

# Supply of Electricity to Franchise Customers

ActewAGL Response to ICRC Draft Decision

23 May 2008



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## 1. Introduction

On 7 February 2008 the ACT Government issued a terms of reference for 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 Commission released its draft decision on 23 April 2008 and seeks responses by 23 May 2008. ActewAGL is pleased to be able to comment on this draft decision. Overall, ActewAGL is satisfied that the draft decision has recognised a number of concerns raised by ActewAGL in relation to the 2007/08 decision, in particular in regard to the retail margin and in maintaining a consistent methodology for calculating the energy purchase cost. However, ActewAGL believes that the decision to exclude customer acquisition and retention costs should be reviewed and ActewAGL would also like the Commission to determine why its estimate of energy purchase costs does not correlate exactly with ActewAGL's calculation, that was derived using the Commission's model.

The current price direction expires on 30 June 2008. The terms of reference requires the Commission to set a one year price direction. This will be the third consecutive annual price direction following the three year price direction in 2003 that was intended to as a transition to the removal of price regulation. The first 'one year' direction was set by the Commission for 2006/07 as an interim measure pending a Government decision on the Commission's recommendation that the TFT (transitional franchise tariff) be removed from 1 July 2007. A decision was not reached in time for the removal of the TFT from 1 July 2007, so the government requested the Commission to make a direction for 2007/08. As yet, no decision has been reached in terms of the timing of the removal of price regulation, necessitating this reference for 2008/09.

ActewAGL continues to recognise the very difficult circumstances involved in setting a regulated price in a competitive market and remains fully supportive of the Commission's recommendation that retail price regulation should be removed. This will allow competition to fully develop in the ACT, delivering to all customers the benefits of greater choice, lower prices, and new and innovative products and services.

The Commission has advised that it:

'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.'<sup>1</sup>

ActewAGL notes that successive price directions continue to expose it to regulatory risk and does not provide the level of certainty required for ActewAGL to conduct its retail business in an increasingly volatile and uncertain electricity market.

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<sup>1</sup> ICRC 2008, p. 3

The Commission has also noted this difficulty:

'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.'<sup>2</sup>

The Commission has also noted that such short term pricing arrangements increase the risks to ActewAGL.

'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 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.'<sup>3</sup>

For this reason, it is critical that this regulated electricity retail price decision not disadvantage ActewAGL relative to its current nor potential competitors in the ACT marketplace. This means the tariff needs to reflect current and emerging market and economic conditions and be able to respond to emerging political initiatives, such as any new policy settings in relation to the management of climate change.

It was for this reason that ActewAGL urged the Commission, prior to the making of the 2007/08 price direction, to acknowledge the risk to the incumbent supplier of having its prices regulated in a competitive and often volatile market environment and emphasised the need to facilitate a smooth transition to a market free of regulatory distortions and constraints. While the Commission has taken some positive steps in this direction in the draft decision for 2008/09, ActewAGL believes that further progress can be made in the final decision. ActewAGL has identified these in this submission, to help inform the Commission's final assessment process for prices in 2008/09.

## **2. Overview of ActewAGL's response to the draft decision**

The main components of ActewAGL's submission are as follows:

- ActewAGL has applied the Commission's method to determining purchase costs and updated the Commission's model with current market data, to establish a purchase price of energy of \$72.06/MWh for 2008/09. While ActewAGL is satisfied that the Commission has maintained a consistent methodology for this calculation, ActewAGL

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<sup>2</sup> ICRC 2008, p. 8

<sup>3</sup> ICRC 2008, p. 6-7

would like to determine why its estimate of energy purchase costs that it derived using the Commission's model does not correlate exactly with the Commission's estimate.

- ActewAGL believes that including customer acquisition and retention costs in the calculation of prices for an efficient retail electricity provider would improve competitive outcomes in the ACT and, as noted by the Commission, be a step closer to providing the benefits of full competition to the residents of the ACT.
- ActewAGL supports the Commission's decision to adopt a retail margin of 5% in its calculations for the TFT in the ACT. ActewAGL has consistently argued that a 5% retail margin is the minimum margin payable to compensate for the risk of operating in a volatile wholesale electricity market. This risk has been recognised and more properly compensated in other jurisdictions for some time.

### ***3. Context for the draft decision***

ActewAGL notes that this price direction is being made in the context of:

- Continuing uncertainty about the future wholesale cost of electricity and market expectations for continuing price volatility given continued low storage levels of the Snowy and TAS hydro schemes;
- Impending government policy decisions in NSW about their retail and generation options;
- Federal government policy directions in relation to climate change;
- Territory government policy directions including the ACT Climate Change Strategy 2007-2025: Weathering the Change;
- Calls for implementation of carbon trading schemes;
- Release of an ACT government discussion paper in December 2007 on a feed-in-tariff option for the generation of solar electricity using photovoltaic cells;
- The ACT Government and ActewAGL announcement in March 2008 that they are to jointly fund a feasibility study into a large-scale solar power plant for the ACT, which will have consideration to regulatory and electricity pricing implications, and will report by July 2008.

The Commission has assessed this external context and expects that prices will continue to be impacted over the next few years:

'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.<sup>4</sup>

In addition, ActewAGL notes that the Commission's 2008/09 price direction is made against a backdrop reflecting:

- A competitive market for supply of electricity in the ACT;
- The risks faced by regulated retailers who are locked into supplying franchise customers at a regulated price;
- Widespread recognition of the potential costs of ongoing retail price regulation;
- Commitments by governments to gradually remove retail price regulation;
- Recognition by IPART and the Commission that, in the transition to removal of price regulation, light-handed regulation which encourages further development of competition is appropriate;
- Recent explicit recognition in NSW that it is appropriate to set regulated prices 'in a way that reduces customers' reliance on regulated prices'<sup>5</sup>.

## 4. Response to the draft decision

### 4.1 The Commission's approach

ActewAGL continues to recognise the very difficult circumstances involved in setting a regulated price in a competitive market and remains fully supportive of the Commission's recommendation that retail price regulation should be removed. ActewAGL has accepted the Commission's broad approach to the determination of retail electricity prices "to draw on benchmark cost information available in the marketplace or in other regulatory decisions within the electricity retail sector in Australia."<sup>6</sup>

However, ActewAGL encourages the Commission to take a further step toward its end goal and apply benchmark information not just "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"<sup>7</sup> but to incorporate some of the costs of a new entrant retailer to reduce customers reliance on regulated prices as has been done in NSW.

In its review of retail electricity tariffs in 2007, IPART was required to base the retail operating costs and margins on those of a mass market new entrant. That is, regulated tariffs are set at

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<sup>4</sup> ICRC 2008, p. 8

<sup>5</sup> IPART 2007, p. 1

<sup>6</sup> ICRC 2008, p. 4

<sup>7</sup> ICRC 2008, p. 4 (emphasis added)



a level that would allow new entrants, with efficient new entrant retail operating costs and margins, to compete. This was in line with the requirement to set prices to facilitate further competition. ActewAGL believes that, in order to facilitate further competition, a similar approach is appropriate for the ACT.

ActewAGL has provided commentary below on the approach to estimating each of the cost components.

## 4.2 Energy costs

### 4.2.1 Energy Purchase Costs

In its review of wholesale purchase costs in 2007/08, the Commission proposed a new purchase cost method in its draft decision, and then applied this method in its final decision. The method and associated hedging assumptions were specified in detail in the final decision.<sup>8</sup> The Commission has proposed in its draft determination to use the same method as it did for the 2007/08 decision.

'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.'<sup>9</sup>

ActewAGL had expressed concern with the method and assumptions when they were initially presented in the Commissions draft decision for 2007/08 prices without any prior notice or warning. Specifically, ActewAGL noted at that time:

1. The difficulty and implications of trying to hypothesise and apply a generic hedging strategy given the assumptions about the timing of purchases and the forecast load covered by hedged contracts at points in time which are unlikely to reflect the commercial nature of managing purchase risk and load volatility in a market environment where existing retailers or new market entrants will adopt differing strategies and approaches to managing risk across competing suppliers.
2. That basing the energy purchase cost allowance on a set of assumptions about hedging behaviour, without prior warning or precedent, highlighted the regulatory risk facing ActewAGL given that it would have been prudent for ActewAGL to continue to expect that any future regulated electricity tariff would continue to reflect wholesale market-based costs, and to develop and implement its purchasing policy accordingly.

In its final decision, the Commission advised that it had nevertheless decided to implement this method as it found this would best meet the competing requirements in s20 of the ICRC Act per the terms of reference for the inquiry:

'While this approach is new, it must be adopted so the Commission can balance the social impacts of its decision (s. 20(2)(g)) with the need to recover efficient costs (ss. 20(2)(c) and (e)).'<sup>10</sup>

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<sup>8</sup> ICRC 2007, p. 31-33

<sup>9</sup> ICRC 2008, p. 17

<sup>10</sup> ICRC 2007 p. 30

## Impact of 2007/08 Decision

In 2007/08, the Commission advised that by using its method and assumptions, its estimate of the electricity purchase costs was \$62.60/MWh for 2007/08. ActewAGL noted at the time, and evidence has since confirmed, that this price remained below the market price for electricity.

ActewAGL has also noted that the Commission's approach at this time conflicted with IPART's view that it is 'preferable to err on the side of overestimating rather than underestimating the costs of electricity purchase.'<sup>11</sup>

Yet the Commission had itself noted the very real risks of underpricing electricity and acknowledged that the TFT was not intended to be a 'safety net' for smaller consumers. The Commission has confirmed this position in its 2008 Draft Decision. ActewAGL fully agrees with the Commission's statement that underpricing will:

'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.'<sup>12</sup>

While the ACT electricity market remains highly competitive in terms of the number of customers that have taken up contracted offers, the ICRC has noted 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."<sup>13</sup>

ActewAGL agrees and is able to advise that:

- it is not aware of any new retailers that have entered the ACT market in 2007/08.
- competitor activity has declined in the ACT, especially from TruEnergy and Energy Australia who were very active in the 2006/07 financial year.

ActewAGL believes that this drop in competitor intensity is highly correlated with the recent market circumstances and purchase cost volatility in combination with the Commission's 2007/08 decision which set the regulated tariff too low compared to price offerings that are tied to the current market price of energy.

## Ongoing Market Uncertainty

In its draft decision, the Commission has noted the continuing impact on the purchase cost of electricity arising from the current market factors. The Commission notes that its methodology for determining the purchase cost:

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<sup>11</sup> IPART 2007a, p. 6

<sup>12</sup> ICRC 2007 p. 35 and ICRC 2008, p. 21

<sup>13</sup> ICRC 2008, p. 26

‘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.’<sup>14</sup>

ActewAGL agrees with the Commission that the impacts of the recent period of volatility in the price of energy will not be reflected as a one-off spike, but will continue to impact for some time given the range of factors contributing to market uncertainty.

### ActewAGL’s purchase cost proposal for 2008/09

In its draft decision, the Commission “found that its estimate of the electricity purchase costs was \$71.69/MWh for 2008–09.”<sup>15</sup>

It is very important for ActewAGL to have a level of certainty in terms of the ongoing application of a method for assessing purchase costs. Given the explicit publication of the Commission’s method and assumptions in the 2007/08 decision and its use again in the 2008 draft decision, ActewAGL has been able to apply the method and update the Commission’s purchase cost model with current market data, to establish its estimate of an equivalent price for 2008/09.

ActewAGL used the average cost of peak and off-peak energy in December and June on the contract market for the period between December 2004 and December 2007 for energy to be delivered in the 2008/09 financial year and entered these average monthly purchase costs into the Commission’s model. The model weights the peak and off-peak prices over the previous three years to calculate an average purchase cost for energy in the 2008/09 financial year.

By applying the Commission’s approach, ActewAGL has derived a purchase price of energy of \$72.06/MWh to apply in 2008/09.

ActewAGL notes that its estimate of \$72.06/MWh, while close, does not correlate exactly with the Commission’s estimate in its draft decision of \$71.69/MWh. ActewAGL has provided information on the derivation of the estimated purchase cost of energy in 2008/09 in the following table which replicates the method and assumptions used by the Commission for the purpose of its 2007/08 final decision. ActewAGL would like to establish why its estimate of energy purchase costs that it derived using the Commission’s model does not correlate exactly with the Commission’s estimate.

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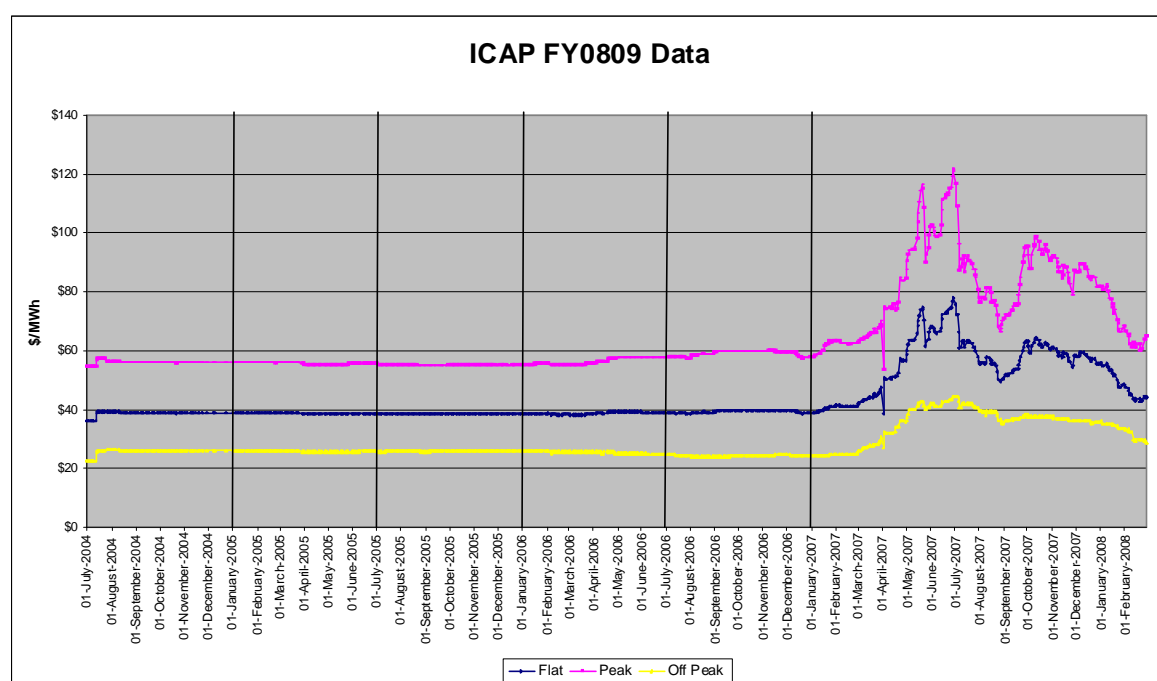
<sup>14</sup> ICRC 2008, p. 17

<sup>15</sup> ICRC 2008, p. 20

## Energy Contract Assumptions

Half Year Ending	Dec-04	Jun-05	Dec-05	Jun-06	Dec-06	Jun-07	Dec-07	Jun-08	Dec-08	Jun-09
Half Year	H1	H2	H1	H2	H1	H2	H1	H2	H1	H2
<b>Contract Energy Price by Time of Day (\$/MWh)</b>										
Peak Time	(\$/MWh)	55.9	55.4	55.1	57.4	58.4	108.8	86.0	86.0	86.0
Shoulder Time	(\$/MWh)	55.9	55.4	55.1	57.4	58.4	108.8	86.0	86.0	86.0
Off-Peak Time	(\$/MWh)	25.8	25.7	25.8	24.8	24.5	42.4	35.9	35.9	35.9

These costs reflect the following forward market for electricity in 2008/09 at this time.



As indicated above and noted by the Commission<sup>16</sup>, there has been a drop in the forward contract market curve. This can be attributed to the mild demands in NSW over summer and the strong rainfall in northern NSW and QLD which are helping rectify water issues. Despite this, the Murray Darling Basin/Snowy Scheme continues to face water issues. The latest snowy water update (1 Feb 08) on its website still states that: "Snowy scheme storage are still at their lowest level since construction". TAS hydro is also extremely low.

<sup>16</sup> ICRC 2008, p. 19

The NSW contract market, especially the outer years, remains extremely illiquid due to a level of 'uncertainty' in the NSW market - driven by issues such as Government ownership of assets, pending sale of NSW retailers, carbon cost and the future cost of gas/availability for generation.<sup>17</sup>

### 4.3 Retail operating costs

ActewAGL is pleased to advise the Commission that it has recently been awarded<sup>18</sup> first place out of 47 utilities in the Customer Service Benchmarking Australia (CSBA) quarterly benchmarking study. ActewAGL is proud of this independent recognition of its service quality to customers. Customers receive a high level of value from ActewAGL's retail services.

In the draft decision, the Commission has taken its estimate of retail operating costs from the 2007/08 price direction and escalated it by the CPI to arrive at an estimate for 2008/09 of \$97.12 per customer. However, escalating in line with the CPI does not adequately reflect recent and expected trends in retail operating costs. In 2007, ActewAGL identified that labour costs had increased at rates in excess of CPI and were expected to continue to do so.<sup>19</sup>

This outcome is compounded by the Commission's decision to omit customer acquisition and retention costs from its retail costs base, though ActewAGL notes the Commission specifically requests:

'submissions to the 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.'<sup>20</sup>

ActewAGL does not believe it is appropriate to make a zero allowance for customer acquisition and retention costs in the retail operating cost as specified in the draft price direction. Part of the cost of retention is the delivery of high value customer service as recognised by the CSBA award.

The concern expressed by the Commission that "should the allowance not be reasonable there could be a detriment to the continued development of retail competition"<sup>21</sup> is a real one and, as noted by the Commission<sup>22</sup>, competitive activity in the ACT has declined over the 12 months since the Commission's last decision, when it elected not to incorporate customer acquisition and retention costs. IPART has included estimates of these costs in its determination for NSW electricity retailers in order to achieve full cost recovery by 2010.

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<sup>17</sup> IPART 2008 p. 9

<sup>18</sup> Benchmarking period for January to March 2008, 30 April 2008

<sup>19</sup> ActewAGL 2007, p. 11

<sup>20</sup> ICRC 2008, p. 24

<sup>21</sup> ICRC 2008, p. 24

<sup>22</sup> ICRC 2008, p. 26

However IPART has recently stated that for NSW regulated electricity prices it “recognises that tariffs remain below that of the hypothetical retailer in 2007/08 and 2008/09.”<sup>23</sup> Yet this does include an estimate for customer acquisition costs.

The Commission has recognised that

‘the development of competition would likely be fostered by allowing these costs into the cost recovery for the TFT customer base’<sup>24</sup>

and noted this was important by including customer acquisition and retention costs in its draft decision in 2007. However, whilst ActewAGL had supported this approach in its response to the 2007 draft decision, the Commission removed these costs from the final decision in 2007 in order to achieve the outcome of “balancing the requirements of section 20(2)”<sup>25</sup>

ActewAGL does not believe that these costs should be used as a balancing tool. ActewAGL believes that the retail operating costs for 2008/09 must now include the customer acquisition costs, as they have been in NSW as part of the IPART three year phased decision, in order to set a TFT at a level closer to market price.

For the final decision, ActewAGL proposes that customer acquisition and retention costs of \$20.85 per customer also be included as part of the retail cost calculation.

## 4.4 Network cost

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.’<sup>26</sup>

In its draft decision, the Commission had estimated a network cost for 2008/09 of \$54.27/MWh by utilising ActewAGL’s 2007/08 network tariffs. ActewAGL Distribution has now published its approved network tariffs for 2008/09<sup>27</sup>.

ActewAGL is able to inform the Commission that the network cost for 2008/09 will be \$56.05/MWh for the 12-month period ending 31 March 2008.

## 4.5 Average franchise price

The Commission’s draft price determination applies a CPI plus X factor to the average franchise price in 2007/08 assuming 2007/08 prices are applied to the actual quantities sold in the 12 months to March 2008. The average franchise price in 2007/08, using the load profile for the 12 months to March 2008 is \$142.00 per MWh, excluding GST.

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<sup>23</sup> IPART 2008, p. 10

<sup>24</sup> ICRC 2008, p. 24

<sup>25</sup> ICRC 2007, p. 5

<sup>26</sup> ICRC 2008, p. 25

<sup>27</sup> <http://www.actewagl.com.au/Publications/Electricity/NetworkChargesPrintableform2008.pdf>



## 4.6 Retail margin

ActewAGL supports the Commission's draft decision to adopt a retail margin of 5% in its calculations for the TFT in the ACT. ActewAGL has consistently argued that a 5% retail margin is the minimum margin required to compensate for the risk of operating in a volatile wholesale electricity market. This risk has been recognised and more properly compensated in other jurisdictions. ActewAGL believes that the allowed retail margin should, as a minimum, be set consistent with the rate applied to comparable entities in other states, and thus should be set to be at least 5%.

In New South Wales, IPART concluded that a 5% retail margin is appropriate based on Frontier Economics' recommendation that the margin should lie somewhere between four and six per cent, and submissions to the review maintained that a minimum of five per cent should be adopted.

In Queensland, the QCA based its decision regarding the retail margin on the recommendation from their consultants, CRA. CRA believed a margin of 5 per cent was appropriate, "based on the *margins accepted in different jurisdictions* and the reduced risk to retailers due to the Authority's proposal to recognise some short run variations in its approach to determining the cost of energy".<sup>28</sup>

ActewAGL has noted emerging evidence to support the Commission's concern 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.'<sup>29</sup>

## 4.7 Cost pass-through mechanism

In December 2007, the ACT Government issued a discussion paper on the introduction of a feed-in tariff (FiT) proposed to apply to renewable energy produced by photovoltaic systems and fed back into the electricity network. ActewAGL supports moves to reduce the ACT's 'carbon footprint', and is involved in schemes designed to reduce the level of carbon emissions and encourage the use of renewable energy.

ActewAGL has advised the ACT Government that it can only support the introduction of a FiT on renewable energy if it is no worse off financially as a consequence of the policy. The regulatory nature of electricity pricing in the ACT has implications for the cost recovery of such a scheme. If it is likely such a scheme would be implemented via network charges, ActewAGL Retail will require a pass through of those additional costs.

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<sup>28</sup> QCA 2007, p24 (emphasis added)

<sup>29</sup> ICRC 2008, p. 26

If any decision to implement a FiT is made *after* this 2008/9 Final Decision is released by the Commission, an appropriate cost pass-through mechanism must be in place so that costs can be recovered in full, once a scheme is underway. ActewAGL has noted that the costs imposed on it could include not only the cost of the tariff but the costs of implementing, managing, administering, reporting, publicising and advising on the scheme.

In addition, the ACT and Commonwealth Governments are actively considering policies to manage carbon emissions. These could have implications for electricity costs during the 2008/09 financial year. ActewAGL seeks assurance from the Commission that ActewAGL would be able to recover in its prices any such additional costs incurred during the regulatory period.

The Commission has not addressed this important matter in its draft decision. ActewAGL would appreciate clarity in regard to this issue in the final decision given that it understands FiT legislation has been tabled for debate in June 2008.



## References

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