensure ActewAGL is able to recover its efficient costs in line with established regulatory practice in other Australian jurisdictions, ActewAGL urges the Commission to include a commercially based benchmark allowance for CARC in its pricing determination for the forthcoming regulatory period.

3.2.3 Energy Efficiency Improvement Scheme costs

The EEIS has been extended for the period 2016 to 2020 and therefore a cost allowance for the scheme needs to be included in the new regulatory period. In the Issue Paper the Commission proposes to use the same approach as used in the previous regulatory period. The Commission's approach relies on forecast and estimated costs in advance of the actual costs being incurred. Due to the timing of the scheme, this will continue to be the case in the new regulatory period and hence a provision will be required for an ex-post adjustment. The Commission's methodology also includes a forward-looking prudence and efficiency assessment.

ActewAGL's view is that the EEIS costs can be assessed for prudence in terms of the abatement mechanisms chosen by ActewAGL to satisfy the schemes legislative requirements. In terms of productive efficiency in delivering the selected activities, ActewAGL employs an open tender process to deliver an efficient cost outcome.

In the 2017-2020 period, the mix of activities under the EEIS is expanding to include activities that will allow the commercial market to participate, in addition to continuing activities in the residential market. Initially, this will offer energy efficient lighting replacement services to the commercial sector commencing in December 2016. A contractor to deliver these services was chosen through an open tender process²⁰ where 1,327 suppliers were notified of the new tender opportunity, 345 viewed the tender notice, 69 downloaded the tender documents and 7 tender responses were received. ActewAGL would be happy to provide the tender documentation and further details of the tender process, if required, to the Commission to assist in the efficiency assessment.

Another important aspect of the scheme is a requirement that energy efficiency activities be undertaken in vulnerable households to increase their opportunity to lower energy use and costs.²¹ The EEIS includes a Priority Household Target (PHT) to ensure fair and equitable access for low income households. ActewAGL's Energy Saving House Call program was designed in line with the EEIS objectives to target and benefit low income households.

To date, ActewAGL has achieved its PHT in each year of the EEIS. ActewAGL's data reveals 74% of customers that fit the criteria of priority household have participated in the program where there is no cost to the customer and the customer receives benefits from the energy efficiency scheme such as bill savings.

²⁰ The web based tendering platform, Tenderlink was used for this process.

²¹ Energy Efficiency Improvement Scheme, Energy Efficiency (Cost of Living) Improvement Bill - regulatory impact statement

Future residential activities will focus on encouraging energy efficient appliance replacement. ActewAGL will be introducing a subsidy in the form of a customer discount for the use of more efficient appliances, which will align prices with similar but less efficient and less expensive appliances.

Transitioning to appliance based activities whereby there is a capital cost contribution required by the customer will impact adoption levels by low income households (e.g. the purchase of a 6-star energy efficient heating or hot water unit).

As such, meeting the PHT with activities that require a capital contribution will:

1. affect equitable access of the ACT residents to the benefits of the EEIS; and
2. impact vulnerable households' access to the EEIS by reducing the available affordable measures to reduce household energy consumption.

Unless the target for priority household participation is reduced or removed, it is likely that the incentives to encourage participation of low income households will need to increase and hence the cost of delivering the obligation under the EEIS will be higher. ActewAGL is also facing the risk of not reaching abatement targets for priority households that will result in a significant increase in the cost of the scheme through the imposition of shortfall penalty rates of \$300 per tonne.²² These risks are not factored into the cost estimation for delivering the EEIS.

3.2.4 Network costs

ActewAGL agrees with the Commission's proposal to continue to directly pass through network costs into retail prices. Network charges are comprised of distribution charges, transmission charges, jurisdictional scheme charges and metering charges. The components of ActewAGL Distribution's (AAD's) network charges have changed so that jurisdictional schemes are now a separate component of the network charge. Jurisdictional scheme charges primarily consist of feed-in tariffs for large, medium and small scale renewable generators but also include the Utilities Network Facilities Tax and the Energy Industry Levy. ACT legislative changes are expected to increase the jurisdictional scheme cost component of network charges.

The AER approves AAD's proposed network pricing shortly before the release of prices on 1 July each year. The 2016/17 network prices approved by the AER were based on the methodology agreed with the AER in the Enforceable Undertaking, which was a CPI increase to 2015/16 approved prices. ActewAGL anticipates that the methodology for determining network prices for 2017/18 will again be determined by an Enforceable Undertaking.

The Enforceable Undertakings ameliorate uncertainty for consumers about the applicable prices caused by delays in the AER remaking its 2015 final decision for AAD's distribution determination.

The AER delay to remaking the 2015 final decision could also result in significant volatility to network prices when the AER final decision is re-made, should that be required by the courts. This is because there will be only one or two years left in the

²² Energy Efficiency (Cost of Living) Improvement (Penalties for Noncompliance) Determination 2015 (No 1)

current five year regulatory period to absorb any changes between the prices actually charged over the current regulatory period and what should have been charged according to the remade final decision. To reduce the impact of price volatility arising from the AER's remade final decision, should that eventuate, AAD proposed, along with other network New South Wales businesses, a rule change for a participant derogation to the AEMC.²³ If granted this rule change will have the effect of smoothing the revenue change over a longer period into the next regulatory control period.

Under the proposed rule change, the AER will continue to determine the revenue amount that can be recovered each year through network tariffs by determining the X-factor that is the normal mechanism for smoothing revenues between years within the regulatory period. The participant derogation allows the AER to incorporate any additional revenue changes resulting from the difference between the AER's 2015 final decision and a remade final decision, should that eventuate, into the smoothing mechanism across regulatory control periods. The AER will have the opportunity to smooth revenues into the subsequent control period as well to achieve a smoother glide path for tariff price changes.

The implication for retail prices of AAD's proposed participant derogation rule change is that the network cost component will not experience large fluctuations up or down across years that could otherwise occur as a result of the AER's remade decision.

ActewAGL expects AAD will continue to provide an annual price proposal to the AER for approval each year²⁴. The adjustments to network pricing methodology based on the Enforceable Undertaking and the participant derogation rule change has no impact on the Commission's process for including network costs in retail prices. ActewAGL understands the AER will continue to review network prices at the same time each year enabling the Commission to incorporate those charges into retail pricing as in previous years.

3.2.5 Other model components

The Commission's Issues Paper welcomes feedback on other components of the pricing model.

Issue 4: The Commission welcomes feedback on its current approach in estimating the cost categories in its pricing model.

In relation to retail costs, ActewAGL maintains its position that the Commission's retailing costs are set too low. As detailed in previous submissions, the retail operating costs allowed by the Commission were the lowest when benchmarked against NSW, Queensland and Tasmania. This is exacerbated when considering the relative smaller scale of the ACT market.

With the exception of the issues discussed above, ActewAGL is supportive of the Commission's approach to estimating the other components of the model, specifically:

²³ AEMC <http://www.aemc.gov.au/Rule-Changes?topicid=1&status=1> ACT DNSP Revenue Smoothing, NSW DNSP Revenue Smoothing

²⁴ Note, the enforceable undertaking replaced AAD's annual price proposal for 2016/17.

- ActewAGL supports the Commission's market-based approach to determining efficient costs for the Large-scale Renewable Energy Target and Small-scale Renewable Energy Scheme. The price of green certificates required to meet the renewable energy targets has seen dramatic price increases due to the perceived shortage of certificates as scheme targets increase in coming years. As a result, prices are expected to stay close to a maximum of almost \$93 as set by the tax effective penalty rate.
- ActewAGL supports the Commission's methodology for calculating energy losses for the transportation of electricity through transmission and distribution networks based on AEMO published data.
- ActewAGL considers the CPI adjustment applied by the Commission to energy contracting costs and National Electricity Market fees to be appropriate.
- ActewAGL considers the benchmark retail margin of 6.04%, applied in ex ante terms consistent with the 2014 decision, is appropriate.
- As the carbon pricing scheme is no longer in effect, ActewAGL believes that the carbon cost component should be removed from the pricing model.

4. Mechanisms to apply for annual price adjustments

This section provides the reasons why ActewAGL supports the continued use of the annual recalibration mechanism and the cost pass-through mechanism which ActewAGL intends to apply for within the next control period to compensate ActewAGL for costs incurred implementing the Power of Choice regulatory changes.

4.1 Annual Recalibration

ActewAGL supports the Commission's proposal to include an annual recalibration in the approach to retail pricing. This is consistent with the approach adopted by the Commission in previous regulatory arrangements. ActewAGL considers that continuing this approach not only provides a reasonable level of stability and predictability but also promotes consumer confidence in the price setting process.

ActewAGL considers that the annual price adjustment mechanism should be calculated as an X-factor that is applied to the weighted average price cap formula. ActewAGL proposes that the elements of the pricing model that should be adjusted annually are:

- LRET and SRES costs calculated using the Commission's market-based approach to determining efficient costs;
- energy losses for the transportation of electricity through transmission and distribution networks based on AEMO published data;
- wholesale energy contracting costs, National Electricity Market fees and total retail operating costs, including CARC, increased by CPI;
- calculation of EPC using the most recent exchange traded ASX forward price data, and a full 23 month averaging period and load data;
- ActewAGL's forecast of efficient and prudent costs under the expanded EEIS to be passed through into retail prices;
- regulated retail customer numbers and usage;
- network costs, as determined by the AER, passed through to customers;
- retail margin remain fixed at a market reflective level of at least 6.04 per cent applied in ex ante terms consistent with the 2014 decision; and
- adjustments for any approved pass through applications.

4.2 Cost pass-through application for Power of Choice

In the 2016/17 annual recalibration regulatory process, ActewAGL initiated a pass-through application for the upcoming costs associated with the Power of Choice regulatory changes released in November 2015 to be implemented on 1 December 2017. We note that costs from Power of Choice were also foreshadowed in the 2015/16 recalibration process.

Background

ActewAGL indicated in the 2016/17 recalibration process that costs associated with the Power of Choice regulatory event are likely to be incurred during 2016/17 and

2017/18. ActewAGL will provide the costs associated with the Power of Choice regulatory change separately to the Commission when more information is available about those costs. At this stage ActewAGL does not have certainty over the nature of the costs, other than there are likely to be impacts on IT systems and business processes.

The Commission indicated in the 2016 Final Decision Retail electricity price recalibration 2016-17, that it will consider this matter as part of the investigation leading up to the next regulatory period commencing 1 July 2017.²⁵

Costs associated with supporting smart meters

The Power of Choice regulatory rule changes will have a considerable impact on ActewAGL's existing market processes and business systems (as well as other electricity retailers) because as the Financially Responsible Market Participant (FRMP) ActewAGL will be responsible for the metering of all its customers. All future and replacement meters must at least comply with the Smart Meter Minimum Services Specification. This means that ActewAGL will be responsible for installing smart meters for all:

- new customers at greenfield sites, urban in-fill through development of apartment buildings and knock-down-rebuild brownfield sites;
- existing customers when their existing meters are required to be replaced due to reaching the end of their useful life; and
- any other existing customers that ActewAGL chooses.

The circumstances where customers can opt out of smart meters are narrow.

Even if the level of demand for smart meters is initially low, ActewAGL will still need to incur significant investment to comply with the PoC regulatory rule changes in order to support the take up of smart meters. Likely costs include but are not limited to:

- making changes to IT systems and business processes to comply with the AEMO procedures, including the B2B procedures which are still to be finalised;
- putting in place contractual and commercial arrangements with the various Metering Coordinators (MC) to arrange for the installation of smart meters at the customer's premises; and
- upgrading its data management and data repository to house half-hourly interval metering data, provided by the MCs on a daily basis.

ActewAGL must have the capability to enable smart metering by 1 December 2017, that is, it must ensure that a MC is appointed for each of its customer's connection points. If ActewAGL fails to achieve this, it will be in breach of National Electricity Rule 7.6.1, which is a civil penalty provision.

As noted in the 2016/17 recalibration process, ActewAGL, like other industry participants, is at the preliminary stage of identifying the likely impacts of the rule

²⁵ ICRC, June 2016, Final Decision Retail electricity price recalibration 2016-17 p.4.

change and developing strategies to put the changes into effect. A more detailed cost pass through submission will be made when the costs of implementing the rule change are better known.

Further policy direction not required

The Issues Paper indicates that the Commission may seek a “policy direction” to include the costs of installing and supporting smart meters in regulated retail prices. ActewAGL considers that the Commission should not rule out categories of costs to be included in retail prices prior to ActewAGL’s and stakeholder submissions on Power of Choice costs.

ActewAGL considers that the necessary policy direction has already been provided to the Commission in several respects. Firstly, the form of the government’s Terms of Reference require that “the Commission must consider the direct impact on electricity costs of government policies and pass through of costs and savings to regulated prices.... Any other schemes implemented to address climate change relevant to electricity pricing”²⁶. Given the policy direction in the terms of reference the Commission needs to consider costs arising from the Power of Choice regulatory event, which ActewAGL has not yet submitted.

Secondly, policy direction is provided in the ICRC Act at clause 20(2) that lists a range of considerations that the Commission must have regard to, including “e) the cost of providing the regulated services” and “h) considerations of demand management and least cost planning”.²⁷ Use of smart meters at customers’ properties is consistent with the considerations e) and h) which the Commission must have regard to in making price directions.

Thirdly, the AER has not sought any further policy directions to recognise that the Power of Choice reforms will lead to additional costs for which cost pass-through applications can be made. In April 2016 the AER provided some distribution firms, including AAD, with an extension to submit cost pass-through applications associated with the Expanding Competition in Metering and Related Services Rule Change component of the Power of Choice reforms until 90 business days after 1 December 2017.²⁸

Fourth, the proponent of the rule changes for the Power of Choice reforms was the COAG Energy Council. Policy changes requested by the COAG Energy Council are managed by the AEMC, which states it is responsible for making “rules under the National Electricity Law, the National Gas Law and the National Energy Retail Law. These rules impact on how companies can operate and participate in the competitive generation and retail sectors. They also govern the economic regulation of electricity transmission and distribution network services and gas pipelines.”²⁹

²⁶ Andrew Barr MLA Treasurer op cit.

²⁷ Ibid p.28

²⁸ <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/cost-pass-throughs/actewagl-cost-pass-through-extension-of-time-limit-to-submit-2016-application>

²⁹ <http://www.aemc.gov.au/About-Us/About-the-AEMC/Our-role>

Given the above policy directions, ActewAGL does not consider that a further formal policy direction is required for the Commission to review and assess any categories of costs resulting from the Power of Choice regulations.

Definition of Regulatory Change Event

The Issues Paper also appears to cast doubt as to whether the Power of Choice reform is a regulatory change event, by stating “The AEMC final rule change of 26 November 2015 does not specify that the installation of smart meters is a regulatory requirement.”³⁰ ActewAGL considers that the Power of Choice reforms are clearly regulatory rule changes for a number of reasons.

The Power of Choice is a regulatory change event as contemplated by the definition in the 2014 Price Direction. The source of the change must be “a decision by any ACT or Commonwealth Authority”³¹ which is defined as any government or any minister, agency or directorate, instrumentality or other authority of government and the Commission, the AEMC, the AER or AEMO. The Power of Choice rule changes were issued by the AEMC which is a relevant authority within the definition of a regulatory change event.

To be a regulatory change event the decision must also have “the effect of varying the nature, scope, standard or risk of providing services to small customers or the manner in which those services are provided.”³² The Power of Choice rule change will impact the nature, scope, standard, risk and manner of providing services to small customers. Impacting the approach to the delivery of electricity services to retail customers is the main objective behind the reforms as articulated by the AEMC’s description of the rule changes:

“The final rule will facilitate a market-led approach to the deployment of advanced meters where consumers drive the uptake of technology through their choice of products and services. This competitive framework for metering services is designed to promote innovation and lead to investment in advanced meters that deliver the services valued by consumers at a price they are willing to pay.

This final determination is part of a series of changes recommended in the Commission's Power of Choice review to support demand side participation in the National Electricity Market (NEM), including network pricing arrangements and access to energy consumption information. Improved access to advanced metering services provides the link in this broader market reform program to give consumers opportunities to better understand and take control of how they use electricity and the costs associated with their usage decisions.”³³

³⁰ ICRC 2016 Issues Paper p 27

³¹ ICRC 2014 Price Direction p.11

³² ICRC 2014 Price Direction p.11

³³ AEMC 2015 “National Electricity Amendment (Expanding competition in metering and related services) Rule 2015, National Energy Retail Amendment (Expanding competition in metering and related services) Rule 2015” p i

Compliance with the rule change decision is not optional for ActewAGL, it is a legal requirement outside ActewAGL's control. The Power of Choice reforms require changes not only to the National Electricity Rules, impacting network firms but also required amendments to the National Energy Retail Rules. The AEMC states the National Electricity Rules govern the operation of the National Electricity Market and that the Rules have the force of law and are made under the National Electricity Law.