



independent competition and regulatory commission

Final Decision
and Price Direction
**Retail Prices
for Non-contestable
Electricity Customers**

Report 7 of 2007
June 2007

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 2007 to 30 June 2008. The Minister's reference is made under sections 15 and 16 of the *Independent Competition and Regulatory Commission Act 2000* (ICRC Act).

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 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. A regulated maximum tariff was applicable to such customers for a period of three years from 1 July 2003 to 30 June 2006. During the 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. The Commission issued its final decision in April 2006. The regulated maximum tariff applicable to such customers was extended for a period of one year from 1 July 2006 to 30 June 2007. The government, through the Attorney-General, has now sought a determination from the Commission on what the transitional franchise tariff should be for a further 12 months.

In developing the price direction for the regulated maximum tariff applicable to customers eligible for these transition arrangements for the period from 1 July 2007 to 30 June 2008, 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 final price direction and reasons for the particular arrangements embodied in the direction.

Paul Baxter
Senior Commissioner
June 2007

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.

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1 Introduction

1.1 Background

The Commission received a reference from the Attorney-General on 16 April 2007, instructing it to provide a price direction for the supply of electricity to franchise customers for 1 July 2007 to 30 June 2008. The Commission has made two previous price directions for this class of retail electricity customers. The first was released in May 2003 and covered the period from 1 July 2003 to 30 June 2006, and the second covered the period from 1 July 2006 to 30 June 2007.

The Commission's first price direction was made at the time of the initial opening of the retail electricity market to competition for small customers (those consuming less than 100 MWh/year). Thus, at the beginning of that price direction, all small customers were on the regulated retail tariff. The initial reference to the Commission instructed it to provide a three-year price direction. The Commission termed the resulting tariff from that price direction the 'transitional franchise tariff' (TFT). Customers who chose to remain on the regulated tariff are called 'franchise customers', and customers who opted for a negotiated tariff with an alternative retailer or with the incumbent retailer, ActewAGL Retail, are called 'non-franchise customers'.

The Commission's first price direction allowed a 4.5% real increase in the franchise revenue for the first year and a 0.5% real increase for each of the remaining two years.⁴ The Commission made that determination based on 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.

The reference the Commission received to initiate the second price direction instructed the Commission to determine first whether it was necessary for the TFT to continue. If the Commission determined that the TFT should continue, the Commission was to determine a new price direction. The Commission's final report, issued in April 2006, 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

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

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

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.

The Commission is now required to extend the TFT for a further period of one year, given the recent reference from the government. As part of the Commission’s current analysis, the Commission has again undertaken a rigorous evaluation of the build-up of retail costs.

1.2 Structure of the final decision

This final decision outlines the Commission’s process for conducting this price direction for the supply of electricity to franchise customers, and explains the context of the review and the key issues the Commission has considered in making the price direction.

Chapter 2 outlines the final 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 provides a summary of the draft decision and discusses the primary issues the Commission has considered in moving to its final decision.

Chapter 4 summarises developments relating to regulated retail tariffs in other states.

Chapter 5 summarises the submissions received by the Commission relating to its draft decision, which was published on 11 May 2007.

Chapter 6 provides in more detail the cost build-up used to determine the TFT.

Chapter 7 reviews other aspects of the TFT and, in particular, safety net provisions and support for vulnerable customers.

Chapter 8 provides the Commission’s conclusions and sets out the Commission’s final decision on the TFT.

The terms of reference for the Commission’s review of the TFT are provided in Appendix 1.

The final price direction is provided in Appendix 2.

2 Overview of the final 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 (the ‘transitional franchise tariff’, or TFT) provided by the incumbent retailer. The obligations imposed on the Commission in determining the charging 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 of 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 retail electricity 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 adjust 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 the 2007–08 regulatory year.

In considering the determination of an appropriate TFT for the 2007–08 year, the Commission has revisited the cost build-up and other information used in setting the TFT over the past four years. 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 weighted average price cap for 2007–08.

2.1 Summary of the retail costs underlying the final decision

The Commission has reviewed the main activities of electricity retailers and, through examination of its previous TFT decisions, publicly available industry information and 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 recently published by the Independent Pricing and Regulatory Tribunal (IPART) in its draft determination⁶ for electricity retailers in New South Wales.

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

	ICRC 2007–08	IPART 2007–08
Energy purchase costs		
Electricity purchase cost (\$/MWh)	62.60	56.50
Energy contracting cost (\$/MWh)	0.70	–
Green costs (\$/MWh)	3.34	4.30
National Electricity Market fees (\$/MWh)	0.71	0.71
Energy losses	4.97%	6.40%
Total energy purchase cost (\$/MWh)	71.70	65.45
Retail operating costs (\$/customer)	94.91	75.00
Customer acquisition costs (\$/customer)	–	35.00
Total retail costs (\$/customer)	94.91	110.00
Retail margin (% of sales, EBITDA)	4.00%	5.00%

Note: IPART's final decision was yet to be published at the time this review was completed, so the Commission is unable to list IPART's final determination.

The estimates of efficient retail costs 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 the 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. The cost savings are only available from those cost elements that can 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 new customers returning to the TFT can be influenced by the retailer's decisions and behaviour.

One concern of the Commission relating to the reference requirement for the TFT to be set for a 12-month period is that market data currently exhibits 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 constrains the Commission in how it is able to allow cost changes resulting from that imbalance to be passed through to consumers by the incumbent retailer. The short reference period means the Commission is unable to transition any price changes over a longer period, as is being contemplated in other jurisdictions.

⁶ IPART, *Draft report and draft determination No. 1 of 2007, Promoting retail competition and investment in the NSW electricity sector, Regulated electricity retail tariffs and charges for small customers 207 to 2010*, April 2007.

In order to meet the legislated requirements of section 20(2) of the ICRC Act, the Commission is constrained to allow large increases in energy cost to be passed through immediately without a transition, which might otherwise be considered. Indeed, large increases in energy cost that 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 Act⁷) because tariffs no longer allow recovery of efficient costs
- reduce the success of demand side management (s. 20(2)(h)) by 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
- reduce the retailer's 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 in Section 3.2.1 of this final decision, the issue of the wholesale energy market clearing price is extremely important in the 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.

In this context, the Commission believes its final decision on the TFT described in this report is the best balance between the conflicting objectives of section 20(2), taking into account the short-term nature of the terms of reference set by the government.

2.2 Cost changes affecting the final decision

In determining the cost estimates 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 2007–08 financial year. While in its draft decision the Commission separately identified and included potential customer acquisition costs related to the churn off and return of TFT customers, after balancing the requirements of section 20(2) it has decided not to change its previous position on excluding those costs from the cost base. The Commission has received and reviewed ActewAGL Retail's estimate of likely 'green' costs, including the mandatory renewable energy target (MRET) and greenhouse gas abatement scheme (GGAS) costs mandated by legislation⁸, and has adopted those in its final decision. The Commission has estimated the NEM fees using public information on the fee structures and estimates of ActewAGL Retail's likely operating circumstances in 2007–08. Likewise, the distribution loss factors provided by NEMMCO and relied upon for many tariff calculations show a slow reduction in distribution loss factors for ACT distribution tariff consumers.⁹ The Commission has adopted the 4% retail margin adopted in the draft decision as opposed to the retail margin on sales (3%) that has been used in previous TFT determinations. This

⁷ References to 'section 20' in this report refer to that section of the ICRC Act.

⁸ *Renewable Energy (Electricity) Act 2000* (Cwth) and *Renewable Energy (Electricity) Regulations 2001*, *Electricity (Greenhouse Gas Emissions) Act 2004* (ACT) and *Electricity (Greenhouse Gas Emissions) Regulation 2004* (ACT).

⁹ NEMMCO, *Distribution loss factor reports for 2005–06, 2006–07 and 2007–08*, Appendix D.

is lower than the average value considered by IPART in its most recent draft determination (5%) primarily because the ICRC retail margin requires a balance in the competing objectives of s. 20(2) of the ICRC Act.

The major change from the cost structure used in previous price directions prepared by the Commission is that the wholesale energy price observed in the electricity pool has increased during 2007, with dramatic increases in recent months. Table 2.2 lists the average annual regional reference price (RRP) for New South Wales from 1998–99 to 2006–07.¹⁰

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
33.13	28.27	37.69	34.76	32.91	32.37	39.33	37.24	44.09

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 the first five complete months of 2007.

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

	January	February	March	April	May
Average (\$/MWh)	55.91	44.76	51.28	78.21	63.28
Median (\$/MWh)	35.22	36.91	42.08	75.98	59.89

As can be seen, average prices for 2007 are much higher than previous average RRP, reaching \$78.21/MWh in April. 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.¹¹ Figure 2.1 charts the average and median average daily RRP by month from July 2005 through June 2007.¹² The change in underlying median price to a higher value suggests a change in the fundamentals of the wholesale electricity market.

Information from NEMMCO and from ActewAGL Retail suggests that this general uplift in the pool price results from water storages in the Snowy Mountains, Victoria and Tasmania falling nearly to their minimum run capacities. This has 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 are being required to withdraw capacity from the market because they cannot access sufficient cooling water from local rivers and storages to allow full-capacity operation. For example the 1,400 MW Tarong base-load plant has been dispatching at around 75% of its rated capacity from the beginning of 2007, and from the end of March 2007 has reduced its available capacity to around 30% 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 and base-load capacity need to be replaced by power from

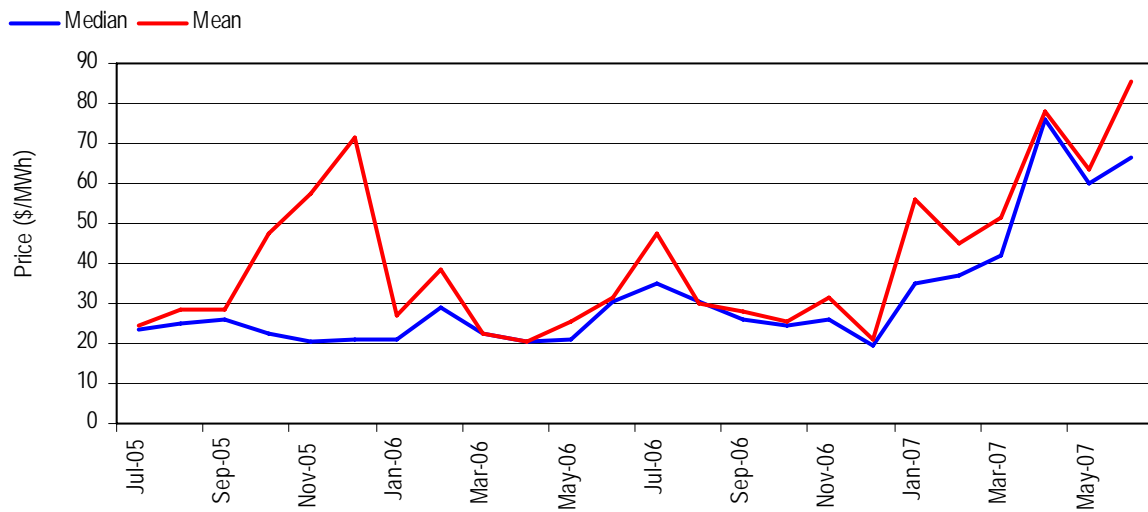
¹⁰ The 2006–07 prices are through 7 May 2007. Data sourced from NEMMCO and available at <http://www.nemmco.com.au>.

¹¹ The average monthly RRP for November 2004 also exceeded \$70/MWh. That high average was driven by an average daily price of \$1115.75/MWh for 30 November 2004. The median RRP for November 2004 was \$30.85/MWh.

¹² June 2007 prices based on the first 11 days in June 2007.

higher cost thermal plants using coal, gas or diesel fuels, in order to maintain the safe operation of the NEM.

Figure 2.1 Average and median of daily RRP by month since July 2005 (\$/MWh)

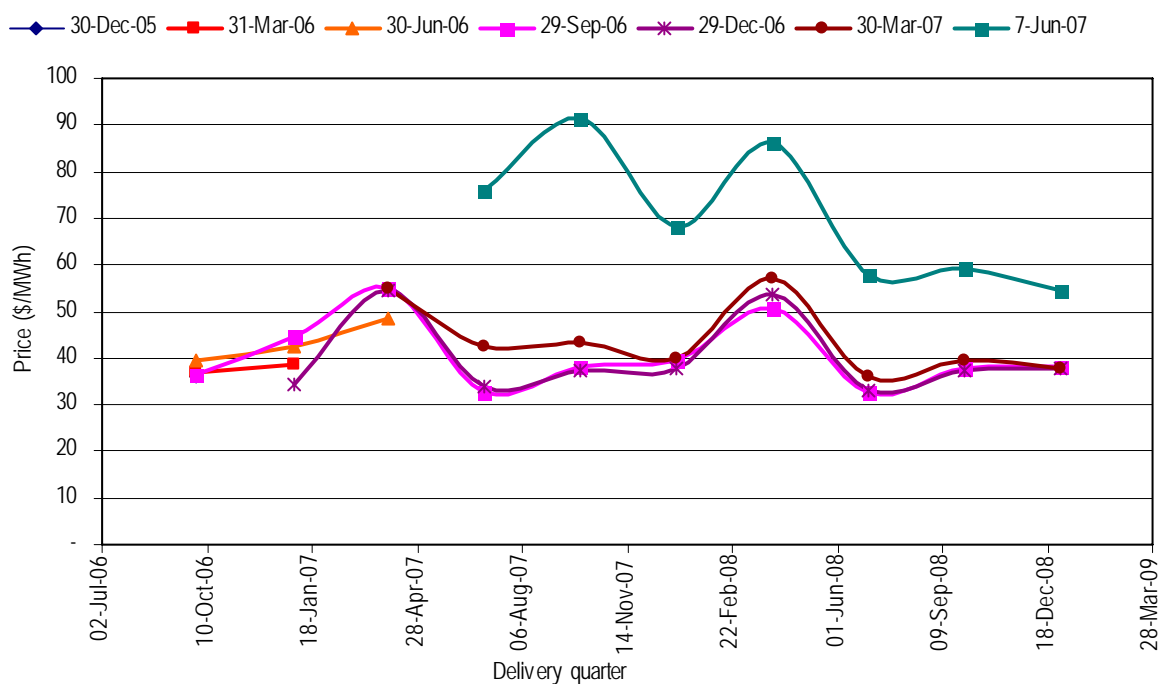


The Commission is aware that good practice in electricity retail business management suggests that these pool prices should be hedged to a certain extent by contracts between the retailers and the generation companies (including by bilateral, caps, swaps and other contracts), and in the financial futures markets. While this would limit the impact in 2007–08 of the energy price rise seen by retailers in recent months, the eventual result is likely to be that the pool prices will influence 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 substantially in 2008–09 and possibly subsequent years.

To explore the impact of hedging on the energy purchase cost, the Commission has accessed market data through a subscription data service. While a number of different types of hedging instruments are used between retailers and generators, Figure 2.2 provides the base swap contract prices for future delivery averaged over the quarter in which the contract was written and for different energy delivery dates. The curves have been smoothed to help highlight the trends.

The Commission observes that, in the current quarter up to 7 June 2007, there has been a substantial increase in the price of the written contracts for future delivery. Thus the changes seen in the spot market are also being reflected in the contract markets as wholesale electricity market participants attempt to hedge to reduce their financial risk and to forestall the increase in energy costs. The Commission notes the tendency for a reduction in premium for later delivery from the prices seen in the last quarter, compared to the prices seen in earlier quarters. This suggests that market participants see this change as a mid-term change which could correct to historical averages over time.

Figure 2.2 Base swap contract price averaged by written quarter vs delivery (\$/MWh)



The Commission has factored these changes into its final decision on the price direction. The approach it has used to calculate an energy cost is described in Section 6.2.1.

2.3 Market outcomes and retail competition

The Commission believes that the development of the competitive, interconnected electricity market at the wholesale level in the eastern and southern states of Australia has delivered significant benefits to electricity consumers and the broader Australian 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 and on continuing investment in new generation plant as demand begins to outpace supply. 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. Similarly, investors in generation capacity will consider the fuel type best able to compete in the marketplace and most likely to be dispatched into the electricity pool when making investment decisions. When the pool price for energy (that is, the overall market price set by demand and supply signals) rises, 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. The Commission has a concern that, after around seven years of stable and generally lower wholesale energy prices, the shortage of water for hydro generation has started a process of re-rating the cost of water as a fuel resource, which may have 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 rise.

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. That is, vigorous competition at the retail level among electricity retailers sourcing electricity from a competitive and hence efficient wholesale market for electricity will be in the best long-term interests of consumers.

All consumers, large and small, need to be active in the marketplace. If there are tariffs on offer at a lower overall expense than the tariff a consumer is currently receiving, TFT or otherwise, the consumer should exercise their right of choice and opt for the lower competitive tariff through a decision to change retail supplier. Ultimately, the benefits of competition will not eventuate if most consumers do not become active participants in the market.

As long as the TFT remains in the market and is regulated by the Commission, the Commission will set the TFT to balance the objectives of section 20 of the ICRC Act. However, the regulatory mechanism cannot develop prices which are as responsive to demand and supply signals as prices in a competitive and open marketplace. Where an open market is operating (as it does for the wholesale supply 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 wholesale prices 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 for 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 most recently commenced processes to review the prices for customers who have not yet exercised their right to enter the contestable retail market are the Independent Pricing and Regulatory Tribunal (IPART) in New South Wales and the Queensland Competition Authority (QCA). The IPART draft report and draft determination was released in April 2007. Table 2.1 summarises the IPART draft decision as it relates to EnergyAustralia.¹³ The IPART report is based on electricity generation forecasts, prepared by Frontier Economics, which pre-date March 2007¹⁴, when there was a notable shift in generation prices (discussed in Section 2.2, above).

The Commission notes that the market-based cost of electricity estimated by Frontier Economics for 2007–08 has a cost price of electricity for peak periods of between \$70.50/MWh and

¹³ IPART, April 2007, extract of Table 8.1.

¹⁴ Frontier Economics, *Energy costs*, final report, March 2007.

\$116.90/MWh, for shoulder periods between \$49.60/MWh and \$76.70/MWh, and for off-peak periods between \$28.30/MWh and \$31.50/MWh. The resulting all-periods weighted average price lies between \$49.10/MWh and \$57.80/MWh.¹⁵ These prices are generally higher than the historical averages in Figure 2.1 and comparable to the high mean RRP seen in December 2005 and May 2007.

The IPART draft findings on the allowance for energy costs to use in the New South Wales regulated retail tariff controls are \$49.80/MWh for Country Energy, \$56.50/MWh for EnergyAustralia and \$58.90/MWh for Integral Energy. These prices include a volatility allowance to compensate for volatility in the electricity pool price.

The QCA released a draft report on its Benchmark Retail Cost Index on 8 May 2007.¹⁶ 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. The QCA relied on analysis undertaken by CRA International which pre-dates the increases in the wholesale electricity pool price experienced from around March 2007. In its draft decision, the QCA has determined a cost of energy of \$56.00/MWh, 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 generation cost estimate for Queensland is calculated using methods that derive the LRMC of energy based on a combination of generation technologies during a single year. The LRMC of energy in Queensland is projected to increase from \$43.30/MWh in 2006–07 to \$44.00/MWh in 2007–08. 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.

The Commission notes from Table 2.3 that the weighted average RRP¹⁷ for April 2007 is \$78.20/MWh and for May 2007 is \$63.28/MWh, both of which are above Frontier Economics' forecast for the 'all periods' weighted average for 2007–08 and above the allowance provided by IPART in its draft report. The RRP for April and May of 2007 is also above the energy cost included in the QCA draft decision, although the Queensland estimate has been built around a requirement to set the Benchmark Retail Cost Index based on the LRMC of generation. The Commission notes that these draft decisions still need to be confirmed following public comment on the drafts. Furthermore, the draft decision in New South Wales is 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 Queensland regulated retail tariff requirement.

For reasons described more fully in Section 6.2.1 of this report, the Commission has adopted a higher energy purchase cost in its analysis. 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 price determination that the Commission is to provide. The Commission cannot ignore the evidence that appears to support a rise in electricity prices at the current time, although it is not possible to determine the full extent of this rise or the likelihood of any price reduction in the near future to levels more consistent with the LRMC estimates prepared by the QCA. The Commission has

¹⁵ See also IPART, April 2007 report, Table 6.5, page 56.

¹⁶ QCA Draft decision: *Benchmark Cost Index for electricity: 2006–07 and 2007–08*, May 2007

¹⁷ As reported by NEMMCO on its website, <http://www.nemmco.com.au>.

therefore adopted an energy purchase cost of \$62.60/MWh that excludes an energy contracting/management cost of \$0.70/MWh, which has been added separately to the cost base. This is above the energy costs included in the IPART draft determination, but below the current prices of energy swap contracts shown in Figure 2.2.

3 Summary of draft decision

This section summarises the Commission's draft decision.¹⁸

3.1 Summary of benchmark retail costs from draft decision

Based on the benchmark cost analysis in its draft decision report, the Commission proposed the cost breakdown provided in Table 3.1 as the reasonable cost base for development of the weighted average price cap to be applied to the TFT for the 2007–08 year.

The Commission believed that these costs were reasonable for an efficient incumbent retailer providing services to the TFT customer base in the ACT. As efficient costs, these costs met the objectives of s. 20(2)(c) and allowed the correct price signals to be seen by end-users of the TFT, which aligned with the objective of s. 20(2)(h) to provide robust demand-side management pricing signals while protecting TFT consumers from excessive price increases, which would not support the objective of s. 20(2)(a), which limits the exploitation of monopoly power.

The cost breakdown for the draft decision was based on the available benchmark costs for each cost category.

The cost category associated with energy contracting costs was separately identified in the draft decision; in the Commission's decisions on the TFT in its 2003 report, this cost category was grouped into the electricity purchase costs.

The Commission also separately identified the customer acquisition and retention costs associated with the development of the TFT, as the adoption of contestable tariffs by previous TFT customers with consumption of less than 100 MWh per year has grown significantly since the introduction of full retail contestability.

In all other respects, the draft decision followed the approach used by the Commission in its previous decisions on regulated retail tariffs. This issue is discussed further in Section 6.2.1.

Table 3.1 Composition of TFT retail price

	2007–08
Energy purchase costs per customer (\$/MWh)	
Electricity purchase cost (\$/MWh)	58.04
Energy contracting cost (\$/MWh)	0.70
Green costs (\$/MWh)	2.83
NEM fees (\$/MWh)	0.71
Energy losses	4.97%
Total energy purchase cost (\$/MWh)	65.38
Retail operating costs (\$/MWh)	9.70
Customer acquisition costs (\$/MWh)	1.54
Total retail costs (\$/MWh)	11.24
Network costs (\$/MWh)	57.19
Total retail costs (\$/MWh)	133.81
Retail margin (% of sales, EBITDA)	4.00%
Total retail price (\$/MWh)	139.16
Assumed CPI change, 2006–07 to 2007–08	3.40%
X factor in CPI+X on MAR in \$/MWh	10.85%

¹⁸ ICRC, *Draft report: Retail prices for non-contestable electricity customers*, Report 6 of 2007, May 2007.

3.2 Weighted average price cap in draft decision

In its draft decision the Commission determined that ActewAGL Retail's franchise tariff revenue should increase by up to the CPI plus 10.85%. The Commission determined in its draft decision that the appropriate value of the CPI was 3.40%. In making this determination for one year, the Commission has not changed the form of regulation faced by ActewAGL Retail, continuing the regulated retail arrangements initiated in its 2003 report.

3.3 Primary issues for review in the final decision

During its analysis of benchmark and market-based costs for the draft decision, the Commission became aware of a number of issues that would affect its development of a final decision. The primary issues identified were:

- evidence of a recent large increase in the wholesale electricity pool price
- evidence that the futures market and bilateral contract prices were reflecting the change in pool prices
- the possibility that the magnitude of the changes in the benchmark costs for TFT customers could impose a large strain on ACT consumers
- processes underway in other jurisdictions to adjust their regulated retail tariffs.

The Commission continues to have less detailed information than ActewAGL Retail on the level of ActewAGL Retail costs for TFT customers, in part due to the commercially sensitive nature of the contestable electricity retail sector.

The Commission has considered these issues and, particularly where submissions raised concerns about them, sought ways to ameliorate their effects.

4 Developments in other states

All jurisdictions associated with the NEM retain some form of residual retail price regulation on retail customer tariffs, to cater for customers who have access to contestable retail tariffs but choose to remain on a regulated tariff with their original incumbent retail supplier. In the ACT, these customers are termed ‘franchise’ customers.

In 2007, the end of a regulatory period approached in a number of other jurisdictions, requiring regulators to reassess the regulatory settings for residual regulated retail tariffs. Of prime interest to the ICRC are the retail price reviews by IPART in New South Wales and by the QCA in Queensland.

IPART is due to publish its final determination on 14 June 2007, and the QCA is due to provide its final advice to its minister on 13 June 2007. For the QCA, subsequent gazettal by the minister will notify the prices for 2007–08 soon afterwards. For the Essential Services Commission of South Australia and the Victorian Department of Primary Industry, the deadlines for updating regulated retail arrangements are 31 December 2007 and 1 July 2008, respectively, to correspond with the ends of their current regulatory periods.

Given the Commission’s deadline of 15 June 2007 for publication of the final price direction, the Commission has had to rely principally on the benchmark information provided in the draft determinations of IPART and the QCA and on the information available on the electricity pool and contract markets. The following two sections briefly describe the draft determinations of IPART and the QCA.

4.1 Draft outcomes from New South Wales

The IPART process commenced with the publication of an issues paper on 14 June 2006, following a reference from the New South Wales Minister for Energy. After submissions from stakeholders and reviews of reports from various independent consultants, IPART published its draft report and draft determination on 4 April 2007. IPART is due to publish its final report and final determination on 14 June 2007.

One of the prime principles imposed on IPART by the reference from its minister was that the benchmark costs it uses to establish the regulatory framework should be based on hypothetical ‘new entrant’ prices. Table 4.1 summarises the IPART draft determination using the cost categories preferred by the Commission in its analysis of ActewAGL Retail’s benchmark costs.

The Commission notes that the IPART approach to regulating the tariffs for franchise customers is based on a weighted average price cap. However, instead of leaving the structure and level of the regulated tariff to the discretion of the incumbent retailer, as is done in the ACT, IPART imposes prescriptive price caps on a tariff-by-tariff basis which it has calculated to meet the forecast price cap for each of three years of the regulatory period from 2007–08 to 2009–10. Table 4.1 presents the results only for the 2007–08 financial year, quoted in 2006–07 dollars.

The Commission also notes that the retail margin used by IPART is applied to the total retail supply costs including network costs in generating the fixed and variable terms of the R values in its regulatory framework. In addition, the real change in prices is over three years.

Table 4.1 Composition of IPART’s draft determination on retail price control

Incumbent retailer (expressed in 2006–07 dollars)	Country Energy	Energy Australia	Integral Energy
	2007–08	2007–08	2007–08
Energy purchase costs per customer (\$/MWh)			
Electricity purchase cost (\$/MWh)	49.8	56.5	58.9
Energy contracting cost (\$/MWh)	–	–	–
Green costs (\$/MWh)	4.7	4.3	4.5
NEM fees (\$/MWh)	0.71	0.71	0.71
Energy losses	12.6%	6.4%	9.0%
Total energy purchase cost (\$/MWh)	62.1	65.5	69.9
Retail operating costs (\$/customer/year)	75	75	75
Customer acquisition costs (\$/customer/year)	35	35	35
Total retail operating costs (\$/customer/year)	110	110	110
Network costs (\$/MWh)	n.a.	n.a.	n.a.-
Total supply costs (\$/MWh)	n.a.	n.a.	n.a.
Retail margin (% of sales, EBITDA)	5.0%	5.0%	5.0%
Total average retail price (\$/MWh)	n.a.	n.a.	n.a.
Assumed CPI change, 2006–07 to 2007–08	3.1%	3.1%	3.1%
Cumulative real price increase 2007-10	12.4%	14.0%	15.7%

4.2 Draft outcomes from Queensland

The QCA process commenced with a reference from the Queensland Minister for Mines and Energy on 16 March 2007. In particular, the QCA has been delegated the responsibility of calculating the Benchmark Retail Cost Index (BRCI) for 2007–08, subject to certain conditions. Following submissions from stakeholders and reviews of reports from various independent consultants, the QCA published its draft decision on 8 May 2007. The QCA is due to deliver its advice on its final findings to the minister on or before 13 June 2007. The minister is expected to gazette the final prices soon afterwards.

One of the prime principles imposed on the QCA by the reference from its minister was that the electricity purchase costs should be based on long-run marginal cost to make prices more stable in the long run. Table 4.2 summarises the QCA draft determination using the cost categories preferred by the Commission in its analysis of ActewAGL Retail’s benchmark costs.

The Commission notes that the QCA approach to regulating tariffs for franchise customers is based on examining the potential percentage changes in each cost category from 2006–07 to 2007–08 to build up the allowed overall BRCI.

The QCA draws a distinction between a gross margin on total sales (the gross amount remaining after network and energy cost components are removed from total sales), and a net margin (the net amount remaining after retail, network and energy cost components are removed from total sales). The 5% is determined on total sales to define the net retail margin in the QCA decision. In this sense, the QCA approach is similar to the approach used by the Commission. The QCA indicates that the BRCI is separate from the retail margin, which should remain stable over time. The BRCI can thus be interpreted to be the sum of the underlying changes in the network, energy and retail cost components of the incumbent retailer and includes inflation (as it is determined from nominal numbers) and the effects of growth in customer numbers and energy consumption. Table 4.2 presents the results for the 2007–08 financial year, quoted in 2007–08 dollars.

Table 4.2 Composition of the QCA's draft determination on retail price control

	2007–08
Energy purchase costs per customer (\$/MWh)	
Electricity purchase cost (\$/MWh)	56.0
Energy contracting cost (\$/MWh)	–
Green costs (\$/MWh)	3.27
NEM fees (\$/MWh)	0.63
Energy losses	–
Total energy purchase cost (\$/MWh)	59.9
Retail operating costs (\$/customer/year)	77.5
Customer acquisition costs (\$/customer/year)	2.0
Total retail costs (\$/customer/year)	79.5
Network costs (\$/MWh)	54.6
Total retail costs (\$/MWh)	124.9
Retail margin (% of sales, EBITDA)	5.0%
Total retail price (\$/MWh)	124.9
Assumed CPI change, 2006–07 to 2007–08	n.a.
BRCI (% from 2006–07 to 2007–08)	9.98%

The Commission notes that the retail margin used by the QCA is applied to the total retail supply costs, including network energy and retail costs, in generating the overall picture of how overall revenues might move between two successive financial years. This margin can be interpreted as similar to the percentage of sales (or EBITDA margin) used by IPART and the Commission. As the CPI assumed by the QCA to occur between 2006–07 and 2007–08 is not defined, the Commission cannot estimate an implied X factor from the QCA's draft decision.

4.3 Approaches in other states

The form of regulation used for franchise customers in other jurisdictions varies widely, both in the form of price control and in its implementation in regulated retail tariffs. As these functions are unlikely to be standardised between jurisdictions or relinquished to the Australian Energy Regulator by the states, there is a need to ensure that benchmark cost studies use information from each jurisdiction on a like-for-like basis.

In its analysis for the final price direction in this report, the Commission has been mindful of potential differences in interpretation of benchmark costs from other jurisdictions.

5 Submissions to the Commission

In its draft price direction released on 11 May 2007, the Commission sought submissions from interested parties on any aspects of the price direction to be imposed on ActewAGL Retail for the year from 1 July 2007 to 30 June 2008. Given that the Commission was required to operate to an extremely short deadline for the development of this price direction, the Commission called for submissions by 8 June 2007.

The Commission received three submissions before the deadline. The submissions were from:

- the Essential Services Consumer Council (ESCC)
- Care Financial Counselling Services (CARE)
- ActewAGL Retail.

The following sections summarise the submissions and highlight each organisation's primary areas of concern about the draft price direction.

5.1 Essential Services Consumer Council

In its submission, the ESCC was concerned that the Commission had 'made no substantive reference to its obligation under s. 20(2)(g) of the ICRC Act to have regard to "the social impacts of the decision".' Further, the ESCC stated:

[the] proposed 14.25% price rise in electricity, in conjunction with other significant cost increases such as private rents, petrol and water, will have a devastating effect on the ability of low income families and individuals in the ACT to maintain even their current, very basic, quality of life. The Council considers that all efforts must be made both to defer and to reduce the cost of franchise electricity from 1 July 2007 because of the immense financial stress that low income households in the ACT are under.

The ESCC recommended three concrete proposals for adoption by the Commission:

- the price direction transitions the proposed price rises in two steps, the first at 1 July 2007 and the second at 1 January 2008
- the Commission disallow any amount for consumer acquisition costs
- the Commission keep the retail margin at 3% of sales (EBITDA), rather than increasing it to 4%.

These three recommendations are discussed in the following sections.

5.1.1 Stepped transition in the price direction

The ESCC accepted that TFT price rises are inevitable because of the pass-through of the new ACT network tax and the recent significant increase in the wholesale electricity cost, linked to the current drought.

However, the ESCC expressed concern that the effects of the drought on wholesale electricity prices may not be as strong as is currently suggested and that strong rains during winter may allow market prices to fall to historical levels. In addition, the ESCC suggested that in the past

ActewAGL Retail's CPI-based price increases have been supported by its hedging strategy and that this has 'delivered good electricity price outcomes for the Territory'. The council further suggested that any hedging strategy should delay the impact of wholesale price rises in the first six months of 2007–08, and that an immediate price rise of 14.25% would provide an inappropriate windfall gain to ActewAGL Retail. Thus, a two-step price increase would allow the Commission to observe the continuing increase in wholesale electricity costs before accepting the second TFT adjustment for the last six months of the 2007–08 financial year.

The ESCC indicated that a two-step approach to the implementation of the price rises would give time for consumers to adjust to increased prices, and would allow 'the ACT government to implement targeted energy cost relief measures for low income consumers'. The ESCC also suggested that this approach was a reasonable balance between ameliorating the social impacts of the Commission's decisions and protecting the sustainable financial position of the incumbent retailer.

5.1.2 Retail operating, consumer acquisition and retention costs

The ESCC indicated that it believed the retail operating costs proposed by the Commission (\$94.91 per customer) did not compare favourably with those proposed by IPART in its draft decision for New South Wales (\$75 per customer). The council further stated that it did not believe the additional amount of \$15.09 per customer, relating to customer churn and marketing, should be recovered from franchise customers on the TFT.

5.1.3 Retail margin

The ESCC did not find the justification for an increase from 3% to 4% in the retail margin on sales (EBTIDA), provided in Section 3.2.9 of the draft price direction, to be convincing. The council did not believe that the protection of ActewAGL Retail's financial viability as default provider and avoidance of a 'California'-type problem were sufficient reasons to justify such an increase. It believed that there was lower risk for the electricity retailer in servicing the TFT customers, and that the lower risk justified a lower margin.

5.1.4 Summary of ESCC's conclusions on social impacts

The ESCC indicated that 'many clients of the Council currently struggle to cover even current consumption costs', let alone find an extra \$10 to \$15 per fortnight to pay off existing utility debt in the form of arrears. It suggested that the level of utility debt would rise sharply under the proposed increases and that, while it could not forecast the social impacts accurately at that point, it expected a further increase in clients seeking hardship assistance and that existing clients would be unlikely to be able to pay for current consumption.

Therefore, the ESCC believed that the proposed increase in the TFT was likely to 'result in significantly increased costs in running the Council processes and to justify a significantly increased level of debt discharge by the Council under s. 208 of the *Utilities Act 2001*'. Further, the ESCC believed that 'these impacts will necessitate a strong response from the ACT government through the energy concession and other safety net mechanisms'.

The ESCC has further indicated that it will consider the issue of impacts and responses over the next few months and will go back to the ACT government with detailed advice on issues arising from any price changes for the TFT.

5.2 Care Financial Counselling Service

In its submission of 7 June 2007, CARE indicated that, as changes in the costs of energy were fed through to TFT consumers, it would be ‘vital to remember that as these changes bite low income households will be the most dramatically impacted and the least able to respond’.

While acknowledging that increases in the TFT were inevitable, given the introduction of the ACT Government’s infrastructure tax and the impact of the drought on wholesale electricity prices, CARE provided comments on the Commission’s draft price direction in three main areas. These comments are summarised as follows:

- CARE supported the ESCC’s recommendations for a two-step process to introduce any price increases, for removal of the recovery of customer churn and retention costs, and for no increase but a retention of a 3% retail margin on the cost of sales.
- CARE believed that the Commission’s report could have been improved by more analysis of the impacts of such price increases on low to moderate income households and on the hardship experienced by people living in poverty in the ACT, and suggested that this focus might only occur where the Commission’s experience in the analysis of the social impacts of its decisions was bolstered by additional resources with skills in this area.
- While economic theory suggested that full retail contestability should bring improvements and benefits to consumers, CARE’s experience suggested that reliance on the contestable marketplace was an insufficient response to the social issues of access, affordability and poverty, and that discussion of the removal of customer protection and targeted customer welfare arrangements in the ACT was foolish and dangerous.

CARE concluded that :

- there is no demonstrable evidence that our clients are receiving any benefits from the contestable electricity market; and
- market developments appear to be working against the mechanisms that allow our clients to obtain and retain safe, fair, affordable access.

CARE has also argued that:

[the] costs of running a household in the ACT have increased dramatically in the last few years. The increases have occurred across markets and have hit hardest in relation to non-discretionary spending. Essential utilities, food, health and education have all increased at a rate in advance of CPI. Accommodation prices have surged and fuel costs have been on a rollercoaster.

CARE further pointed out that, while interest rates seemed to be stabilising, personal debt as a proportion of GDP was approaching the highest levels in history, and ordinary households were overextended with debt, with little chance that this could easily be corrected.

CARE had a significant concern that ‘low to moderate income households have not kept pace with the price increases’ and, indeed, ‘are falling further behind’. There was also ‘increasing evidence of vulnerability amongst slightly higher income consumers’, with increases in demand from ‘the mortgage belt’ for support services, and this should be a significant concern for all.

CARE acknowledged that the ACT has one of the best systems in Australia for ameliorating ‘the impacts of financial hardship on access to and payment for utility services through the ESCC’. To relieve pressure on that system, CARE recommended an urgent review of the available concessions, which are now considerably out of date, so that more people are not pushed into poverty.

CARE believed that consideration of these issues in the Commission’s draft price direction would have been useful.

5.3 ActewAGL Retail

In its submission, ActewAGL Retail stated that the Commission’s draft price direction used cost estimates that:

- did not ‘adequately reflect the market reality of sharply rising wholesale electricity prices’
- were ‘out of step with other recent regulatory decisions’
- did not ‘adequately take account of the costs that new entrants will face and the implications this may have for the ongoing development of competition in the ACT electricity market’.

ActewAGL Retail also presented updated estimates of its ‘green’ costs. The following sections summarise ActewAGL’s main concerns and contentions.

5.3.1 Energy purchase costs

ActewAGL Retail believed that the energy purchase cost allowance used by the Commission in the draft decision was insufficient at \$58/MWh, but also had further concerns about the Commission’s approach. These are broadly summarised in the following paragraphs.

Changed methodology for energy purchase costs

ActewAGL Retail had a concern over the Commission adopting a simplified analysis of a retail hedging arrangement to arrive at an estimate of forward energy purchase costs. One concern with this approach was that it was a new approach for the Commission and had been introduced without warning or precedent in previous Commission decisions.

As an alternative, ActewAGL Retail proposed ‘that the TFT should be based on the market-based wholesale energy costs’¹⁹, as was the case in the Commission’s 2003 price direction. ActewAGL Retail listed the costs that it proposed to the Commission in 2003, which the Commission accepted as reasonable at that time:

- the expected forward cost of purchasing energy at pool prices in the NEM
- the expected forward cost of purchasing energy through contracts with generators
- trading and hedge management costs

¹⁹ ActewAGL Retail, 5 June 2007, Section 3.2, page 7.

- an allowance for the effect of customer churn in the ACT market.

In its current submission, ActewAGL Retail stated that the current forward market prices were approximately \$80/MWh. The discussion in its submission and the data available from market sources in its Chart 1 (see also Figure 6.2 in this report) suggested that ActewAGL Retail believed this number to be equal to the expected forward cost of purchasing energy at pool prices in the NEM (that is, the first item in the above list).

ActewAGL Retail provided some comments, covered in the following paragraphs, on this methodology.

Unreasonable assumptions in hedging model

ActewAGL Retail believed that the Commission's assumptions for its 'simplified (but hopefully robust)' model²⁰ were unreasonable. In particular, ActewAGL Retail made the following contentions:

- The ACT load profile was very different from that of the average New South Wales region because the ACT had greater temperature variances and fewer flat load customers, resulting in higher average energy purchase costs.
- The forward hedge profile, including the timing of purchases and the percentage of forecast load covered by hedge contracts, was unreasonable and 'unlikely to reflect the purchasing policy of existing retailers or new market entrants due to the differing strategies and approaches to managing risk across competing suppliers'.²¹
- The Commission had not been transparent in its approach. ActewAGL Retail cited as an example the comment that the Commission believed that prices in the forward futures markets were likely to be 'slightly higher' than bilateral hedge contracts between a retailer and a generator.

Failing to reflect market information

In the context of observed increases in the pool price, forward electricity futures prices and average wholesale contract energy prices, ActewAGL Retail believed that the Commission was not reflecting market information when it stated that it 'cannot ignore the evidence that appears to support a rise in electricity prices at the current time, although it is not possible to determine the full extent of this rise or the likelihood of any price reduction in the near future'.²²

ActewAGL Retail indicated that a number of submissions to IPART's current regulated retail tariff review have suggested that IPART review its energy purchase cost assumptions, as its original modelling was done before the recent apparent changes in the market fundamentals. Thus, the Commission's statement that its proposed \$58/MWh was consistent with IPART's draft determination overlooked the fact that it might have to review the energy purchase costs, given that the RRP from NEMMCO for April 2007 was \$78.20/MWh and the futures contract prices for 2007–08 delivery have been and remain above \$81/MWh. ActewAGL Retail also pointed out that

²⁰ ICRC, May 2007, page 15.

²¹ ActewAGL Retail, 5 June 2007, Section 3.2.2, page 8.

²² ActewAGL Retail, 5 June 2007, page 9, reflecting on ICRC, May 2007, page 9.

the Commission's estimates had the energy purchase cost rising by an additional 36% to \$79.10/MWh in 2007–08, and suggested that this indicated that the energy purchase cost of \$58.04/MWh for 2007–08 was unreasonably low and that while 'consumers may benefit in the short-term (that is, over the coming year) from a decision to set purchase costs significantly below current market value this is not a situation that can be sustained'.²³

ActewAGL Retail believed the Commission was neglecting the real price signals in the wholesale market, and believed that 'recent and expected increases should be fully reflected in the Commission's final decision, and not be left to be addressed by an uncertain "pass-through" process mid-way through the year'.²⁴

5.3.2 Retail operating costs

ActewAGL Retail stated that it 'believes that escalating in line with CPI does not adequately reflect recent and expected trends in retail operating costs'. It quoted an ABS survey showing an 11% increase in electricity supply labour costs for 2004–05 (well above average inflation); a consultant's report provided to the Essential Services Commission of Victoria which showed that 'the demand for both technical and customer service staff has increased significantly'; and a BIS Shrapnel forecast that wages costs in the electricity, gas and water sectors would grow and 'outpace national wages growth over the next 6 years, with average weekly earnings forecast to increase by 5.7% per annum'.²⁵

Further, ActewAGL believed that the allowance proposed by the Commission for customer acquisition and retention costs was too low and below the level that would be experienced by new entrants. While acknowledging that the Commission was not bound by a 'new entrant principle' in its decision making (unlike IPART, which is bound by this principle in the reference it received from the New South Wales Government), ActewAGL Retail believed that anything less than a new entrant cost allowance would 'not align with the intention to foster competition by reflecting new entrant costs in the TFT'.²⁶

5.3.3 Retail margins

ActewAGL Retail believed the Commission should reflect recent regulatory draft decisions in other jurisdictions, which have adopted 5% as the retail margin. It suggested that the Commission had misunderstood the approach IPART adopted when it increased the retail margin by 3% above the 2006–07 level and adopted 5% for the three years from 2007–08 to 2009–10. ActewAGL Retail also pointed out that the QCA has adopted 5% to apply from 2007–08.

On this basis, ActewAGL Retail suggested that the one percentage point increase to 4% for 2007–08 was too low and was undertaken without justification. It indicated that the Commission should be consistent with the 5% 'rate applied to comparable entities in other states' and that, if the energy purchase costs are to be set lower than the market prices, the retail margin would have to

²³ ActewAGL Retail, 5 June 2007, Section 3.2.3, page 10.

²⁴ ActewAGL Retail, 5 June 2007, Section 3.2.3, page 10.

²⁵ ActewAGL Retail, 5 June 2007, Section 3.3, page 11.

²⁶ ActewAGL Retail, 5 June 2007, Section 3.3.1, page 12.

rise above 5% to ‘take account of the additional risks that this would impose’ on ActewAGL Retail.²⁷

5.3.4 Green costs

ActewAGL Retail submitted that the Commission should revise its estimates of the MRET and GGAS costs imposed on ActewAGL Retail to accommodate more accurate forecasts based on the prescribed legislative methodology. These estimates have been provided under a separate, confidential submission, and propose:

- an MRET cost of \$1.47/MWh
- a GGAS cost of \$1.87/MWh.

²⁷ ActewAGL Retail, 5 June 2007, section 3.4, page 12.

6 Analysis of efficient costs

In developing its price direction for 2007–08, the Commission must ensure that it has regard to the provisions of section 20 of the ICRC Act, as required by the Act and by the reference provided by the Attorney-General. The Commission believes that these provisions provide a list of issues (sometimes considered as objectives) that it needs to address in determining the weighted average price cap under which the TFT levels for 2007–08 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 both through the consideration of 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.

This section of the report describes 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 an incumbent retailer servicing TFT customers should be the cost used in this price direction. The Commission is not required to estimate the costs of a new entrant retailer, but it does consider the costs that competitive players might experience in the marketplace. The Commission reiterates that its reference from the government is not the same as IPART’s, which among other things requires IPART to consider the cost of a new entrant, or the QCA’s, which requires the QCA to consider energy purchase costs derived from an LRMC analysis.

The Commission notes that, in a period of increasing energy prices, a new entrant 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, as has been required of the QCA, 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.

6.1 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 final 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 those objectives or issues are central to the question of the reasonable pricing of retail electricity to TFT customers.

Nevertheless, 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 that 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.

6.2 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 considered the submissions it has received from stakeholders in this price direction, it has examined external benchmarks and market information, and it has considered these inputs in the context of the guidance provided by section 20(2) of the ICRC Act. Following consideration of these issues, the Commission has arrived at the cost values it believes should be used for each of these retail costs and which will be recovered under a weighted average price cap from the regulated TFT customers.

The following subsections of the report are divided into two parts. The first responds to the comments by interested parties about the particular cost categories under discussion, and the second outlines the Commission's findings on its preferred approach to balance the objectives of its reference from government and the objectives of section 20(2) of the ICRC Act.

6.2.1 Electricity purchase costs

Response to comments on energy purchase cost methodology

In its submission, ActewAGL Retail provided a claim for \$80/MWh energy purchase costs. Apart from noting that these were the current costs seen in the electricity futures markets for delivery in 2007–08, ActewAGL Retail did not elaborate on its actual hedged energy purchase costs for its ACT franchise customers, and provided no information for the Commission to use relating to the energy costs of providing regulated services (s. 20(2)(e) of the ICRC Act). As in other jurisdictions, the Commission must make its decisions despite an asymmetry of information between the regulator and the incumbent supplier. In the absence of specific and commercially sensitive information on actual electricity purchase costs, the Commission believes it is reasonable to continue to use a benchmark cost analysis, as it has done in the past.

ActewAGL Retail further suggested that the Commission's approach was new, had been introduced without warning or precedent, and was therefore unreasonable. The Commission believes ActewAGL Retail is referring to the Commission's use of assumptions relating to contract purchase timing, contract energy costs over time, the franchise customers' approximate load profile and the use of futures to hedge forward commitments.

The Commission disagrees with ActewAGL Retail's observations. In its 2003 price direction, the Commission relied on ActewAGL Retail's submission, which was based on the forward costs of purchasing energy, on expected forward contracts, on trading and hedge management costs, and on an allowance for customer churn (see Section 5.3.1 of this report). Clearly, in proposing energy purchase costs of \$80/MWh without adjustment, ActewAGL Retail has not provided for the effects of expected forward contracts (the second point in ActewAGL Retail's methodology, which was adopted by the Commission at that time).

In the absence of information relating to forward contracting arrangements in ActewAGL Retail's submission, the Commission has had to develop a detailed analysis to meet the principles it adopted in its 2003 price direction. 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)).

It is unreasonable for ActewAGL Retail to argue that no allowance should be made for its contracted (or hedged) purchase price for electricity for franchise customers and that, as a consequence, the Commission should allow energy purchase cost rises from approximately \$40/MWh in October 2006 (see Figure 2.1) to \$80/MWh in May 2007. In reality, ActewAGL Retail is hedged, and the actual purchase costs are likely to lie somewhere between these cost extremes for delivery in 2007–08.

By using the \$80/MWh without correction, ActewAGL Retail is assuming that the new entrant costs are the costs which are most appropriate for s. 20(2)(e) of the ICRC Act, but appears to neglect the need for efficient pricing (s. 20(2)(c)) in order to keep cost increases for consumers as small as possible, and to delay cost increases as long as possible to limit unnecessary adverse impacts on consumers (s. 20(2)(g), before relying on the cost recovery, appropriate rates of return and sustained investment principles (ss. 20(2)(e), (d) and (i), respectively). Neither the government's reference nor the objectives of s. 20(2) of the ICRC Act impose on the Commission such a requirement to recover the current marginal cost to the exclusion of all other considerations.

With regard to new entrants to the ACT consumer market²⁸, the Commission notes that competition is occurring on three fronts. The three 'new' entrants competing for franchise customers are:

- new ACT retailers that have an incumbent parent or affiliate in another jurisdiction in the NEM
- new ACT retailers that do not have an incumbent presence in the NEM
- ActewAGL Retail, in its operations as a retail supplier offering contestable tariffs to franchise customers.

All retailers that have an incumbent presence in the NEM would already have hedging contracts in place for its existing contestable and franchise customers. This includes 'new' retailers of the first and third type above as well as the incumbent retailers in the ACT. Hence, the Commission

²⁸ The Commission does not regard a retailer with no presence in the ACT, but rather a retailer offering contestable tariffs to franchise customers, as a new entrant. In such a case, 'entry' may have occurred already and the barriers to new entry are the barriers to growth of additional market share from a low base.

believes it is reasonable to assume that the changes in wholesale electricity pool prices will gradually affect the total energy purchase costs as incremental new contracts are required into the future. Such changes are likely to occur over a one- to two-year period.

The Commission believes this assumption and the simplified methodology it is using to estimate electricity purchase costs are reasonable in the absence of other direct information. Further, the assumption and the methodology supported a balance between ensuring that efficient costs are allowed to be recovered (ss. 20(2)(d), (e) and (i)), that immediate rises to current contract prices that are likely to include a windfall gain above existing hedging arrangements are excluded, and that this ameliorates social impacts on consumers (s. 20(2)(g)). At the same time, the pricing signals resulting from inflation in the costs of electricity generation are eventually fed through to consumers (s. 20(2)(j)) to allow higher prices to dampen demand (s. 20(2)(h)).

For its final decision on the price direction, the Commission has continued to use current market data and a number of assumptions about an ideal electricity retail hedging strategy to understand the reasonable electricity purchase costs that might be faced by an incumbent retailer in the ACT during 2007–08.

Response to comments on unreasonable assumptions

In its submission, ActewAGL Retail commented that the ACT load profile was very different from the New South Wales regional load profile assumed by the Commission, that the forward hedging strategy in timing and percentage coverage of forecast load was unlikely to reflect the policies of existing or new entrant retailers, and that the Commission was less than transparent in selecting contract prices from the forward futures markets.

The Commission has undertaken additional research in an effort to address these issues. All these issues relate to improving the input data used to estimate costs, so any improvement in the data improves the Commission's considerations under ss. 20(2)(c), (d), (e) and (i) of the ICRC Act.

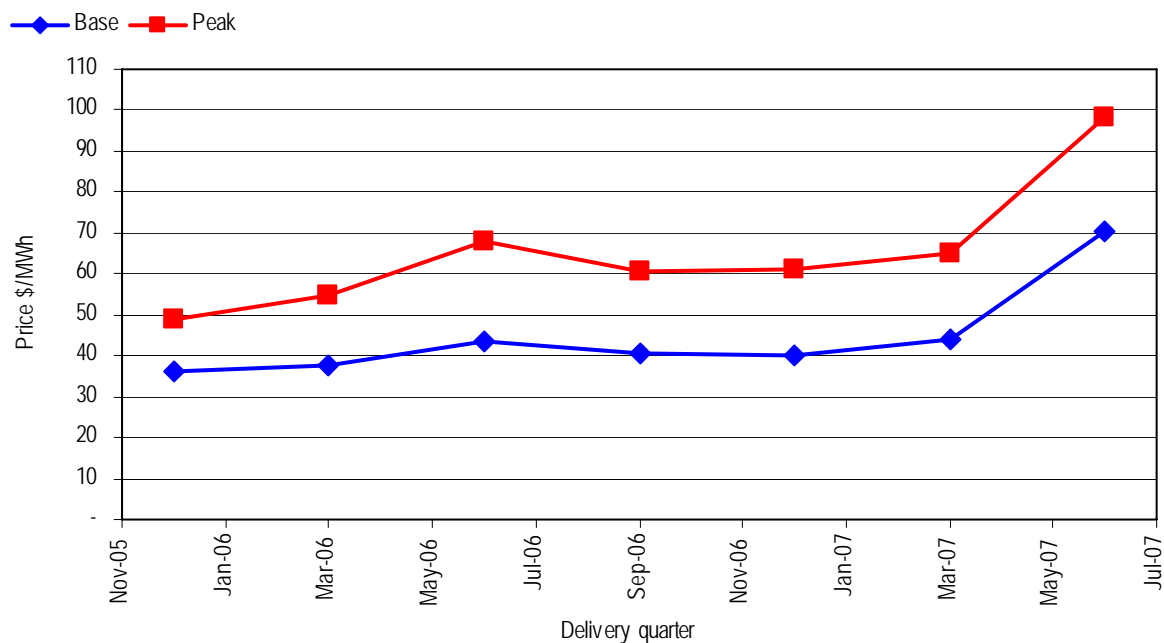
In relation to the load profile of ACT residential customers, the Commission has accessed information derived from 2005 NEMMCO annual data and has adjusted the block load profile (Table 6.2) to better match the ACT residential load profile. The load profile has a narrower peak period than was assumed in the draft price direction (taking into account the comments made by ActewAGL Retail). The Commission believes that adjustments to this assumption support ss. 20(2)(a) and (e) of the ICRC Act.

In relation to the timing of forward contract purchases and the percentage of the load covered by certain dates prior to the delivery date, the Commission did not gain additional insight from the submissions provided. While ActewAGL Retail suggested that these assumptions were unlikely to reflect incumbent and new entrant risk mitigation strategies across competing suppliers, it did not provide any insight into how this assumption might be improved. However, it did not contend that such a strategy was wrong. The Commission notes that the use of a uniform strategy over the period of wholesale market price rises is more likely to reflect the changes seen in electricity purchase costs than the use of a strategy that differed before and after the price rises. Therefore, the Commission believes there is no reason to change the assumptions used in the draft price direction for its analysis of the final price direction. Those assumptions are summarised in Table 6.1. The Commission believes this approach provides a reasonable cost analysis that supports ss. 20(2)(c), (d) and (e) of the ICRC Act.

Response to comments on transparency

ActewAGL Retail stated that the Commission was not transparent in its derivation of forward future price, and queried the accuracy of the Commission's comment that these were likely to be slightly higher than bilateral hedge contract prices. To address this concern, the Commission has undertaken additional analysis of the base swap contract prices over the period from 1 January 2006 to 7 June 2007 for delivery of energy between 1 October 2006 and 31 December 2008. This data is provided in one view in Figure 2.3 in Section 2, and in a second view as the average of swap costs for delivery on a quarterly basis in Figure 6.1. When the swap prices in Figure 6.1 are compared to the futures prices in Figure 6.2, it is by no means certain that the average swap price always lies below the average futures price. Therefore, the Commission concedes that its comments on price relativity in its draft report were inaccurate.

Figure 6.1 Average base swap prices by delivery date, \$/MWh



Nevertheless, in reaching a decision on contract energy prices, the Commission must decide whether it should rely on the futures prices or the swap prices in the hedging model used in its analysis. In developing its hedging portfolio, an electricity retailer is likely to use a mix of swaps, caps, futures and other hedging instruments. One problem with using a more complex approach to model a retailer's hedge portfolio is that the 'reasonableness' of such a necessarily complex model can be questioned when compared with the incumbent retailer's hedging strategy. To retain a simpler approach, and given the lack of better information provided by ActewAGL Retail, the Commission prefers to continue to use futures prices in its analysis for the final price direction. The Commission believes this approach provides a reasonable cost analysis which supports ss. 20(2)(c), (d) and (e) of the ICRC Act.

The approach adopted for the final price direction

Following consideration of the submissions received, the Commission has adopted the following assumptions to complete its modelling of reasonable electricity purchase costs for the final price direction. Specifically, 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 shown in Table 6.1, assuming the retailer has achieved this by 30 June 2007.

Table 6.1 Assumptions about hedged contracts

Six-month delivery period (ending date)	31 December 2007	30 June 2008	31 December 2008	30 June 2009
Percentage of forecast load hedged by contract	105%	80%	50%	25%

- c For its final price direction, the Commission has changed the load profile shape used in the draft price direction to accommodate the more realistic load and pool price profile for TFT customers served by ActewAGL Retail. Table 6.2 provides the assumed block profile of energy purchase requirements for the TFT customer group.

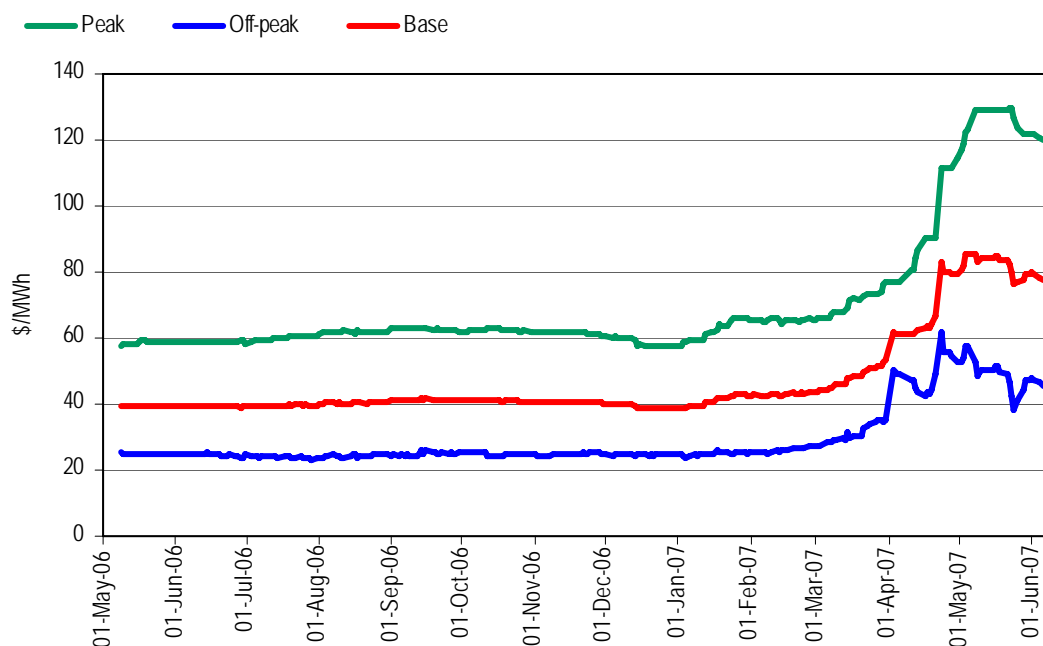
Table 6.2 Block profile of energy purchase requirements

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

a Output rounded to one significant figure.

- 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 the price of electricity futures for New South Wales and of base and peak swap contracts for delivery over 2006–07 and 2007–08. While the futures contracts 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 believes it is reasonable for its final decision to assume that the futures prices observed in the marketplace serve as a reasonable benchmark for developing the energy purchase costs for TFT customers. Figure 6.2 shows the implied futures settlement prices for base-load delivery, and the breakdown of this into peak and off-peak load delivery.

Figure 6.2 New South Wales implied futures settlement price for 2007–08, May 2006 to June 2007 (\$/MWh)



e The price for the proportions of the hedge book shown in Table 6.2 are then taken from the graph of the pricing data (Figure 6.2). While in its draft decision the Commission made the assumption that the ‘base’ futures price is the price available for delivery during shoulder periods of the load profile, ActewAGL Retail suggested that this interpretation was not correct. It suggested the likely outcomes for hedging would be to hedge shoulder periods at the peak prices available at the time. Table 6.3 shows the dates between which the futures prices are averaged to develop the price for that block of load to be delivered to TFT customers in the future.

Table 6.3 Assumed periods for futures 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	June and July 2006	November and December 2006	January 2007	23 April and 5 June 2007

Based on these assumptions and this 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 leading up to 30 June 2009. The average of the costs for the six-month periods ending 31 December 2007 and 30 June 2008 was used as the estimate of the 2007–08 electricity purchase costs. The Commission found that its estimate of the electricity purchase costs was \$62.60/MWh for 2007–08. The Commission notes that, using the same methodology, the electricity purchase costs for 2008–09 are estimated to be \$85.72/MWh. While this estimate is not central to its analysis for the 2007–08 year, the Commission observes that the electricity marketplace does not believe that recent increases in the energy pool price are to be short-lived, and participants are actively hedging to secure lower energy prices than might otherwise be available in the pool during the 2008–09 financial year.

In undertaking this analysis using independent market data and a simplified model to hedge 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) of the ICRC Act), 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)). It has also used a stepped contract purchase timing profile to ensure that immediate energy price rises that imply no energy price hedging are not used, as the implied windfall gain from such a price profile would be counter to its requirement to consider the social impacts of its decisions under s. 20(2)(g).

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 7.1). 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 constitute 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 consumers in the ACT.

6.2.2 Energy risk management costs

Comments on risk management costs

The Commission did not receive any comments on the estimate of a \$0.70/MWh risk management costs it included in the draft decision.

The approach adopted for the final price direction

For its final price direction analysis, the Commission will continue to add an energy risk management cost.

In its previous 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 and has adopted \$0.70/MWh as the reasonable cost base for this activity. 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).

6.2.3 Green costs

Response to comments on green costs

For its draft decision, the Commission did not have access to the detailed data required to verify green costs for 2007–08. Following the publication of the Commission’s draft decision, ActewAGL Retail has provided a separate, confidential submission containing the detailed data necessary to verify a more accurate calculation of MRET and GGAS costs under the relevant legislation for 2007–08. The outcome of this analysis was provided in the ActewAGL Retail submission, as indicated in Section 5.3.4 of this report.

The approach adopted for the final price direction

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 for the coming year using the methodology prescribed by Commonwealth law.²⁹ The Commission has taken ActewAGL Retail’s estimates for 2007–08, provided in its submission, as being reasonable for inclusion in the analysis of the weighted average price cap. The MRET has been estimated at \$1.47/MWh and the GGAS has been estimated at \$1.87/MWh. Table 6.4 shows the estimated outcomes for 2007–08, along with the IPART and QCA outcomes provided in those regulators’ recent draft determinations.

While the estimates are 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 2007–08 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 bases, the green costs estimates for ActewAGL Retail differ from the IPART estimates for EnergyAustralia. The Commission notes that the ActewAGL Retail outcome using the detailed information is more in line with the other jurisdictions than appeared to be the case in the draft decision.

Table 6.4 Green costs (\$/MWh)

	ICRC 2007–08	IPART 2007–08	QCA 2007–08
NRET	n.a.	0.20	n.a.
MRET	1.47	0.90	1.08
GGAS	1.87	3.20	2.21 ^a
Total green costs	3.34	4.30	3.29

a 13% gas scheme

6.2.4 NEM fees

Comments on NEM fees

The Commission did not receive any comments on the estimate of a \$0.71/MWh for NEM fees that it included in the draft decision; nor did it receive any additional information from ActewAGL Retail on estimates of those costs.

²⁹ *Renewable Energy (Electricity) Act 2001* (Cwth).

The approach adopted for the final price direction

The Commission has not received a submission from ActewAGL Retail providing its estimates of the NEM general participation fees, full retail contestability fees and the costs of ancillary services likely to be applicable in 2007–08. To produce a timely report, the Commission has adopted for its final price direction the values used by IPART in that regulator’s recent draft determination for 2007–08. The values used are shown in Table 6.5.

Table 6.5 NEM fees (\$/MWh)

	ICRC 2007–08	IPART 2007–08
Market fees		
Participant	0.35	0.35
Full retail contestability	0.06	0.06
Ancillary services	0.30	0.30
Total NEM fees	0.71	0.71

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).

6.2.5 Energy losses

Comments on energy losses

The Commission did not receive any comments on the estimate of 4.97% for the low-voltage loss percentage that it included in the draft decision.

The approach adopted for the final price direction

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. The Commission has adopted the value of 4.97% for the low-voltage loss percentage to apply in its analysis for the final price direction. Table 6.6 shows the loss factors used by the Commission in previous decisions.

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 uses the values to estimate the total network costs in 2006–07 and the likely energy demand requirements for TFT customers for 2007–08.

Table 6.6 Energy loss factors

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

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

6.2.6 Retail operating costs

Response to comments on low retail operating cost estimates

In its submission, ActewAGL Retail argued that the inflation of the Commission’s 2003–04 retail operating cost of \$85 per customer by the CPI to produce a cost of \$94.91 per customer in 2007–08 was insufficient and did not recognise a number of independent studies which purported to show that costs for this sector had risen faster than costs in the general economy. In its submission

of 1 June 2007, the ESCC argues that the \$94.91 does not compare well with the \$75.00 proposed by IPART, and that the Commission’s value appeared to be too high.

The approach adopted for the final price direction

In the past, the Commission has preferred to rely on industry benchmarks and regulatory precedent to guide the estimate of retail operating costs. Following ActewAGL’s comments on the draft decision, the Commission again reviewed the draft determinations by the QCA relating to Energex et al and IPART relating to EnergyAustralia et al.

The use of a CPI inflation adjustment to the previous \$85.00 per customer provides an estimate, which at \$94.91 per customer per year (or \$9.70/MWh) for the 2007–08 financial year remains well above the regulatory outcomes in other jurisdictions (albeit in draft determinations) (Table 6.7). The Commission accepted that the impact of the recovery of similar fixed costs across a larger customer base could account for some of the difference seen in other jurisdictions.

Table 6.7 Retail operating costs (Draft decisions)

	QCA (Energex) 2007–08	IPART (EA) 2007–08	ICRC 2007–08
Retail operating cost	\$77.50	\$75.00	\$94.91

Following consideration of the comments provided in the submissions, the Commission is of the view that a retail operating cost allowance of \$94.91 per customer is reasonable for the 2007–08 financial year. The Commission believes such an outcome is a reasonable balance between the need to allow cost recovery (s. 20(2)(e)) but also to require the incumbent to operate efficiently (s. 20(2)(c)) and to acknowledge the need to consider the social impacts of its decisions (s. 20(2)(g)) by requiring ActewAGL Retail to manage its controllable costs to within the general price inflation seen over this five-year period. This was relevant where external and uncontrollable costs (such as generation costs) were likely to rise by a value well above the general inflation rate in the economy. The Commission prefers to use \$94.91 per customer per year (or \$9.70/MWh) for the 2007–08 financial year for its final decision.

6.2.7 Customer acquisition and retention costs

Response to comments on low customer acquisition cost estimates

In its submission, ActewAGL Retail argued that the customer acquisition cost proposed by the Commission was too low and that the value used by IPART of \$35.00 per customer was more reasonable, as it was closer to the cost which a new entrant would likely experience. In its submission, the ESCC argued that it was unreasonable to load what appeared to be costs associated with retail competition onto franchise customers. The submission from CARE also indicated that, in CARE’s view, the customer retention costs should be removed.

The approach adopted for the final price direction

While its original decision in 2003 did not separately identify costs associated with the ‘new entrant’ activity of acquiring new customers, in its draft decision the Commission believed that the development of competition would likely be fostered by allowing those 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.

In its draft decision, the Commission accepted 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 (the Commission would not endorse recovery of such costs from the franchise customers). In addition, the gradual erosion of the TFT customer base by competition means that the fixed costs of the provision of

Table 6.8 Customer acquisition costs (draft decisions)

	QCA (Energex) 2007-08	IPART (EA) 2007-08	ICRC 2007-08
Customer acquisition cost	\$2.00	\$35.00	\$15.09

services to this customer group (or retention costs) must rise in \$/MWh terms. In its draft decision, the Commission felt that it should allow the recovery of efficient costs in relation to these activities (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 would likely require the inclusion of additional per-unit costs associated with loss and churn of TFT customers. The Commission did not accept that this cost should be as high as the costs for a new-entrant electricity retailer, as is now argued by ActewAGL Retail, because there should be no need to advertise for return of these customers to the TFT. Further, the Commission does not believe it is bound by the new entrant cost principle to the exclusion of the other objectives of s. 20(2) of the ICRC Act.

Given the very strong comments by the ESCC and CARE, the Commission again compared the external regulatory benchmarks from QCA and IPART against its draft decision. Table 6.8 suggests that the regulatory precedent on these costs is far from being clear (albeit from the output of draft determinations). The Commission also noted a misinterpretation in its draft decision relating to the QCA outcome, which on further examination provided \$2.00 per customer³⁰ for acquisition and retention costs.

For its final price direction, the Commission believed it should better balance the social impacts of its decisions (s. 20(2)(g)) against the need to reduce the barriers to entry for new entrants (s. 20(2)(c)), and that the balance of these objectives meant that the Commission would not allow any recovery of customer acquisition and retention costs into its benchmark cost base. The Commission feels that the final decision on this matter is justified because such costs could be argued to be low on a per customer basis (see the QCA draft decision) and could be argued to be covered by the CPI allowance already applied by the Commission for the retail operating costs. The Commission believes the negative social impact of the inclusion of such costs in this instance outweighs the need to reduce barriers to new entry. The Commission recognises that the use of an external benchmark for these costs supports the aims of ss. 20(2)(a), (e), (i) and (j), but that those objectives deserve lower weight than the negative social impacts of inclusion of these costs.

6.2.8 Network tariffs

Response to comments on network tariff estimates

The submissions received by the Commission did not comment specifically on the network costs assumed in the draft decision. However, in its confidential submission regarding the detailed green

³⁰ QCA, *Benchmark Retail Cost Index for Electricity : 2006-07 and 2007-08*, draft decision, May 2007, page 23.

cost estimates, ActewAGL Retail provided its early estimate of \$53.22/MWh for the network costs for 2007–08.

The approach adopted for the final price direction

The Commission has utilised the outcomes of its March 2004 price direction relating to ActewAGL Distribution's network tariffs³¹ and the forecast prices in a confidential submission on the annual network pricing report³² to derive a network cost for 2007–08. In arriving at the network cost estimate, the Commission has used the approved tariffs for 2006–07, the proposed tariffs for 2007–08, the forecasts of customer numbers and energy usage (MWh) for the retail TFT adjustments for 2006–07, the average customer loss rate and average energy growth rate from 2004–05 to 2006–07, the CPI estimate for 2007–08, and a 0% X factor. ActewAGL Distribution has only recently delivered its annual pricing report³³, which describes the proposed network tariff adjustment application for 2007–08. However, the Commission's initial analysis confirms that the average network cost to franchise customers of \$53.22/MWh appears reasonable for 2007–08. The Commission believes this approach supports the objectives of s. 20(2)(a) through arm's length confirmation 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).

6.2.9 Retail margin

Response to comments on allowed retail margin

In its submission, ActewAGL Retail argued that the retail margin increase from 3% to 4% proposed by the Commission was too low and that the 5% value used by IPART was more reasonable and also corresponded to the value used by the QCA. ActewAGL Retail also argued that, were the Commission to impose an electricity purchase cost below a market rate, the retail margin needed to be higher to reflect the resulting regulatory risk. In its 1 June 2007 submission, the ESCC argued that there was no justification for an increase in the retail margin allowed. The submission from CARE also indicated that in its view there should not be an increase in the retail margin allowed, based on the adverse impacts of such a decision on CARE's constituents.

The approach adopted for the final price direction

In its previous price direction for 2003–04 to 2005–06, the Commission adopted a retail margin of 3% of the retail sales value. Following consideration of the submissions it has received, and benchmarking its draft decision outcomes against recent regulatory draft decisions, the Commission confirms the rise in retail margin from 3% to 4% that it contemplated in its draft decision. The Commission believes that a 4% value for the retail margin on total sales, while lower than proposed in both the IPART and QCA draft determinations, is sufficient for the TFT customer segment in the context of the Commission's decisions on electricity purchase and other costs, and when these costs are compared to those in other jurisdictions on a like-for-like basis.

³¹ ICRC, *Final decision: Investigation into prices for electricity distribution services in the ACT*, March 2004.

³² ActewAGL Retail, *Annual Pricing Report 2007–08, Electricity Distribution Services*, 4 May 2007.

³³ Dated 4 May 2007 and received by the Commission on 7 May 2007.

There are two arguments which the Commission has considered in arriving at this conclusion. First, the retail margin provides a return to the regulated retail entity, among other things to compensate it for the risks it bears in aggregating an uncertain retail load and purchasing this load in a wholesale electricity pool (albeit using hedging strategies to mitigate such risks to the greatest extent possible). The Commission believes that the wholesale electricity market is displaying a change in price volatility which reflects into the price and availability of hedging contracts that would justify a re-rating of the risks experienced by retailers and hence an increase in the retail margin allowed. The increased volatility also increases the costs to the retailer as it must secure additional working capital (which comes at a financing cost) to finance variations away from its contracted position. This is described in the Frontier Economics report prepared for IPART³⁴. Unlike the approach adopted by IPART in its draft determination, the Commission prefers to increase the retail margin rather than to add a volatility premium to the electricity purchase cost.

Second, the change in volatility is accompanied by an increase in the average pool price which is related to apparent externalities which are impacting the balance in supply and demand for electricity at the wholesale level. The increase in the average price seen in the electricity pool has led to a step change in the prices in the contract market and in the futures market. The Commission is best able to address the average increase in the pool and hence contract prices by ensuring that its estimate of the average contract costs for electricity to service TFT customers is not artificially constrained, but that it reasonably reflects both the existing market prices and a reasonable hedging strategy for an incumbent retailer in the ACT. The Commission believes its change in the electricity purchase cost from \$58.04/MWh in its draft decision to \$62.60/MWh reflects the calibration of its model to market realities. The Commission again notes that this outcome is significantly less than the \$80/MWh requested by ActewAGL Retail, as discussed in Section 6.2.1 of this report.

Therefore, the Commission will use a 4% retail margin on total sales as reasonable compensation for the risks for the incumbent in the ACT, and incorporate this value into the average revenue cap for 2007–08.

The Commission recognises that the 4% retail margin it prefers will apply immediately in 2007–08, without any transition period, whereas the IPART-proposed 5% each year for the three-year regulatory period will be transitioned through the smoothing process applied to the forecast cost base and applied over the three years of the IPART draft determination.

The Commission believes this approach meets the objectives of ss. 20(2)(d) and (i), and that overall the social impacts of its decisions on the total cost bundle to be included in ActewAGL Retail's cost bundle are ameliorated because of consumers' access to competing contestable tariffs. Where the Commission's decision on the allowed weighted average price cap for 2007–08 has factored in costs which might in future appear high against the actual outcomes in 2007–08, consumers can choose tariffs of a lower cost where they are offered by competing retailers. The Commission believes this property of the contestable market serves the interests of consumers on the TFT under s. 20(2)(g) of the ICRC Act. The Commission also notes that the 4% retail margin is less than the 5% retail margin proposed by IPART and the QCA, and the difference can be partially attributed to the consideration of the impact of the change on ACT customers.

³⁴ Frontier Economics, *Energy Costs*, Final Report, March 2007, section 5.4.

6.3 Summary of cost elements

Based on the benchmark cost analysis in Section 6.2, the Commission believes the cost breakdown in Table 6.10 provides the reasonable cost base for development of the weighted average price cap to be applied to the TFT for the 2007–08 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 6.10 Composition of TFT retail price

	2007–08
Energy purchase costs per customer (\$/MWh)	
Electricity purchase cost (\$/MWh)	62.60
Energy contracting cost (\$/MWh)	0.70
Green costs (\$/MWh)	3.34
NEM fees (\$/MWh)	0.71
Energy losses	4.97%
Total energy purchase cost (\$/MWh)	70.70
Retail operating costs (\$/MWh)	9.70
Customer acquisition costs (\$/MWh)	–
Total retail costs (\$/MWh)	9.70
Network costs (\$/MWh)	53.22
Total retail costs (\$/MWh)	133.62
Retail margin (% of sales, EBITDA)	4.00%
Total retail price (\$/MWh)	137.63
Assumed CPI change, 2006–07 to 2007–08	3.40%
X factor in CPI+X on MAR in \$/MWh	12.9%

6.4 Weighted average price cap outcome

The Commission has generated cost estimates for 2006–07 and compared them to the cost estimates for 2007–08 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 6.10, the X factor preferred by the Commission for its final price direction is 12.9%.³⁵

Based on the regulatory CPI estimate of 3.4% for 2007–08, 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 2007–08 must allow average price increases of 16.7% for TFT customers.

³⁵ Note that this number is derived by use of the formula $(1+\text{delta}\%) / (1+\text{CPI}) - 1$ so that the second order terms in the price control are effective. This is required because the cost changes reflected in the delta% are large, and the second order terms thus become important in a calculation using a polynomial.

7 Other aspects of the transitional franchise tariff

7.1 Safety net provisions

The Commission has carefully considered the submissions by ESCC and CARE as they relate to the impacts of continuing and multiple price rises on less well-off ACT consumers. To the extent that it can under the powers given to it by legislation and by government reference, the Commission has considered and, where appropriate, adopted the recommendations brought forward by these stakeholders. However, the Commission recognises its limited mandate in areas associated with social welfare and the more financially vulnerable consumers in the ACT community. The Commission reiterates its comments from its draft decision, as follows.

In its previous reports, the Commission has stated that ‘the TFT was never intended to be a safety net measure for more vulnerable customers’.³⁶ 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 the 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 2007–08, the Commission has sought to set a price which does not reflect the short-term marginal cost of energy at approximately \$80/MWh (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 significant price increases to take effect from 1 July 2007. 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 2007–08.

The Commission notes that a competitive market already exists for electricity supply in the ACT. Should generation costs decline during 2007–08, competition among 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.

³⁶ ICRC, April 2006, page 2 and Section 4.4.1, pages 25–28.

7.2 Support for vulnerable customers

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, the ACT Council of Social Service and other support agencies.

The Commission notes that the government has already made some additional funding available to provide support for customers who are affected by the introduction of the government's Network Facilities Tax, which will take effect from 1 July 2007 and will add around \$60 per year to an average household customer's electricity bill in 2007–08. The Commission notes that there is likely to be an accumulation of higher utility charges in 2007–08 as a result of tax changes in the ACT, increasing generation costs for electricity, and higher water charges. Those 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.

These higher utility charges also come at a time when there is concern about the rising cost of housing in the ACT, higher petrol and transport costs, and concern that the costs of household necessities are rising at a greater rate than the general rate of inflation and the growth in incomes or income support arrangements.

CARE has been a strong advocate of the need for a more in-depth study into the impact of such cost increases on low-income households, and has noted on a number of occasions the desirability of the Commission undertaking a study to better inform itself and the community on the impact of pricing decisions on the overall welfare of lower income households. As noted above, the Commission does not have the legislative powers or a mandate to undertake such study. However, the Commission agrees that there is a need for a more detailed examination of the social welfare impact of rising costs on lower income households in the ACT. In this and previous reports, the Commission has highlighted the importance of the safety net arrangements for disadvantaged groups in the ACT. However, for those arrangements to be effective they need to be reviewed periodically. While the Commission could be issued with a reference to undertake such a review, the Commission cannot initiate a review.

The Commission recognises the flow-through impact of the current price increase for utility services in the ACT, has sought to ensure that the increases reflect a recovery of efficient costs (and not monopoly charges), and has sought the use of pricing mechanisms which can soften the impact of the increases on small-volume users. By their very nature, utility prices cannot be set in a way that allows price discrimination between individual consumers (or consumer groups) who consume the same quantity and quality of the service. However, the Commission has sought to ensure that there is at least some bias in the prices towards users who are able to constrain their consumption, thereby providing some relief to more parsimonious consumers. To address further the concerns of groups such as ESCC and CARE requires more targeted funding support from government.

7.3 Pass-through arrangements

Response to comments on a two-step transition and cost pass-throughs

In its submission, the ESCC argued that there was a need to transition the price rises proposed by the Commission in two steps, one at 1 July 2007 and the second at 31 December 2007. The ESCC provided an analysis of the costs which could be used to achieve these two steps. In its submission, CARE also indicated that in its view there should be a transition over the year and that a two-step process would, to a limited degree, help its constituents cope with an additional price rise for another basic cost of living. In its submission, ActewAGL Retail argued in support of the Commission's stated preference for the TFT to cease, to effectively allow ActewAGL Retail to control its own pricing, and to allow it to pass through external costs where possible under the discipline of full retail contestability.

The approach adopted for the final price direction

The Commission's determination is for a 12-month period. In its draft decision, the Commission mooted the possibilities of a two-stepped transition for price increases and the opportunity to include additional cost pass-throughs during the single-year regulatory period. It has carefully considered the submissions it has received and, in particular, the necessity and practicality of undertaking the price adjustment in two steps with the opportunity for additional cost pass-throughs.

The Commission is conscious that fluctuations in generation costs might be greater than expected or, indeed, that heavy rains in the various catchments might produce lower than expected generation costs. So not only is there a possibility of a further long-term increase in the underlying price for generated electricity in response to the drought and other external events, there is also a possibility that prices will return to levels more in line with those experienced over recent years (for example, should the drought break). The outcome for 2007–08 is very uncertain.

The Commission believes that, in coming to a decision on whether two steps of price adjustment should occur, and/or on whether ActewAGL Retail should be allowed to apply for additional pass-through of costs before the second of the transition steps, it should rely on the properties of markets and place more weight on the social impacts of its decisions under s. 20(2)(g) than on ensuring risk-free inclusion of uncertain cost increases during 2007–08 under s. 20(2)(e). Such weighting is considered reasonable, given that the government's reference imposes a single-year regulatory period.

The Commission's consideration of these issues is as follows.

First, no additional pass-throughs will be allowed for the one-year regulatory period. Where costs for TFT customers rise through external events beyond the control of ActewAGL Retail, it must bear those costs under the weighted average price cap imposed by this final decision for the 2007–08 financial year. However, the Commission believes that, by way of its price-hedging assumptions and allowances, it has adequately compensated ActewAGL Retail for the cost rises which may be reasonably assumed for 2007–08. The Commission does not believe that the social impacts of its decisions under s. 20(2)(g) of the ICRC Act will allow it to reconsider its decision, even for pass-throughs of uncontrollable costs. In this instance and in the context of the allowances made in determining price, the Commission places a stronger weight on the social impact provisions than on the other provisions of s. 20(2) of the ICRC Act.

Second, the Commission does not believe that a stepped transition for price rises is justified, given the availability of contestable retail tariffs to TFT customers. Should the expected cost increases during 2007–08 not come to pass (particularly of wholesale electricity costs), TFT customers have the option to choose an alternative retail supplier to achieve the price reductions which the ESCC and CARE would otherwise prefer the Commission to impose on the TFT through a mid-term adjustment based on benchmark costs from the marketplace and other sources. While this provides some support for cost recovery under s. 20(2)(e), it is dependent on the behaviour of TFT customers who exercise choice when they identify contestable tariffs in a market where costs may indeed fall from current levels. The Commission notes that not all of the clients of ESCC and CARE can bundle their energy and/or telecommunications needs, which is what would be required to access the discounts currently offered in the contestable energy market. However, if generating costs fall and that allows retail prices to fall, there will be some degree of market and community pressure on ActewAGL Retail to re-examine its pricing structure. In such circumstances, it is noteworthy that the TFT is an upper limit on prices and not a floor price which ActewAGL Retail must charge. This is the nature of the weighted average price cap imposed by the Commission.

Furthermore, the Commission notes that a mid-year price adjustment would require additional administration costs and would ultimately shift some of the cost increases to the second half of the year, creating possible distortions in consumer cost effects where there is a cyclic pattern in consumption over the year.

The Commission considers that this approach to additional cost rises and to further cost falls is a reasonable regulatory outcome for a single-year regulatory period, and best balances the conflicting objectives of s. 20(2) of the ICRC Act as discussed above. Its approach would likely differ under a different term of reference and under different market circumstances.

8 Conclusion on the final price direction

In this final decision on the price direction for 2007–08, the Commission has considered the build-up of efficient costs for the provision of retail electricity services by ActewAGL Retail to customers on the regulated retail tariff, or TFT. In coming to its decision, the Commission has considered ActewAGL’s likely costs for 2007–08, especially taking into account the recent increases in electricity pool prices. The Commission has been 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 Retail’s franchise tariff revenue may increase by up to the amount of 16.7%, which incorporates a CPI factor and an X factor. The Commission has determined that the appropriate value of the CPI is 3.40% and the appropriate value of the X factor is 12.9%. In making this determination for one year, the Commission has not changed the form of regulation faced by ActewAGL Retail.

The Commission will not consider additional cost pass-through applications for the 2007–08 financial year and will not accommodate a two-step transition to the weighted average price cap, as proposed by the ESCC and CARE.

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 2007 (No. 1)

Disallowable instrument DI2007—96

made under the

Independent Competition and Regulatory Commission Act 1997, ('the Act'), section 15 (Nature of industry reference) 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 from 1 July 2007 to 30 June 2008.

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 requirements 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 administrative changes to its billing system and to provide information on the new tariff to customers.

Simon Corbell MLA

Attorney-General

16 April 2007

Appendix 2 Final price direction

This appendix contains the Commission's price direction in respect of the transition franchise tariff (TFT) for the period from 1 July 2007 to 30 June 2008

1 Period of the direction

The provisions below will apply to the period from 1 July 2007 to 30 June 2008.

2 Variation to price of retail electricity services

The maximum price that may be charged by ActewAGL Retail for the provision of electricity services to franchise customers during the period must be calculated 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 2007–08 price for component j of the regulated retail tariff i

P_{ij}^{t-1} is the actual 2006–07 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 = 3.4%

X = 12.9%

3 Commission's regard for section 20 of the ICRC Act

When making any direction about prices in a regulated industry, the Commission is required to take into account a number of issues identified in section 20 of the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act). The Commission's conclusions on each of those matters, considered in regard to its decision on the TFT for electricity, are summarised in the following table.

ICRC Act s. 20 issues	Commission conclusions
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	The Commission considers that competition, both current and imminent from existing and new entrants, will ensure appropriate efficient pricing of electricity and the provision of service options that will best meet the needs of consumers. It is proposed that the government will retain the ability to refer retail pricing of electricity to the Commission should there be evidence of market failure or abuse of market power at any time in the future.
Standards of quality, reliability and safety of the regulated services	Competitive market conditions will ensure that service standards are met. Exercise of choice by consumers will ensure that competing retailers are required to maintain and improve service standards while operating in a competitive environment. The existing technical regulations relating to safety and quality of electricity provided will remain unchanged.
The need for greater efficiency in the provision of regulated services to reduce costs to consumers and taxpayers	Competition is acknowledged as the optimal method for ensuring efficient provision of services, and the Commission has concluded that existing and potential imminent competition will ensure the efficiency of the provision of electricity services to small consumers.
An appropriate rate of return on any investment in the regulated industry	The Commission's analysis of the retail margins currently included in the TFT applying in the ACT confirm that they are consistent with the margins included in regulated and contestable retail price offerings in other states.
The cost of providing the regulated services	The margin analysis undertaken by the Commission incorporates the full flow-on of network and generation costs, albeit using a general hedging strategy which the Commission believes all reasonable and financially viable retailers use to mitigate their exposure to the electricity pool. The margin analysis also demonstrates that retailers are able to recover their retailing costs in the current TFT tariffs, and decisions by retailers to discount below the TFT price indicate a further margin within which retailers are able to compete and remain viable in this market. The Commission has confirmed that customer churn off the TFT is continuing in May 2007 in the face of rising wholesale electricity costs. Withdrawal of the TFT in a competitive market will still allow retailers to recover their costs.
The principles of ecologically sustainable development mentioned in s. 20(5) of the Act	Pricing of electricity to reflect its actual cost, including charges such as greenhouse gas emission costs, provides a clear signal to consumers of environmental and ecological sustainability issues and encourages best use of energy resources. The decision will not alter the pass-through of these costs as is at present included in electricity prices.
The social impacts of the decision	The Commission has examined the social implications of the decision, and has highlighted the continuing need for funding of targeted assistance (including for the operation of the Essential Services Consumer Council) for vulnerable households. The Commission has retained a set weighted average price cap for the 2007–08 financial year, without access to additional cost pass-throughs, as a balance between the social impacts of its decision and the imperative to allow the incumbent franchise retailer to recover its efficient costs. The access to choice of alternative retail supplier provides a safeguard should the set TFT become more costly than available contestable tariff offerings.
Considerations of demand management and least cost planning	Greater opportunities for competition in the ACT market are expected to bring new service and pricing offers, including time-of-use tariffs, which will have a positive impact for better demand management.
The borrowing, capital and cash flow requirements of persons providing regulated services and the need to renew or increase relevant assets in the regulated industry	The Commission's margin analysis has confirmed that the margins allowed in the TFT are adequate to meet the financing needs of the electricity retailers, and the margins applying on discounted electricity offerings observed in the marketplace are consistent with margins offered by competitive retailers in other jurisdictions.
The effect on general price inflation over the medium term	There is not expected to be any significant impact on price inflation from this decision as retailers compete to maintain or expand their customer bases. It should be noted that the general price inflation in the near to mid-term may change where the electricity pool price and the contract prices being offered to manage this pool price risk continue to increase due to external market supply and demand imbalances. The control or influence of such externalities is outside the mandate of the Commission.
Any arrangements that a person providing regulated services has entered into for the exercise of its functions by some other person	Not applicable, as incumbent retail supplier has not brought forward for consideration any third party contracts that cannot otherwise be serviced under the proposed weighted average price cap.

Glossary and abbreviations

ACT	Australian Capital Territory
ActewAGL	ActewAGL Retail
BRCI	Benchmark Retail Cost Index
Commission	Independent Competition and Regulatory Commission
CPI	Consumer Price Index
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-run marginal cost
MRET	mandatory renewable energy target
MWh	megawatt hours
NEM	national electricity market
QCA	Queensland Competition Authority
RRP	regional reference price
TFT	transitional franchise tariff
Utilities Act	<i>Utilities Act 2000 (ACT)</i>