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A few words.

The Independent Competition and Regulatory Commission

GPO Box 296

CANBERRA CITY ACT 2601

3 February 2012

Dear Sir/Madam

Re: Issues paper – Retail prices for non-contestable electricity customers 2012-14, December 2011

AGL welcomes the opportunity to comment on the Independent Competition and Regulatory Commission's (***the Commission***) *Issues paper: retail prices for non-contestable electricity customers – 2012-14 (**Issues Paper**).*

AGL operates across the supply chain and has investments in coal-fired, gas-fired, renewable and embedded electricity generation. AGL is Australia's largest private owner, operator and developer of renewable generation in Australia with 1,205 MW of renewable capacity (at 30 June 2011). AGL is also a significant retailer of energy with over 3 million electricity and gas customers. AGL has previously participated in the ICRC consultation process associated with the *Review of retail Prices for non-contestable electricity customers – 2010-12 (**2010 Review**).*

Regulatory Approach

The Commission has noted that the Australian Energy Market Commission (AEMC) "recently completed a review of the effectiveness of competition in the ACT retail electricity market and questioned the Commission's approach to setting the regulated tariff".[1] The Commission has also identified that an option for increasing competition is that the regulated retail tariff be based upon the efficient costs of a new entrant business, rather than those of the incumbent retailer.

AGL supports the AEMC's suggestion that the Commission should consider the costs of a new entrant retailer, rather than solely the efficient cost of the incumbent. Using a 'new-entrant retailer' approach is the preferred approach in other jurisdictions (i.e. SA) and this approach would more accurately represent the costs of non-incumbent retailers operating in the ACT market.

Energy Purchase Cost Methodology

As in previous submissions, AGL is of the view that the current methodology used to calculate the energy purchase cost (EPC) does not represent the costs and risks faced by a retailer in servicing a small customer load in the ACT. AGL made a number of submissions to the Commission's 2010 Review highlighting a number of the reasons why the Commission's proposed approach was not appropriate, these included:

- The approach does not reflect the way in which retailers' hedge their load or price a customer;

[1] ICRC, *Issues paper: retail prices for non-contestable electricity customers – 2012-14, Report 11 of 2011,* December 2011. Page 5

- The approach implies that retailers can perfectly forecast their load, with no allowance for forecasting error;
- Under this approach, retailers still face uncertain price outcomes as they remain highly exposed to pool prices; and
- The approach does not account for retailer risks including liquidity and extreme event risk i.e. there is no account for holding insufficient hedge cover at specific times and being exposed to high pool prices.

AGL also maintains that regulated retail electricity prices should consider the long run marginal cost (LRMC) of generation of supplying a retailers' small customer load. In the past, the Commission had suggested that setting regulated prices using the LRMC of generation implied that if retailers purchase electricity above a wholesale market price (at a particular point in time) then they are altruistically supporting their suppliers.[2] Clearly it is not the case that retailers act in an altruistic manner in relation to their suppliers. However, AGL notes that this comment does not acknowledge that retailers are often vertically-integrated and/or exposed to power purchase agreements (PPAs) and these arrangements, which invariably reflect LRMC, are used to manage wholesale market risk and ensure supply for their customers over time periods greater than one year. It could also be argued that because the NSW regulated retail price is based upon the LRMC of generation (in part) to ensure security of supply is maintained, that an approach based solely on a market-based cost of electricity supply 'free rides' on the value of the 'security of supply' created by the NSW regulatory process.

Commissions' EPC methodology

The Commission has highlighted that the passage of the legislation for the introduction of a carbon pricing mechanism from 1 July 2012 has likely impacted the price and liquidity of forward electricity contract trading over recent months. In Figure 2.1 of the Issues Paper the Commission sought to identify the impact on 2012 'carbon inclusive' futures prices of policy announcements and Commonwealth Parliament votes related to the carbon pricing mechanism. The Commission has implied that a direct correlation can be made between changes in the futures price and these events. AGL is of the view that it is not possible to accurately isolate the impact of one particular policy or event in the market on futures prices. The price of these contracts traded on the ASX Australian Futures Exchange is settled on a single price and therefore the anticipated policy environment and resulting costs to generators at the time of settlement is likely to be accounted for by the market. As market sentiment and political dynamics change over time it is likely expectations over the carbon pricing mechanism also changed resulting in different futures prices. Therefore, using 'carbon inclusive' futures price data from this period would result in an under estimation of retailers costs associated with the carbon pricing mechanism.

Figure 2.3 and 2.4 in the Issues Paper clearly demonstrate the reduction in open interest and cumulative trading volumes for electricity futures contracts for the period following the introduction of the carbon pricing mechanism. This serves to highlight that during this period retailers have been hedging their electricity load in different markets and through other mechanisms. AGL would suggest that retailers have been using over the counter (OTC) contracts to hedge future electricity requirements. OTC contracts include standardised commodity contracts which are traded often using a broker or other intermediary. Brokers (i.e. ICAP) often publish prices curves and trading volume information for interested parties.

In order to mitigate the risk associated with uncertain carbon pricing policy the Australian Financial Markets Association (AFMA) developed an addendum to the standard Commodity Transaction contract (i.e. Australian Carbon Benchmark (ACB) Addendum) which allows the parties to adjust the price of the transaction to subject to the introduction of a carbon price i.e. carbon-exclusive contract. AGL notes that in May 2011 AFMA clarified the

[2] ICRC, *Final Technical Paper, Model for Determining the Energy Purchase Cost Component of the Transitional Franchise Tariff, Report 3 of 2010*. Page 16.

process on which their price survey information was collected so as to ensure that prices quoted from 4 July 2011 were on a solely 'carbon-exclusive' basis, in line with the ACB Addendum.

If the Commission is not minded to amend their market-based EPC approach, AGL believes that using a 'carbon-exclusive' forward contract price (in the existing EPC methodology) plus an allowance for carbon costs would be the most appropriate approach for 2012-13. In order to reflect retailers' requirements to purchase hedge cover prior to the period in question AGL would urge the Commission to sample forward contract prices over a period of 2-3 years. If 'carbon-exclusive' prices are not available for that period, then the Commission should use as long a period as can be provided by this data.

AGL notes that the impact of carbon pricing policy uncertainty on forward prices could change over time, and in turn this may affect the liquidity in these markets. However, due to the 2-3 year time period over which retailers hedge their load the Commission should consider further whether using 'carbon-inclusive' forward prices is appropriate in 2013-14.

Allowance for carbon price

As noted in the Issues Paper, due to a lack of liquidity in exchange traded forward contracts the Commission cannot rely on this as a source of price data that would reflect a retailer's exposure to costs associated with the introduction of the carbon pricing mechanism. In this case, the Commission should consider the other mechanisms by which retailers are exposed to carbon costs and develop a methodology to be used with the approach described above for the 2012-13 'black' component of the EPC.

AGL suggests that an allowance for the introduction of a carbon price is calculated on the following basis:

- Use an approach based on the ACB Addendum i.e. NEM average carbon intensity[3] multiplied by a carbon reference price (i.e. price of carbon unit) for the period;
- The carbon reference price is based on the carbon unit charge in the Clean Energy Act, 2011 i.e. $23 in 2012-13;and
- Set an average carbon intensity (ACI) based on an ACI calculated over one year using the most recently available data. Using one year of data is required to reflect any seasonal variation in the ACI i.e. generation mix changes depending on the demand requirements. AEMO have published a Carbon Dioxide Equivalent Intensity Index (CDEII) for generation in each NEM region, and the NEM as a whole, from 19 June 2011. The methodology for this calculation is available on the AEMO website.[4] An ACI could be calculated by the Commission to replicate the CDEII over a full year based on published 'as generated' generator outputs, auxiliary use and emission intensities. However, an alternative option would be to use an average of the AEMO CDEII for the period of 19 June 2011 to 31 May 2012. This would cover close to a full year and likely represent a reasonable average for a year.

Green costs

The Commission has noted that for the 2011-12 TFT a market-based approach was used to calculate prices for large-scale generation (LGC) certificates. AGL notes that this approach potentially results in a similar problem as described for the EPC i.e. negative impact on retail competition because in NSW the IPART LGC price is based on the LRMC of meeting

[3] Average carbon intensity used in the ACB Addendum is calculated in the basis of the NEM intensity for the period of the contract and applied at settlement. The use of the NEM intensity recognises the interconnected nature of the NEM and that participants trade across regions and are likely to be exposed to carbon costs across more than one jurisdiction.
[4] AEMO, *Carbon Dioxide Equivalent Intensity Index Procedure*, Version 1.00 (2010) available at http://www.aemo.com.au/electricityops/0910-0009.pdf

the LRET.[5] AGL suggests that using an LRMC approach would be more appropriate in setting the TFT. If the Commission is not prepared to change their current approach, AGL suggests that the Commission sample LGC prices so as to reflect a retailer's approach of hedging their liability prior to the relevant period.

Retail operating costs

As noted earlier, AGL is of the view that in setting the TFT, it is more appropriate that the Commission consider the costs of a new entrant retailer, and specifically account for customer acquisition and retention costs (CARC).

AGL also notes that retail margin should be viewed in the context of the overall approach of setting regulated prices. On this basis, it is not appropriate to use a direct comparison with other jurisdictions (i.e. NSW) to establish whether the proposed margin is adequate.

If you have any queries in relation to this matter, please do not hesitate to contact Andrew Dudgeon on (02) 9921 2612 or adudgeon@agl.com.au.

Yours sincerely,

Elizabeth Molyneux

Head of Regulated Pricing

AGL Energy Ltd

[5] IPART, *Changes in regulated electricity retail prices from 1 July 2011 – Final Report and Determination*, June 2011. Page 39