



independent competition and regulatory commission

Draft Decision
**Retail Prices
for Non-contestable
Electricity Customers**

**Report 2 of 2008
April 2008**

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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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 franchise customers for the period from 1 July 2008 to 30 June 2009. The Minister's reference dated 7 February 2008 is made under sections 15 and 16 of the *Independent Competition and Regulatory Commission Act 2000* (ICRC Act).

This reference makes the fourth price control arrangement for transition franchise tariff (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); and
- The current reference requires a regulated maximum tariff applicable to TFT customers for a further period of one year from 1 July 2008 to 30 June 2009, and this report outlines the Commission's draft determination of the maximum tariff change.

In developing the price direction for the regulated maximum transitional franchise tariff applicable to customers eligible for these transition arrangements for the period from 1 July 2008 to 30 June 2009, 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 price direction and reasons for the particular arrangements embodied in the direction.

Paul Baxter
Senior Commissioner
April 2008

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1 Introduction

1.1 Background

In the ACT, the retailing of electricity to customers consuming more than 160 megawatt hours (MWh) per year was made contestable from 1998.¹ The electricity supply industry in the ACT was opened for retail competition to customers consuming more than 100 MWh/year from 1 July 2001.² Following the recommendation that full retail contestability (FRC) be introduced for all customers in the ACT, the government opened the market for customers using less than 100 MWh/year to competition from 1 July 2003.³ 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.

The Commission received a reference from the Attorney-General, instructing the Commission to provide a price direction for the supply of electricity to franchise customers 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 per 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 the Commission 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 standard retailer, ActewAGL Retail, are called 'non-franchise customers'.

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 the provision of 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 released an issues paper in November 2005 and considered the submissions received on that paper in reaching its draft decision.

¹ *Utilities Act 2000*.

² Disallowable Instrument 2001–93.

³ Independent Competition and Regulatory Commission, *Final report: Full retail contestability in electricity in the ACT*, July 2002. Disallowable Instrument 2003–20.

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

The Commission issued its final decision in April 2006. In this 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 legislative changes to the *Utilities Act 2000* 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 the Commission received a further reference from the Attorney-General, instructing the Commission to provide a price direction for the supply of electricity to franchise customers for a transitional period from 1 July 2007 to 30 June 2008. In undertaking this review, the Commission decided to revert to an analysis based upon a rigorous examination of the costs incurred by ActewAGL Retail in the provision of retail electricity services to franchise customers. This was required because of the length of time since the first cost study during early 2003, that the evidence of large changes in the wholesale electricity charges which were a major cost input for ActewAGL Retail in supplying services to these franchise customers.

In its final report released 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 2008.⁶ In this final report, the Commission made the observation that the reference requirement for the TFT to be set for a 12-month period required the Commission to factor in current market data that was exhibiting a large increase in the electricity pool price resulting from supply–demand imbalances in the wholesale electricity market, leading 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 customer by the incumbent retailer. The short reference period meant the Commission was unable to transition any price changes over a longer period, as was decided in other jurisdictions, at around the same time (eg: the Independent Pricing and Regulatory Tribunal, IPART, in NSW and the Essential Services Commission of South Australia, ESCOSA, in SA).

The Commission has now received a further reference from the Attorney-General, instructing the Commission to provide a price direction for the supply of electricity to franchise customers for a transitional period from 1 July 2008 to 30 June 2009. As part of the Commission's current

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

⁶ ICRC, *Final Decision and Price Direction: Retail prices for non-contestable electricity customers*, Report 7 of 2007, June 2007.

analysis, the Commission is again undertaking a rigorous evaluation of the build-up of retail costs. This is again required as the wholesale electricity market has begun to exhibit less volatility and the wholesale electricity prices have begun to reduce towards the long-term averages seen prior to early 2007. This will have fundamental impacts on the cost structures of an incumbent retailer servicing franchise customers and for new entrant retailers seeking to draw customers away from the TFT tariffs provided by ActewAGL Retail, through application of price discounts and additional service features.

In undertaking this fourth review of TFTs the Commission is still of the view raised in its April 2006 report, that there is sufficient competition in the small customer segment of the electricity retail market (<100kWh pa) within the ACT that the government might consider the abolition of TFTs.

1.2 Structure of the draft decision

This draft decision outlines the Commission's process for conducting this determination, and explains the context of the review and the key issues the Commission will consider in making the determination.

Chapter 2 outlines the draft decision in terms of the overall cost build-up used by the Commission and some of the major cost movements that have contributed to the Commission's decision on prices.

Chapter 3 summarises in more detail the cost build-up used to determine the TFT.

Chapter 4 summarises some of the safety net arrangements that will apply to protect consumer interests.

Chapter 5 summarises the Commission's conclusions, setting out the Commission's draft decision on the TFT.

A draft price direction is provided in Appendix 2.

2 Overview of the draft decision

In the ACT, customers who choose not to use an electricity tariff offered by a competing electricity retailer or opt for a contract from the incumbent retailer, ActewAGL Retail, remain on a regulated retail tariff (called a ‘transitional franchise tariff’, or TFT) provided by the incumbent retailer. The obligations imposed on the Commission in determining the changing levels for the TFT are described in the *Independent Competition and Regulatory Commission Act 1997* (the ICRC Act). In particular, the provisions of section 20 of the ICRC Act provide guidance to the Commission on how to balance its regulatory obligations for price directions. A price direction needs to balance a number of conflicting objectives, including the need for reliable supply services of a defined quality, the need for efficient delivery of services with incentives to reduce costs, the need to encourage participation in the retail electricity sector by allowing financially viable service provision, and the need to have regard to the social impacts of the tariff levels and general price inflation.

The Commission’s approach to the determination of retail electricity prices for ActewAGL Retail customers who choose to stay on the TFT has been to draw on benchmark cost information available in the marketplace or in other regulatory decisions within the electricity retail sector in Australia. This benchmark information has been used to arrive at a reasonable estimate of the economically efficient cost base of an incumbent electricity retailer providing retail electricity supply services to a regulated customer segment. It is worth emphasising that all electricity retailers operate as aggregators of energy demand from small, medium and large consumers of electricity who benefit from collective purchasing of energy from generators in a competitive electricity market. While the retailer profits from this aggregation, each customer is better off because their collective bargaining power and their ability to hedge energy price volatility is significantly enhanced through joining with a retailer, rather than accessing the electricity market directly.

Having arrived at an economically efficient cost base for the incumbent electricity retailer using the guidance of section 20 of the ICRC Act, the Commission has converted that cost base into an incentive-based regulatory framework which has the form of a weighted average price cap. The weighted average price cap allows ActewAGL Retail to rebalance the TFT towards the efficient cost base underlying each of those tariffs subject to regulation. ActewAGL Retail is allowed to set prices for the regulated customer base through the TFT up to the level set by the weighted average price cap defined in the Commission’s price direction for a particular regulatory year.

In considering the determination of an appropriate TFT for the 2008–09 year, the Commission has revisited the cost build-up and other information used in setting the TFT last year. It has continued using the same methodology and similar assumptions as were used for the development of the TFT for the 2007–08 year. The following sections of this report describe the various cost components of an incumbent electricity retailer and the economically efficient cost levels which the Commission believes should be incorporated into the revenue yield cap for 2008–09.

2.1 Summary of the retail costs underlying the draft decision

The Commission has reviewed the main activities of electricity retailers and, through examination of its previous TFT decisions, publicly available industry information and the most recent regulatory draft and final decisions, has arrived at an estimate of the economically efficient cost

base of an incumbent electricity retailer operating in an environment similar to that of ActewAGL Retail. Table 2.1 summarises the main retail cost elements and compares them to the values published by the Independent Pricing and Regulatory Tribunal (IPART) in its final determination of June 2007⁷ for electricity retailers in New South Wales for 2008–09. While IPART expressed its final decision in \$2006–07, the Commission has adjusted these numbers to 2008–09 nominal numbers using its inflation assumptions for the period from 2006–07 to 2008–09.

Table 2.1 Summary of estimated efficient retail costs, ICRC and IPART

	ICRC 2008–09	IPART (*) 2008–09
Energy purchase costs		
Electricity purchase cost (\$/MWh)	71.69	57.56
Energy contracting cost (\$/MWh)	0.72	-
Green costs (\$/MWh)	4.95	5.08
NEM fees (\$/MWh)	0.72	1.06
Energy losses	4.86%	6.80%
Total energy purchase cost (\$/MWh)	81.87	68.03
Retail operating costs (\$/customer)	97.12	79.36
Customer acquisition costs (\$/customer)	-	37.03
Adjustment for Double Counting (\$/customer)	-	(5.29)
Total retail costs (\$/customer)	97.12	111.10
Retail margin (% of sales, EBITDA)	5.00%	5.00%

Note (*): Assumes Energy Australia data from IPART escalated to nominal numbers using the Commission’s CPI assumptions.

While the IPART energy purchase cost at \$57.56/MWh appears low compared to the Commission’s estimate, they are based on differing assumptions. IPART’s estimate used market modelling outcomes developed by Frontier Economics which exhibits the following properties:

- the market model exploits different hedging strategies to develop an efficient frontier of energy prices from which Frontier Economics recommends the most efficient point at the ‘elbow’ of the efficient frontier inflection point;
- the model factors in the effect of the ETEF and the businesses are only exposed to the market prices of hedging products for delivery of energy from Q1 of 2008; and
- the franchise customers of the retail businesses in NSW are likely to exhibit different load profile and consumption characteristics that those on the TFT with ActewAGL Retail.

The Frontier Economics report indicates that the difference between its model derived results and those derived from market contract cost data is of the order of \$9/MWh to \$12/MWh. While it is difficult to identify what is the primary reason for the difference in IPART’s estimates from those of the Commission, the Commission believes most of these stem from the slow wind-back of the

⁷ IPART, *Final report and final determination, Promoting retail competition and investment in the NSW electricity industry, Regulated electricity retail tariffs and charges for small customers 2007 to 2010*, June 2007.

ETEF and the choice of the most efficient hedging strategy from the various scenarios run. It is well to remember that the IPART numbers were derived prior to the energy cost increases seen in late 2007, although these cost increases were also a feature of the Frontier Economics modelling.

The Commission has relied on energy market trading data and a simplified hedging strategy which is not dynamic and does not change over time, to derive its estimates of the wholesale energy costs to cover the needs of TFT customers.

IPART has recently undertaken its annual review of market based energy purchase costs to see whether the cost of energy has increased by more than 10% from the levels incorporated in its June 2007 final decision.⁸ Its draft decision indicates it does not believe there is any reason to increase the energy cost allowance in its June 2007 decision because energy purchase costs have not changed by more than 10% from those used in its final decision. Indeed the Frontier Economics analysis⁹ as summarised in IPART's March 2008 draft report indicates that estimates of energy purchase costs for 2008–09 have fallen by between 2.3% and 2.8%. As discussed above the Commission believes the three differences identified in the dot points above strongly influence this result.

The estimates of efficient retail costs presented in Table 2.1 are those costs which are added at the retail level. The additional costs which are recovered in the TFT are the pass-through of the regulated transmission costs into the regulated distribution costs, and the pass-through of the combined regulated distribution and transmission costs as network use of system costs recovered from all consumers at the retail level.

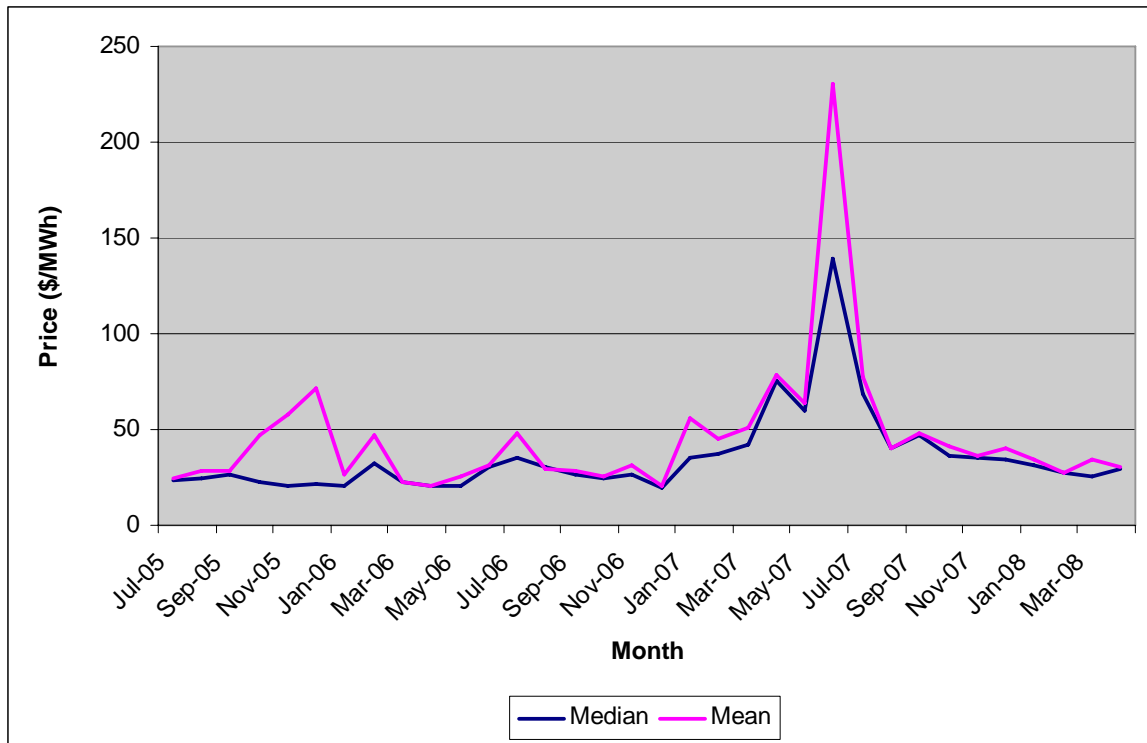
While the overall weighted average price cap applied by the Commission at the retail level for TFT customers allows for the recovery of efficient costs of retail supply to TFT customers, the nature of the cap allows the retailer to improve its overall productivity through efficiency improvements that result in cost savings. These cost savings are only available from those cost elements which are able to be influenced by the activities of the retailer. Thus, for example, government taxes and charges placed on the retailer are simply passed-through costs, as are network use of system costs. However, general 'back room' billing costs and costs associated with winning new customers are able to be influenced by the retailer's own decisions and behaviour.

One concern of the Commission relating to the reference requirement for the TFT to be set for a 12-month period, particularly the period from 1 July 2007 to 30 June 2008, was that the large increase in the volatility of the energy purchase cost resulting from supply–demand imbalances in the wholesale electricity market in that year could not be passed through to consumers immediately by the incumbent retailer. The issue can be seen in Figure 2.1 below, where from early 2007 the median pool price in NSW began to rise above its previous trading band.

⁸ IPART, *Draft report, Market based electricity purchase cost allowance - 2008 review*, March 2008, refer Table 3.1, page 8.

⁹ Frontier Economics, *Final Report, Annual Energy Cost Review*, March 2008, refer Figure 10, page 19.

Figure 2.1 Mean and Median NSW Pool Prices from July 2005 to Apr 2008



The result was that forecasting the duration and extent of energy cost changes for purposes of setting the TFT became more risky if the regulator was to ensure the incumbent retailer was able to cover its wholesale electricity cost within the TFT.

In such circumstances, if the regulator has underestimated the appropriate wholesale price to be passed through to consumers there may be a need for a further reference from government to allow the TFT to be adjusted in a timely manner to respond to large changes in the wholesale cost of energy, since an unchanged TFT might no longer meet the legislated requirements of the ICRC Act. In these circumstances of volatility in the wholesale price of electricity may of course operate in both directions, with any failure to adjust prices downwards with a reduction in the wholesale market price resulting in consumers having to pay prices that do not reflect market prices. This issue remains for the current reference for a further 12 month period to 30 June 2009.

For example, large increases in energy cost which cannot be passed through by the incumbent supplier to TFT customers under the provisions of a particular TFT determination reduce economic efficiency (s. 20(2)(c) of the ICRC Act¹⁰) because tariffs no longer allow recovery of efficient costs, reduce the success of demand side management (s. 20(2)(h)) through muting the price signals seen by consumers, inhibit sustainable financial viability (s. 20(2)(i)) by limiting the incumbent retailer from passing through costs which it has limited opportunity to control, and reduce its ability to meet its contracted functional obligations in the national electricity market (NEM), which is a breach of the ICRC Act (s. 20(2)(k)). As discussed below in Section 3.2.1 of this draft decision, the issue of wholesale energy market volatility is extremely important in the

¹⁰ References to s. 20 in this report refer to that section of the ICRC Act. See Section 3.1 of this report.

decision about the TFT level. The short-term nature of the terms of reference set for the Commission only exacerbates the problem faced by the Commission in setting a TFT that meets all the requirements of the Act.

For purposes of the current determination, the Commission has been assisted by a reduction in the volatility and the average wholesale prices seen during the second half of 2007 and as a result there appears to be less of a need for the application of an energy cost pass-through device in the TFT calculation for the period 1 July 2008 to 30 June 2009. However, with rising demand for coal internationally, the continuation of drought conditions, and the espousal of a public policy approach in favour of the pricing of carbon emissions, there is every likelihood that electricity prices will increase over the next few years with flow on impacts in terms of the retail prices paid by consumers.

2.2 Cost changes affecting the draft decision

In determining the cost estimates presented in Table 2.1, the Commission has used the retail operating cost estimates which underlie its earlier decision for the TFT from 2003–04 to 2005–6 and escalated those costs by the CPI calculated on a historical basis to arrive at estimates for the 2008–09 financial year. While considering the inclusion of customer acquisition costs (not previously included in the cost base), the Commission remains of the view in this draft report that, on balance, there is no need to include these costs into the ActewAGL Retail cost base provided reasonable assumptions are used about the retail hedging strategy likely to be employed by a hypothetical retailer servicing customers of the type covered by the TFT and CPI cost escalations are applied to other retail operating costs. While customer acquisition costs have been used by IPART in NSW, this has been as a result of the requirements placed on IPART by its terms of reference to estimate the cost for a new entrant electricity supplier. Thus, IPART has been required to estimate the costs of a marginal entrant who needs to acquire customers and must include in its recoverable cost base the cost of acquiring those customers. In the ACT, the incumbent retailer, ActewAGL Retail already has an existing customer base and under ACT legislation is required to allow the return of customers to the TFT should they decide that they no longer wish to buy their electricity under a negotiated contract from another retailer (or from ActewAGL Retail itself). The terms of reference for the Commission are related exclusively to s. 20 (2) of the Act. Thus, the costs that ActewAGL retail incurs become a balance between those of the new entrant and those other aspects of s. 20 (2), including efficient service delivery (s. 20(2)(c)) to assist the reduction of the costs paid by consumers, without the exploitation of monopoly power (s. 20(2)(a)).

The Commission has separately estimated the likely green costs, including the mandatory renewable energy target (MRET) and greenhouse gas abatement scheme (GGAS) costs mandated by legislation¹¹, and the NEM fees using public information on the fee structures and estimates of ActewAGL Retail's likely operating circumstances in 2008–09. Likewise, the distribution loss factors published by NEMMCO and relied upon for many tariff calculations show a slow reduction in the distribution loss factors for ACT distribution tariff consumers.¹² The Commission has

¹¹ *Renewable Energy (Electricity) Act 2000* (Cwth) and *Renewable Energy (Electricity) Regulations 2001*.

¹² NEMMCO, *Distribution loss factor reports for 2005–06, 2006–07 and 2007–08*, Appendix D. For 2008–09 the Commission is using the calculation it has approved for publication by NEMMCO.

adopted a slightly higher retail margin (of 5%) than has been used in previous TFT determinations. It is at the same retail margin of total electricity sales (effectively % EBITDA) as has been adopted in most jurisdictions in their recent final determinations, including IPART, QCA and effectively ESCOSA.

The major change from the cost structure used in the early price directions prepared by the Commission was that the wholesale energy price observed in the electricity pool exhibited dramatic increases in the second half of 2007, and this has only begun to subside during the first half of 2008. Table 2.2 lists the average annual regional reference price (RRP) for New South Wales from 1998–99 through 2007–08.¹³

Table 2.2 Average yearly RRP for New South Wales (\$/MWh)

1998–99	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
33.13	28.27	37.69	34.76	32.91	32.37	39.33	37.24	58.72	41.38 (*)

Note (*): Average to 20 April 2008.

While there was a slight increase in the average yearly RRP in 2006, the effect did not become dramatic until 2007. Table 2.3 shows the average and the median RRP for New South Wales for 2007.¹⁴

Table 2.3 Average and median monthly RRP for 2007 (\$/MWh)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
Average (\$/MWh)	55.91	44.76	51.28	78.21	63.28	230.66	77.87	39.94	47.95	40.72	36.01	40.16
Median (\$/MWh)	35.22	36.91	42.08	75.98	59.89	138.76	68.48	40.23	47.54	35.79	35.10	34.72

As can be seen, average prices for mid 2007 are much higher than previous average RRP, with average RRP in June reaching \$230.66 per MWh before beginning to fall. Median prices are also included to demonstrate that the increase in the pool price is driven by a change in underlying fundamentals and not generated by large one-off shocks to the market.¹⁵

Information from NEMMCO and from ActewAGL Retail suggests this general uplift in the pool price resulted from water storages in the Snowy Mountains, Victoria and Tasmania falling nearly to their minimum run capacities. This resulted in the steady withdrawal of capacity from the Snowy, Victorian and Tasmanian hydro plants as the water fuel source nears depletion. In addition, some of the thermal base-load plants in Queensland had to withdraw capacity from the market because they could not access sufficient cooling water from local rivers and storage facilities to allow full-capacity operation. The base-load plant appeared to be dispatching at between 30% and 50% of its rated capacity, which is significantly less than in previous years. While some of this plant provides peaking capacity, other facilities provide base load. Both peak

¹³ The 2006–07 prices are through 31 March 2008. Data sourced from NEMMCO and available at <http://www.nemmco.com.au>.

¹⁴ This is the period across which the highest mean and median price spikes occurred.

¹⁵ The average monthly RRP for November 2004 also exceeded \$70/MWh as shown in Figure 2.1. That high average was driven by an average daily price of \$1,115.75/MWh for 30 November 2004. The median RRP for November 2004 was \$30.85/MWh.

and base-load capacity need to be replaced by power from higher cost thermal plants using coal, gas or diesel fuels.

The Commission is aware that good practice in electricity retail business management suggests that these pool prices should be hedged to a certain extent by contracts between the retailers and the generation companies (including bilateral, caps, swaps and other contracts), and in the financial futures markets. While this limited the impact in 2007–08 of the energy price rise seen by retailers, the eventual result was that the pool prices influenced contract prices over the mid-term (two to three years), such that the energy cost for ActewAGL Retail (and other retailers in the ACT) will rise again in 2008–09, but given the subsequent reduction in pool prices should fall in the following one or two years subject to any new price shocks or policy changes which could introduce new costs (such as the cost of carbon emissions). The result of a hedging strategy in this instance is that the hump in pool prices seen in mid 2007, will lead to a delayed hump in hedged contract price during late 2007 or early 2008.

The Commission has factored these changes into its draft decision on the price direction. The approach it has used to calculate an energy cost is described in Section 3.2.1.

2.3 Market outcomes and retail competition

The Commission believes that the development of the competitive interconnected electricity market in the eastern and southern states of Australia has delivered significant benefits to the broader Australian economy and to electricity consumers of all sizes. Such benefits include increases in network service charges and energy prices at a rate that has been less than the broader inflation rate in the economy.

Under the competition and market reforms of the past decade, the balancing of supply and demand for electricity in the wholesale electricity market has provided a mechanism for achieving the lowest reasonable cost of electricity in an economically efficient manner. The outcomes of this market will always depend on the availability of reasonably priced fuels for the generators. If one form of fuel has price rises greater than another, then the generator using cheaper fuel will be ‘dispatched’ for supply purposes before the generator using a more expensive fuel type. As a result, consumers have enjoyed prices for electricity which have been relatively low and have risen at rates commensurate with the general inflation rate when averaged over longer time periods. When the pool price for energy rises (that is, the overall market price set by demand and supply signals), there is a price signal to encourage investment in new generation capacity, the enhancement of existing generation (for example, investment in closed cooling cycles) and/or the replacement of existing generation with alternative, cheaper fuel types.

During mid 2007 the Commission was significantly concerned that, after around seven years of stable and generally lower energy prices, the shortage of water for hydro generation had started a process of re-rating the cost of water as a fuel resource, which may have led to a medium-term impact on the price of electricity in the NEM. This does not alter the benefits flowing to consumers who continue to have access to the lowest price available from a market. However, it does mean that prices for electricity will likely rise. As has transpired, the late spring/summer rains in NSW and Queensland appear to have alleviated the situation and through vigorous competition in the NEM the pool prices have begun to fall and return to a level where supply is more in balance with demand.

One concern of the Commission is that the benefits of the energy market need to flow to consumers, particularly small consumers. This is best achieved where consumers directly access the retail market and exercise their right of choice of retailer. Shopping around for a retailer to supply their needs at the lowest price is the best way for smaller consumers to reap the benefits of competition.

While the TFT, which is regulated by the Commission, seeks to balance the objectives of section 20 of the ICRC Act, the regulatory mechanism cannot develop prices which are as responsive to demand and supply signals as a competitive and open marketplace. Where an open market is operating (as it does for the generation of electricity), prices will fluctuate with changes in factors affecting that market (much as it does for the supply of crude oil or fresh fruit and vegetables). The Commission needs to allow for the pass-through of those changes in costs to avoid a situation in which retailers can no longer afford to subsidise the supply of electricity to their customers. Similarly, the Commission would seek to reduce prices where the generation costs are falling. The issue for the Commission is one of timing, as the regulatory process is time consuming and does not respond as quickly as the marketplace.

The Commission encourages all consumers using TFTs to exercise their choice of retailer and to seek lower prices of electricity supply where they are available. At the same time, it must be recognised that major shifts in the underlying generation costs will flow through to retail prices at all levels.

2.4 Recent regulatory decisions

The jurisdictional regulators which have finalised processes to review the prices for customers who have not yet exercised their right to enter the contestable retail market are IPART for 2007–08 to 2009–10, the Queensland Competition Authority (QCA) for 2006–07 to 2007–08, ESCOSA for 2008 to 2010, and the Office of the Tasmanian Energy Regulator (OTTER) for 2006–07 to 2009–10. The QCA has commenced a further one year price control review for 2008–09.

The IPART final report and final determination was released in June 2007. Table 2.1 summarises the IPART draft decision as it relates to Energy Australia.¹⁶ The IPART report is based on electricity generation forecasts prepared by Frontier Economics which pre-date March 2007¹⁷, from when there was a notable shift in generation prices. Nonetheless, their forecasts showed a humped pool price outcome which has subsequently been confirmed in the market place, albeit at a higher pool price than forecast by Frontier Economics.

The Commission notes that the market-based cost of electricity estimated by Frontier Economics in its March 2007 report for 2008–09 has a cost price of electricity for peak periods (using the conservative or high estimate rather than the efficient frontier estimate) of between \$68.22/MWh and \$113.32/MWh, for shoulder periods between \$48.86/MWh and \$74.50/MWh, and for off-peak periods between \$28.18/MWh and \$31.46/MWh. The resulting all-periods weighted average price lies between \$48.01/MWh and \$56.74/MWh.¹⁸

¹⁶ IPART, April 2007, extract of Table 8.1.

¹⁷ Frontier Economics, *Energy costs*, final report, March 2007, Figure 22.

¹⁸ See also IPART, June 2007 report, Table 6.5, page 84.

The IPART final findings in June 2007 on the allowance for energy costs to use in the New South Wales regulated retail tariff controls were \$51.21/MWh for Country Energy, \$58.51/MWh for Energy Australia and \$61.16/MWh for Integral Energy.¹⁹ These prices include a volatility allowance for volatility in the electricity pool price. In its more recent draft report of March 2008 which reviews these energy purchase costs, IPART has determined that these energy purchase costs do not need to be adjusted because the underlying time of day estimates by Frontier Economics in its March 2008 report do not exhibit a change of greater than 10% from those used for IPART's final decision, as discussed in Section 2.1 above.

The QCA released a final report on its Benchmark Retail Cost Index in June 2007.²⁰ In its report, and to meet the requirements of the Queensland legislation, the QCA has had to consider the long-run marginal cost (LRMC) of electricity generation in that state. In its final decision, the QCA has determined a cost of energy of \$77.00/MWh for May 2007 and \$56.00/MWh for June 2007, which includes an 'energy purchase' cost element designed to reflect the retailers' load shape, the volatility of spot prices and the correlation between spot prices and load.

The QCA released a draft report on its Benchmark Retail Cost Index in February 2008.²¹ In its report, and to meet the requirements of the Queensland legislation, the QCA has had to consider the long-run marginal cost (LRMC) of electricity generation in that state. In its draft decision, the QCA has determined a cost of energy of \$62.25/MWh, which includes an 'energy purchase' cost element designed to reflect the retailers' load shape, the volatility of spot prices and a hedging strategy assumed to apply over the two years before the energy is delivered.

These costs are before taking into account various other costs such as Queensland's 13% Gas Scheme, MRET and NEM fees, and the 'energy purchase' costs.

In its final determination of November 2007²², ESCOSA used two different approaches to estimate the LRMC of energy for each quarter of the regulatory period from 1 January 2008 to 30 December 2010. ESCOSA has adopted a range of energy prices of between \$76.66/MWh and \$87.70/MWh for 2008 and \$78.77/MWh and \$88.60/MWh for 2009.

In December 2006, OTTER made its final decision on 'fallback' tariffs associated with fallback contracts available to each tranche of its opening of retail competition to new entrants. The grace period tariffs apply for 12 months following the opening of each tranche of customers to retail competition. OTTER has regulated these fallback tariffs using a 12% gross margin for all retail operating costs above the wholesale electricity costs plus the network tariff costs (NUoS). The approach used by OTTER is neither a long-term safety net tariff nor a tariff similar to the TFT for franchise customers in the ACT. To date the Tasmanian government has yet to make its final decision over the application of FRC and/or the use of a longer-term tariff similar to the TFT for the last tranche of retail customers with consumption less than 150kWh, which is due for competition based on their consumption during the 12 months ending 30 June 2009.

¹⁹ 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, Table 6.1, page 75, Country Energy \$48.4/MWh, Energy Australia \$55.3/MWh and Integral Energy \$57.8/MWh in \$2006/07 adjusted to nominal \$2008–09 using the Commissions CPI calculation for the relevant regulatory year.

²⁰ QCA *Final Decision: Benchmark Retail Cost Index for Electricity: 2006–07 and 2007–08*, June 2007, page 3.

²¹ QCA *Draft Decision: Benchmark Retail Cost Index for Electricity: 2008–09*, February 2008, page 15.

²² ESCOSA, *2007 Review of Retail Electricity Price Path, Final Inquiry Report & Price Determination*, November 2007, Table 7.6, page A-51.

The Commission notes that the weighted average RRP²³ for June 2007 was \$230.66/MWh but that this has fallen to \$30.59/MWh for the first 20 days of April 2008. The Commission in this draft decision proposes to use an energy price of \$71.69/MWh for 2008–09.

This price is higher than adopted for IPART (whose final determination preceded the major price rises in late 2007 and whose recent draft report suggests there is no need to amend its final determination), and is slightly less than that adopted by ESCOSA (whose decision was made later in 2007). The energy prices used by IPART and QCA are generally based on the LRMC of generation, and are not or only slightly influenced by the contract market used by retailers to hedge their energy price risk. Furthermore, the final decision in New South Wales dated June 2007 was based on a three-year price path which incorporates a smoothed transition to the higher generation costs. In Queensland, the requirement to use a long-run marginal estimate also implies a longer term approach to setting the TFT requirement.

For reasons which are described more fully in Section 3.2.1 of this report, the Commission has adopted an energy purchase cost which follows the contract energy market outcomes in its analysis. It follows from the decision for 2007–08 and uses the same assumptions for energy price hedging which the Commission believes are reasonable for an incumbent retailer supplying franchise customers under a TFT. In part, this reflects the requirement that the Commission consider section 20 of the ICRC Act, and the single-year, one-off nature of the last three price determinations that the Commission has had to provide. The Commission has not had access to a smoothing mechanism that could be possible for longer price control periods and has been adopted by IPART and ESCOSA.

The Commission cannot ignore the evidence that demonstrates a rise in electricity prices during 2007 and a more recent fall, nor the lagged hump in pricing that follows from reasonable hedging arrangements for an incumbent retailer, having access to the contract prices which follow a similar humped profile. The Commission has therefore adopted an energy purchase cost of \$71.69/MWh for 2008–09 that excludes an energy contracting/management cost of \$0.72/MWh, which has been added separately to the cost base. This is broadly consistent with the energy costs included in the ESCOSA final determination.

²³ As reported by NEMMCO on its website, <http://www.nemmco.com.au> .

3 Analysis of efficient costs

In developing its price direction for 2008–09, the Commission must ensure that it has regard to the provisions of section 20 of the ICRC Act. This is required by the Act and by the reference provided by the Attorney-General. The Commission believes that these provisions provide a list of issues (sometime considered as objectives) that it needs to address in determining the weighted average price cap under which the TFT levels for 2008–09 will be developed.

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. However, the costs it considers (s. 20(2)(e)) for ActewAGL Retail 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 these objectives through the consideration of both actual cost information provided by ActewAGL Retail and through 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.

The following subsections of the report describe the build-up of the estimates of the various cost components of retail electricity supply in the ACT. The Commission currently considers that the cost base for TFT customers should be based on the costs to an incumbent to service these customers. The Commission is not tied to the need to estimate the costs of a new entrant retailer, although it will have strong regard for the costs that such competitive players might experience in the marketplace.

The Commission notes that, in a period of volatility in energy prices, new entrants may be less inclined to enter a new market as a retail electricity supplier. Given that the terms of reference for this review have specified a 12-month TFT, the Commission is not able to transition price changes over a number of years, as is possible under the IPART determination. However, the Commission is not constrained in having to use an estimate of the LRMC for electricity generation, but rather must address the short-run market that is serviced primarily by incumbent retailers who are competing in the ACT market and, in the case of ActewAGL Retail, providing services to franchise customers.

3.1 Section 20 criteria

Section 20(2) of the ICRC Act states:

- 20 (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.

In this draft decision, the Commission does not believe there is a need to place specific emphasis on the issues raised by subsection 20(2)(b) which relate to service quality and subsections 20(2)(f) and 20(5) which relate to ecologically sustainable development. Neither of these objectives or issues are central to the question of the reasonable pricing of retail electricity to TFT customers.

However, the Commission recognises that the green costs factored into the retail cost base (such as MRET and GGAS) have begun to address increasingly widespread concerns that the consumption of fossil fuels comes at an environmental cost in air quality, increased carbon emissions to the atmosphere and, potentially, increased global warming. To the extent the MRET and GGAS costs are included in the price, there is a potential to dampen the demand for electricity and thereby contribute to ecologically sustainable development.

The Commission also recognises that demand side management (s. 20(2)(h)) is better served when the price of the electricity consumed is based on the best estimate of the costs to provide electricity. This is especially so when, and if, the cost of energy in the wholesale pool rises in accordance with demand and supply conditions. Indeed, when the electricity price is kept artificially low, the price signals to encourage reduced consumption are muted. Excess consumption has a negative emissions impact, as well as an adverse impact on the economically efficient delivery of retail electricity services.

3.2 The electricity retail cost elements

The costs of retail electricity supply can be grouped into the following categories:

- energy costs grouped by:
 - energy purchase costs
 - energy hedging, contract and management costs
 - green costs (MRET and GGAS fees)
 - energy losses
- retail costs grouped by:
 - retail operating costs
 - customer acquisition and retention costs
- network costs:
 - distribution network costs
 - transmission network costs.

The Commission has examined external benchmarks and market information to arrive at the cost values it believes should be used for each of these retail costs, which will be recovered under a weighted average price cap from the regulated TFT customers.

3.2.1 Electricity purchases

For the draft decision on the price direction, the Commission has used current market data and a number of assumptions about an ideal electricity retail hedging strategy to assist in understanding the reasonable electricity purchase costs which might be faced by an incumbent retailer during 2008–09. To provide continuity with the one-year determination made for 2007–08, the Commission has used the same assumptions as applied in the 2007–08 decision. This has implications for the resulting average wholesale price for 2008–09 that is estimated by the Commission as it did for the wholesale price used in the 2007–08 decision. However, in this instance, rather than resulting in a wholesale price that could have been set near the peak of the generators' prices for electricity in mid 2007, it will result in a price that still includes some of the effect of that price hump during the last calendar year.

The hedging assumptions used are summarised as follows.

- a The retailer seeks to have more than 100% of its forecast load from the TFT customer base hedged at least six months before delivery (specifically, hedge to 105% of the forecast load).
- b The retailer begins to build its hedge portfolio a minimum of 24 months prior to delivery. The proportion of the forecast load which is hedged for each six-month period of future delivery is provided in Table 3.1, assuming the retailer has achieved this by 30 June 2008.

Table 3.1 Assumptions about hedged contracts

Six-month delivery period (ending date)	31 December 2008	30 June 2009	31 December 2009	30 June 2010
Percentage of forecast load hedged by contract	105%	80%	50%	25%

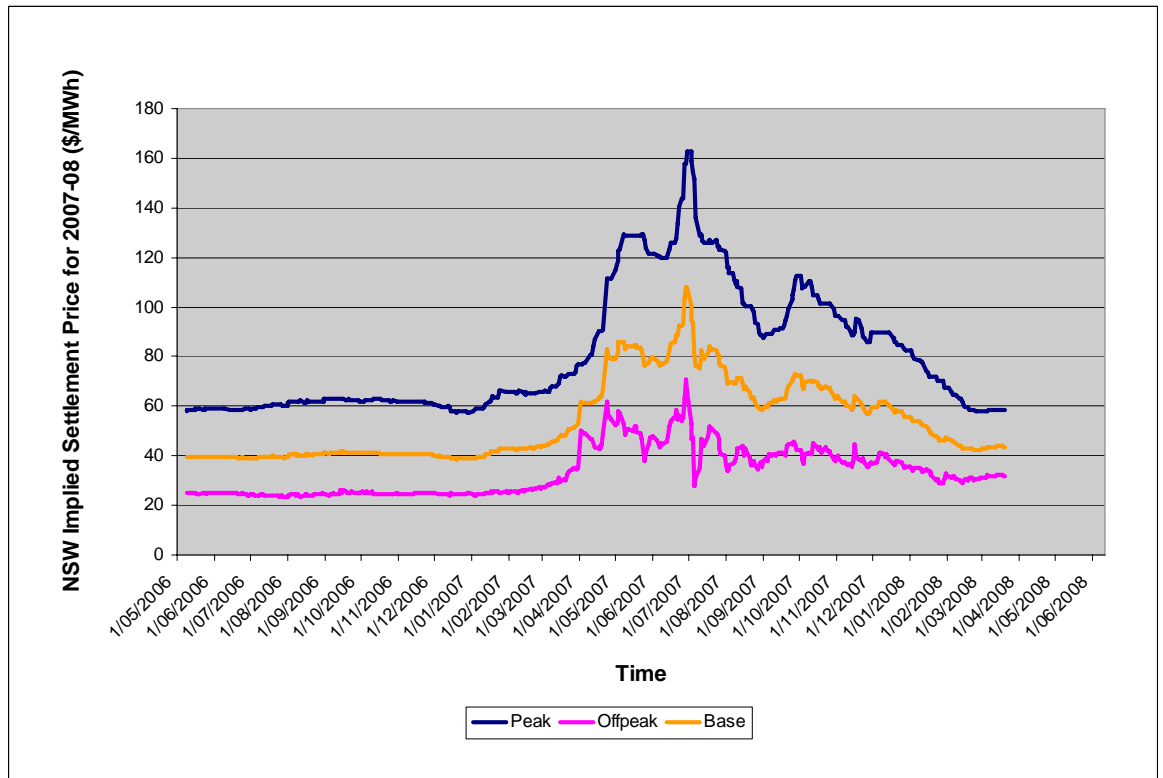
- c The load profile shape and pool price profile for TFT customers served by ActewAGL Retail is the same as the annual average of the load profile and the pool price profile for the New South Wales region for the 2006 calendar year, as sourced from NEMMCO. The annual average pool price data is used to define the average period of the day experiencing peak, shoulder and off-peak prices. Table 3.2 provides the assumed block profile of energy purchase requirements for the TFT customer group.

Table 3.2 Block profile of energy purchase requirements

Approximate pricing profile	Hours/day	% time
Peak	4.5	18.60%
Shoulder	7.6	31.60%
Off-peak time	11.9	49.80%
Total	24	100.00%

- d The cost of bilateral contracts is typically arrived at during confidential negotiations between retailers and generators. The Commission has reviewed the publicly available data on electricity futures for New South Wales. While these are financial instruments, they should reflect the confidential marketplace for bilateral, swaps, collars, caps and other electricity hedging contracts, albeit adjusted for differences in the risks borne in each contract. If this were not the case, there would be arbitrage opportunities and any differences between the two markets would soon be traded away. The Commission has assumed that the futures prices observed in the marketplace are likely to be slightly higher than those in the negotiated market for reasons including the lower liquidity experienced in the developing futures market. Also, it is unlikely that ActewAGL Retail could or would want to purchase all its hedging requirements through the futures market. Nonetheless, the Commission believes that the prices seen in this market serve as a reasonable benchmark for developing the energy purchase costs for TFT customers. Figure 3.1 shows the implied futures settlement prices for base-load delivery and the breakdown of this into peak and off-peak load delivery.

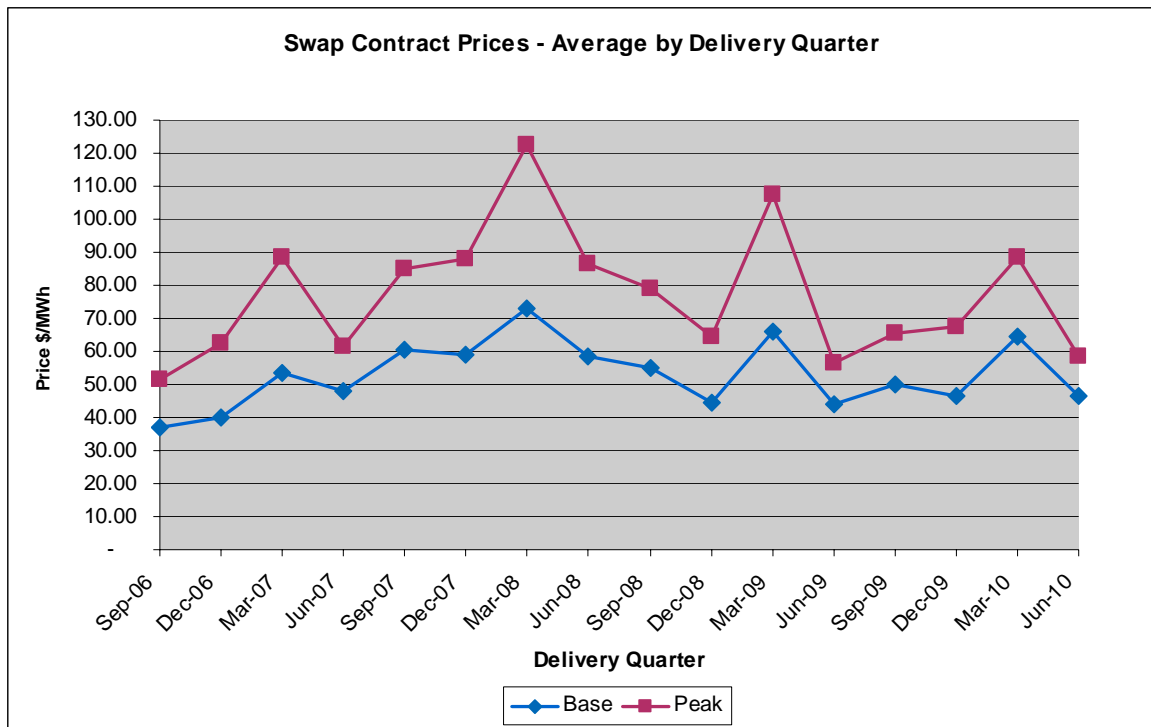
Figure 3.1 Implied futures settlement price, 8 May 2006 to 3 April 2008



The Commission notes that since its decision last June 2007, the severe increases in settlement price have retracted and are now closer to the long-term average values seen prior to the upwards pressures seen from the drought and its impact on availability of both peaking plant (lack of hydro capacity) and base load plant (lack of cooling water restricting base load output).

The Commission also looked at the swap prices to assist with determining projected electricity prices out beyond the historical period observed. Figure 3.2 suggests the swap prices for base-load delivery and peak-load delivery.

Figure 3.2 Swap Prices for Future Delivery



Again the Commission observes that the price is reducing during the delivery period 2008–09, and following quarters.

- e The price for the proportions of the hedge book shown in Table 3.1 are then taken from the average of the pricing data (either futures or swaps), with the assumption that the ‘peak’ futures price is the price available for delivery during shoulder periods of the load profile given the nature of the TFT customers and the previous submissions of ActewAGL Retail;. Table 3.3 shows the dates between which the futures or swap prices are averaged to develop the price for that block of load to be delivered to TFT customers in the future.

Table 3.3 Assumed periods for futures or swap price averaging

Six-month delivery period (ending date)	31 December 2007	30 June 2008	31 December 2008	30 June 2009
Dates for averaging price data	October to December 2007	July 2007 to March 2008	January to March 2008	January 2007 to March 2008

- f The cost of a \$300 cap on peak prices was excluded from the analysis, but would be prudent operating practice for this type of customer base.

Based on these assumptions and analysis, the Commission has calculated the weighted average hedge portfolio cost resulting from the average prices being weighted by time-of-day profile and delivery period and proportion of the hedged forecast load. This has provided an average cost for delivery in each of the four six-month periods to 31 December 2008. The two cost data points for the six-month periods ending 31 December 2008 and 30 June 2009 were used as the estimate of the 2008–09 electricity purchase costs. The Commission found that its estimate of the electricity purchase costs was \$71.69/MWh for 2008–09. The Commission notes that using the same methodology the electricity purchase costs for 2009–10 are estimated to be \$62.48/MWh. While this estimate is not central to its analysis for the 2008–09 year, the Commission observes that the

electricity marketplace does not believe the price increases seen in the energy pool price in late 2007 are to be repeated in the short-term, and more risk tolerant market participants are now likely actively buying from the pool rather than completing their hedging arrangements, to secure lower energy prices than might otherwise be available in the contract market.

In undertaking this analysis using independent market data, and a simplified (but robust) approach to hedging the risks of purchasing wholesale energy from a competitive market pool, the Commission has drawn the primary balance between the social imperatives of the provision of reliable electricity to TFT customers (ss. 20(2)(b) and (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)). The Commission has not varied its methodology from the 2007–08 year but has updated the data inputs for the forecast period to better represent reasonable expectations of market outcomes.

The Commission reminds stakeholders in retail electricity service delivery that the TFT is not intended to be a ‘safety net’ to be used for social or targeted support to smaller consumers. Other mechanisms mandated and funded through government and community programs are in place to fulfil that need (see Section 4.2, below). Under the requirements of section 20 of the ICRC Act, the Commission cannot allow the imposition of cross-subsidies between contestable and non-contestable customer groups, particularly in the costs associated with the purchase of electricity, which constitutes a large proportion of the retail costs of electricity. The allowance of significant cross-subsidies associated with underpricing the costs of TFT would severely impede the offering of alternative tariffs by competing retailers, increase the barriers to entry of new-entrant retailers, accelerate the rate of electricity cost increases in the medium term, and potentially limit the equitable flow of benefits of reform in the electricity sector to all consumers in the ACT.

3.2.2 Energy risk management costs

In its prior decisions on the TFT, the Commission factored the costs of managing an energy trading desk and the other costs of hedging the retailer’s forecast load into the electricity purchase cost. Given that the estimates of the electricity purchase cost in this report are based on market measures of cost which do not factor in those costs, the Commission has added a separate estimate of energy-purchase risk-management costs. It is reasonable that the retailer recover such costs, as this is the prime risk reduction function that the retailer carries out on behalf of its aggregate customer base. While the costs of undertaking this function are small, its value underpins the retail margin that the retailer expects because of complexity of the function. The Commission has canvassed market information for its 2007–08 decision and adopted \$0.70/MWh as the reasonable cost base for this activity. This has been escalated by the CPI to provide an estimate of \$0.72/MWh for 2008–09. The recovery of these costs meets the economic efficiency objective in s. 20(2)(c), as well as the cost recovery provisions of s. 20(2)(e).

3.2.3 Green costs

During the annual rate adjustments to the TFT under the weighted average price cap imposed by the Commission, ActewAGL Retail is required to calculate costs of its MRET and GGAS obligations using the methodology prescribed by Commonwealth law.²⁴ For this draft determination, the Commission has taken ActewAGL Retail’s approved estimates for 2007–08 and escalated them by the change seen between the 2006–07 and 2007–08 financial years, as an approximation of the more detailed calculation. For its final determination, the Commission shall review the renewable power percentage mandated in Regulation 24 of the Commonwealth’s Renewable Energy (Electricity) Regulations 2001 to arrive at values for 2008–09. Table 3.4 shows the estimated outcomes for 2008–09, along with the IPART²⁵ and QCA²⁶ outcomes provided in those regulators’ final and draft determinations respectively.

While the estimates for the final determination will be based on data from ActewAGL Retail, the approach used is mandated by law and is checked annually by the Commission. The Commission feels that the estimates are reasonable for the 2008–09 year and, being cost based and having not been unduly overstated, balance the requirements of s. 20(2)(i) on cost recovery and s. 20(2)(a) on avoidance of misuse of monopoly power. As expected, due to the size and load shapes of the comparative customer base, the green costs estimates for ActewAGL Retail are likely to differ from the IPART estimates for Energy Australia.

	ICRC 2008–09	IPART 2008–09 (b)	QCA 2008–09
NRET (a)	n/a	0.42	n/a
MRET	1.83	1.27	1.29
GGAS	3.12	3.39 ^a	2.26
Total green costs	4.95	5.08	3.55

a 13% gas scheme
b Stated in nominal terms whereas IPART used 2006–07 \$/MWh

²⁴ *Renewable Energy (Electricity) Act 2001* (Cwth).

²⁵ IPART, Final Determination, June 2007, Table 6.7, page 88, escalated to nominal numbers using the Commission’s CPI assumptions.

²⁶ QCA, Draft Determination, February 2008, page 15.

3.2.4 NEM fees

The Commission has not received a submission from ActewAGL Retail which provides its estimates of the NEM general participation fees and FRC fees and the costs of ancillary services likely to be applicable in 2008–09. To produce a timely report, the Commission has adopted the values used by IPART in its final determination of June 2007 for 2008–09²⁷, but adjusted from the nominal 2006–07 numbers to 2008–09 using the Commission’s assumptions on inflation rate. The Commission will work to verify the best estimate of these fees for its final price direction. The values used are provided in Table 3.5.

Table 3.5 NEM fees (\$/MWh) nominal

	ICRC 2008–09	IPART 2008–09
Market fees (a)		
Participant	0.35	0.35
FRC	0.06	0.06
Ancillary services	0.31	0.31
Total NEM fees	0.72	0.72

a Stated in nominal terms whereas IPART used 2006–07 \$/MWh

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).

3.2.5 Energy losses

Before the beginning of each financial year, NEMMCO publishes its report of distribution loss factors so that distribution and retail businesses can factor the impacts of distribution losses into the tariff structures that they apply to various customer segments. The loss factors are used in the estimate of the electricity purchase costs to allow the retailer to recover the costs of energy losses as the energy is delivered across the distribution network to its customers. Ultimately, the customer pays for the energy lost in delivery to their take-off point. Table 3.6 shows the loss factors used by the Commission.

The Commission has extracted the distribution loss factors for the ACT provided in the NEMMCO reports to assist with its estimate of the weighted average price cap which applies to the TFT. It also used the values to estimate the total network costs in 2007–08 and the likely energy demand requirements for TFT customers for 2008–09.

Table 3.6 Energy loss factors

	ICRC 2005–06	ICRC 2006–07	ICRC 2007–08	ICRC 2008–09
Energy losses	5.19%	5.06%	4.97%	4.86%

The Commission recognises that the recovery of these energy losses meets the objective of ss. 20(2)(d), (e), (h) and (i) by ultimately requiring customers to pay for the energy they consume. As this approach to energy losses in the distribution system is mandated in the NEM framework, the objectives of s. 20(2)(k) are also met through this approach.

3.2.6 Retail operating costs

In the past, the Commission has preferred to rely on industry benchmarks and regulatory precedent to guide the estimate of retail operating costs. The Commission has taken its estimate of those

²⁷ IPART, June 2007, Table 6.8, page 90.

costs from its previous price direction report²⁸ and escalated them by the CPI to arrive at an estimate of \$97.12 per customer per year (or \$9.94/MWh) for the 2008–09 financial year. This is somewhat higher than the regulatory number adopted by IPART (\$75 per customer in 2006–07²⁹, or \$79.36 in 2008–09 terms using the Commission’s inflation assumptions), but the impact of the recovery of similar fixed costs across a larger customer base could account for some of the difference.

3.2.7 Customer acquisition and retention costs

While its original decision in May 2003 and subsequent decisions have not separately identified costs associated with the ‘new entrant’ activity of acquiring new customers, the Commission believes that the development of competition would likely be fostered by allowing these costs into the cost recovery for the TFT customer base. This would support the objective of s. 20(2)(c) by reducing the barrier to entry for competing electricity retailers, which would allow competing price discounts to be offered to the TFT customer base.

The Commission accepts that ActewAGL Retail pays operating costs when it takes previous non-TFT customers back onto the TFT, even when it has paid no advertising costs to encourage such customer return. In addition, the gradual erosion of the TFT customer base by competition means that the fixed costs of the provision of services to this customer group (or retention costs), must rise in \$/MWh terms to allow the recovery of its efficient costs (ss. 20(2)(e) and (i)). While the CPI adjustment to the original retail operating costs assists with this cost recovery, the Commission recognises that the loss of approximately 20% of the customer base to competitive tariff offerings requires the inclusion of additional per-unit costs associated with loss and churn of TFT customers. The Commission does not accept that this cost is as high as the costs for a new-entrant electricity retailer, because there is no need to advertise for these customers.

The Commission has compared the external regulatory benchmark provided in the IPART final determination of June 2007 (\$105 per customer per year in 2006–07, or \$111.10 per customer per year in 2008–09, which includes a \$37.03 customer acquisition cost in 2008–09) with the QCA recent draft decision which has allowed a rate of \$28.47 per customer in 2007–08 and \$18.00 per customer in 2008–09 for these costs.³⁰ The reduction by QCA in 2008–09 reflects a lower expected churn rate of 10% in that year.

For its draft price direction, the Commission remains of the opinion expressed in its previous final report for 2007–08 that it has previously allowed sufficient costs per customer for the combined costs of retail operating and customer acquisition/retention. However the Commission recognises that the use of an external benchmark for those costs supports the aims of ss. 20(2)(a), (e), (i) and (j). Hence the Commission is seeking submissions to this draft price direction which address the issue of whether the Commission has allowed sufficient retail cost to allow recovery of reasonable customer acquisition costs, recognising that should the allowance not be reasonable there could be a detriment to the continued development of retail competition.

²⁸ ICRC, May 2003.

²⁹ IPART, June 2007, page 94, Table 7.1.

³⁰ QCA, February 2008, page 28.

3.2.8 Network tariffs

The Commission has utilised the outcomes of its ActewAGL Retail’s 2007–08 network tariffs³¹ to derive an average network cost estimate for 2008–09. In arriving at the average network cost estimate, the Commission has used the approved network tariffs for 2007–08, the forecasts of customer numbers and energy usage (MWh) for the network tariff adjustments for 2007–08, the average energy growth rate expected for TFT customers between 2007–08 and 2008–09 (assumed to be minus 3.14%), the CPI estimate for 2008–09, and a 0% X factor. The resulting estimate of network cost for 2008–09 is \$54.27/MWh. The Commission seeks submissions on the network cost factored into the TFT cost base analysis before it makes a decision on the final price direction.

The Commission believes this approach supports the objectives of s. 20(2)(a) through arm’s length acceptance of cost data otherwise delivered by a regulated entity, while at the same time accepting that the recovery of network cost pass-throughs is a legitimate activity for the retailer, which meets the objectives of ss. 20(2)(c), (d), (e), (i) and (k).

3.2.9 Retail margin

In its price directions for 2003–04 to 2005–06 and for 2006–07, the Commission adopted a retail margin of 3% of the retail sales value. In 2007–08 the Commission adopted a retail margin of 4% of the retail sales value. Benchmarks against recent regulatory final and draft decisions suggest that this value may continue to be too low for the current stage of development of competitive markets. Table 3.7 below summarises the recent benchmarks from other jurisdictions.

In its final decision³², ESCOSA adopted a 10% retail margin on wholesale electricity cost (WEC) plus retail operating cost (ROC). It equated this to being approximately the same as in other jurisdictions of 5% of sales revenue, where sales revenue is

Table 3.7 Retail Margin Benchmarks

	ESCOSA 2008–09	IPART 2008–09	QCA 2008–09	OTTER 2008–09	ICRC 2007–08
Cost Basis	WEC+ROC	EBITDA	EBITDA	Gross Margin	EBITDA
Retail Margin	10%	5%	5%	12%	4%

considered to be earnings before interest, tax, depreciation and amortisation (EBITDA). In this sense the ESCOSA approach does not consider the average network costs for the TFT customers, or in its jurisdiction “standing contract” customers. This was retained over the period of the 3 year price path from 1 January 2008 to 31 December 2010. In effect therefore, the ESCOSA decision was similar in quantum terms to the decisions taken by IPART and QCA.

In its final decision³³, IPART adopted a 5% retail margin on EBITDA (% of sales). This was retained over the period of the 3 year price path from 1 July 2007 to 30 June 2010.

The QCA is constrained to use a Benchmark Retail Cost Index (BRCI) approach to its regulation of TFT Customers, or in its jurisdiction “notified price” customers. In its most recent final

³¹ Refer to ActewAGL web site: <http://www.actewagl.com.au/electricity/networks/charges2007.aspx> .

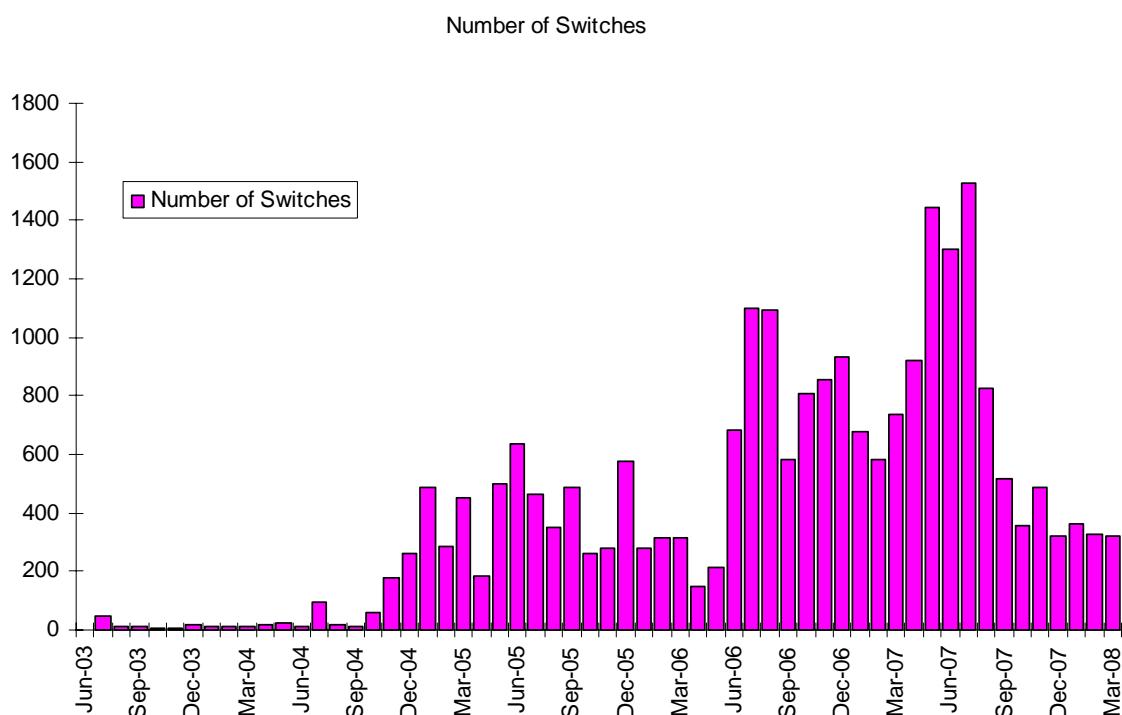
³² ESCOSA, 2007 Review of Retail electricity Price Path, Final Inquiry Report & Price Determination, November 2007, page A-67.

³³ IPART, Promoting Retail Competition and Investment in NSW Electricity Industry, Regulated Retail Tariffs for Small Customers from 2007 to 2010, Final Report and Determination, June 2007, page 94.

decision³⁴, the QCA adopted a 5% retail margin on EBITDA (% of sales).³⁵ The Commission also notes that in its more recent draft decision, the QCA has used 5% in both 2007–08 and 2008–09.³⁶

The Commission has sought the most recent data on customer churn in the ACT to determine whether its previous allowance of a 4% retail margin was sufficient to cover the efficient retail costs for TFT customers and to encourage continued entry by competing retailers. The following Figure 3.3 shows that the customer churn has reduced markedly in the last 12 months

Figure 3.3 Customer Churn or Switching in ACT (NEMMCO Data)



In analysing these figures the Commission notes that the total number of customers on contestable tariffs rose from around 26,000 in 2006 to around 35,000 in 2007, but that the split in switching levels of TFT customers to contestable tariffs offered by ActewAGL Retail as opposed to those offered to new entrants, in 2007, were approximately 21,000 moving to an ActewAGL Retail tariffs and approximately 14,000 moving to an alternative retail provider.

The Commission is concerned that the robust competition during the period June 2006 to August 2007 has dropped off markedly since September 2007 and now usually remains below 400 customer switches per month. This strongly suggests the 4% retail margin allowance provided in the Commissions determination for the period 2007–08 was too low, and below efficient costs, which implies not enough weight was provided to meeting the objectives of ss. 20(2)(d), (e) and (i) of the Act.

³⁴ QCA, Final Decision, Benchmark Retail Cost Index for Electricity, 2006/07 to 2007/08, June 2007, Table 3, page 6.

³⁵ QCA, Draft Decision, Benchmark Retail Cost Index for Electricity, 2006/07 to 2007/08, May 2007, Table 4.1, page 24.

³⁶ QCA, February 2008, page29.

The Commission believes that issues such as the higher unit costs associated with a reduced regulated TFT customer base, and a recovery of fixed costs (albeit at a reduced cost allocation), require a further rise in the allowed retail margin for the regulated TFT. Therefore, the Commission proposes to adopt a 5% retail margin in the average revenue cap for 2008–09. This is the same as the retail margin used by IPART in its transitional period over three years, whereas the 5% proposed by the Commission will apply immediately in 2008–09, rising from the 4% used in 2007–08. The Commission believes this approach better meets the objectives of ss. 20(2)(d), (e) and (i) of the Act.

3.3 Summary of cost elements

Based on the benchmark cost analysis in Section 3.2, the Commission believes the cost breakdown provided in Table 3.8 provides the reasonable cost base for development of the weighted average price cap to be applied to the TFT for the 2008–09 year.

The Commission believes that these costs are reasonable for an efficient incumbent retailer providing services to the TFT customer base in the ACT. As efficient costs, these costs meet the objectives of s. 20(2)(c) and allow the correct price signals to be seen by end-users of the TFT, which meets the objective of s. 20(2)(h) while protecting TFT consumers from excessive price increases, which would not support the objective of s. 20(2)(a).

Table 3.8 Composition of TFT retail price

	2008–09
Energy purchase costs per customer (\$/MWh)	
Electricity purchase cost (\$/MWh)	71.69
Energy contracting cost (\$/MWh)	0.72
Green costs (\$/MWh)	4.95
NEM fees (\$/MWh)	0.72
Energy losses	4.86%
Total energy purchase cost (\$/MWh)	81.87
Retail operating costs (\$/MWh)	9.94
Customer acquisition costs (\$/MWh)	0.00
Total retail costs (\$/MWh)	9.94
Network costs (\$/MWh)	54.27
Total retail costs (\$/MWh)	146.08
Retail margin (% of sales, EBITDA)	5.00%
Total retail price (\$/MWh)	153.38
Assumed CPI change, 2007–08 to 2008–09	2.33%
X factor in CPI+x on MAR in \$/MWh	7.86%

3.4 Weighted average price cap outcome

The Commission has taken its previous cost estimates for the 2007–08 year and compared these to the cost estimates for 2008–09 to generate the required X factor in the weighted average price cap to be imposed on ActewAGL Retail for its TFT customers. As shown in Table 3.8, the X factor preferred by the Commission for its draft price direction is 7.86%.

Based on the regulatory CPI estimate of 2.33% for 2008–09, the Commission proposes that, in order for ActewAGL Retail to recover its efficient costs and to meet the objectives of the section 20 of the ICRC Act, the weighted average price cap for 2008–09 must allow average price increases of 10.38% for TFT customers.

4 Other aspects of the transitional franchise tariff

4.1 Safety net provisions

In its previous reports³⁷, the Commission has stated that ‘the TFT was never intended to be a safety net measure for more vulnerable customers’. The Commission is still of this view. In other industries and for other goods and services, a competitive retail market is usually considered to offer the best guarantee against price gouging or exploitation of consumers. In a market where there is a degree of volatility, as there is in the electricity market, a competitive retail market will help to smooth out that volatility as retailers seek to minimise the churn of customers that can occur when prices change rapidly and regularly.

In setting the TFT for 2008–09, the Commission has sought to set a price which does not reflect the short-term marginal cost (although this might be the price that a new retail entrant might charge if they had not hedged in advance of the current price increases), while at the same time recognising that prices will need to rise as the underlying price of electricity generation rises.

In these circumstances, the TFT provides a degree of certainty and stability for consumers’ likely electricity costs over the next 12 months. To ensure security of supply and to avoid any potential for events such as those in California, where retail prices were set below generation costs, forcing retailers to leave the market and suppliers to fail, the Commission has recognised the need for large price increases to take effect from 1 July 2008. This, in itself, represents a form of ‘safety net’ for security of supply to consumers. At the same time, it comes at a cost, which is reflected in the higher charges that will apply in 2008–09.

The Commission notes that a competitive market already exists for electricity supply in the ACT. Should generation costs decline further during 2008–09, competition between suppliers for the growing number of households that have converted to a non-franchise competitive supplier will force the early pass-through of those price reductions.

The Commission continues to support current arrangements for more vulnerable customers, including the targeted use of community service obligations; rebates and concession arrangements for welfare benefit and pension recipients; and the consumer advocacy and support services provided by the Essential Services Consumer Council, Care Financial Counselling Service (Care ACT), the ACT Council of Social Service and other support agencies.

The Commission notes that on the 11 April 2008³⁸, the ACT Government announced an extension of the current concession rebate arrangements to health care card holders. The ACT Government provides the concessions listed in Table 4.1.

³⁷ ICRC, April 2006, page 2 and Section 4.4.1, pages 25–28.

³⁸ Media Release, Jon Stanhope, Chief Minister, ACT, 11 April 2008.

Table 4.1 Concession

Energy
General Rates (Pensioner rebate of General Rates and Fire and Emergency Services Levy)
Life Support
Low Vision Aids Scheme
Motor Vehicle Registration and Drivers Licenses
Public Transport
Secondary Bursary Scheme
ACT Senior Spectacles
ACT Spectacles Subsidy
Student Transport
Taxi Subsidy Scheme
Water and Sewerage

The concession arrangements provide a maximum annual rebate of \$189 on the electricity bills if holders of health care cards. “Coupled with the new water rebate, this will mean eligible households will receive a maximum rebate of around \$238 per year.”³⁹

The Commission notes that there is likely to be an accumulation of higher utility charges in 2008–09 as a result of higher than historical averages of generation costs for electricity and the recent decision for higher water charges. These additional costs will have an impact on those in the community who are less well off, and appropriate funding of support programs by the government is required to address this issue.

³⁹ Media Release, Jon Stanhope, Chief Minister, ACT, 11 April 2008.

5 Conclusion on the draft direction

In this draft decision, the Commission has considered the build-up of efficient costs for the provision of retail electricity services by ActewAGL to customers on the regulated retail tariff. In coming to its determination, the Commission has considered ActewAGL's likely costs for 2008–09, especially taking into account the recent increases in the electricity pool price. The Commission is also mindful of the requirements of section 20 of the ICRC Act, and its obligation to balance the requirement for prices that reflect the costs of supply against the social implications of price increases.

The Commission has determined that ActewAGL's franchise tariff revenue may increase by up to the CPI plus 7.85%. The Commission has determined that the appropriate value of the CPI is 2.33%. In making this determination for one year, the Commission has not changed the form of regulation faced by ActewAGL.

The Commission is seeking comments from interested parties on this draft price direction for the year from 1 July 2008 to 30 June 2009 as it applies to ActewAGL Retail.

The Commission is operating to a short deadline for the development of this price direction, for the finalisation of which it proposes the following timeline:

Activities	Dates
Release of the draft direction	Tuesday, 22 April 2008
Final submissions to the ICRC	Friday, 23 May 2008, 5.00pm
Final report and final price direction	Friday, 13 June 2008
ActewAGL Retail implementation of tariff changes	From 1 July 2008

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.

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.

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 1)

Disallowable instrument DI2008–13

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 2008 to 30 June 2009.

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

7 February 2008

Appendix 2 Draft price direction

This appendix contains the Commission's draft price direction in respect of the transition franchise tariff (TFT) for the period from 1 July 2008 to 30 June 2009. The Commission has had regard to section 20(2) of the *Independent Competition and Regulatory Commission Act 1997* in making this draft price direction.

1 Period of the direction

The provisions below will apply to the period from 1 July 2008 to 30 June 2009.

2 Revenue control for 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 in accordance with 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 2008–09 price for component j of the regulated retail tariff i

P_{ij}^{t-1} is the actual 2007–08 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 2007

CPI = 2.33%

X = 7.86%

Glossary and abbreviations

ACT	Australian Capital Territory
ActewAGL	ActewAGL Retail
Commission	Independent Competition and Regulatory Commission
CPI	Consumer Price Index
FRC	full retail contestability
ESCOSA	Essential Services Commission of South Australia
GGAS	greenhouse gas abatement scheme
ICRC Act	<i>Independent Competition and Regulatory Commission Act 1997 (ACT)</i>
IPART	Independent Pricing and Regulatory Tribunal (NSW)
LRMC	long-term marginal cost
MRET	mandatory renewable energy target
MWh	megawatt hours
NEM	national electricity market
OTTER	Office of the Tasmanian Energy Regulator
QCA	Queensland Competition Authority
RRP	regional reference price
TFT	transitional franchise tariff
Utilities Act	<i>Utilities Act 2000 (ACT)</i>