

Issues Paper

Investigation into Retail Prices for Non-Contestable Electricity Customers in the ACT

December 2002

The Independent Competition and Regulatory Commission (ICRC) is established by the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act) 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 the determination of competitive neutrality complaints and providing advice about other government regulated activities.

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For further information on this inquiry or any other matters of concern to the Commission please contact Ian Primrose, Chief Executive Officer, on 62050779.

Foreword

The Treasurer has issued a reference to the Independent Competition and Regulatory Commission (the Commission) to conduct an investigation to determine retail prices for electricity in the Australian Capital Territory (ACT) for those services provided to franchise customers after the introduction of Full Retail Contestability (FRC) on 1 March 2003.

The electricity supply industry in the ACT was opened for retail competition to customers consuming greater than 100 Megawatt/hours (MWh) per annum from 1 July 2001. In its report of July 2002 on Full Retail Contestability (FRC) for electricity the Commission recommended that FRC be introduced for all customers in the ACT. The Government has determined that this will occur from 1 March 2003.

Contestable electricity tariffs are made up of regulated transmission and distribution charges, a generation charge based on a competitive market for electricity supply to retailers, the retail service costs (including costs associated with customer contact, billing and churn, cash collection, and electricity market risk hedging) and a commercial retail margin. In the contestable market, the retail costs and margin are subject to market pressure which drive prices to efficient levels through competition between retailers for the contestable customers. However, for those customers who do not wish to avail themselves of the opportunity to make a choice of competitive supplier, the Government has announced that it will allow a three year period during which those customers can remain with their existing supplier, ActewAGL Retail, and has asked the Commission to determine the retail price that these customers will pay.

Under the terms of the reference issued by the ACT Treasurer (see Appendix A), the Commission to make a direction on the level, and structure of regulated retail prices for franchise customers consuming less than 100 MWh pa during the three-year transition period commencing 1 March 2003. For the purposes of this investigation, the regulated tariffs for non-contestable customers consuming less than 100 MWh pa will be termed Transition Franchise Tariffs (TFT). The current inquiry will address the question of setting the TFT up until 28 February 2006. A further inquiry will be undertaken at or prior to that date to determine whether the TFT should be extended for a further period.

As the reference was issued under sections 15 and 16 of the Act, the Commission is required to publish a draft report and, after consultation, a final report containing the price direction.

Proposed timetable for the inquiry

Issues Paper released	20 December 2002
Submissions on the Issues Paper close	17 January 2003
Draft Report	24 January 2003
Submissions on the draft report close	10 February 2003
Release of the Final Report and Direction	As soon as possible after 14 February 2003

The reference requires the Commission to consider a range of matters and to provide a price direction that will be effective from 1 March 2003. In the course of its inquiry the Commission will be seeking public submissions and information relating to the issues raised in this paper and subsequent reports.. The Issues Paper provides a general overview of the issues in the Inquiry as a focus for discussion. It is not intended to be an exhaustive or exclusive rehearsal of the issues. At this stage the Commission would welcome information about any issues dealing with the determination of an appropriate price for the particular circumstances that will apply to the TFT. The Issues Paper provides an initial opportunity for making submissions to the Commission. The Commission will accept submissions in writing, oral submissions and submissions transmitted by post or electronically.

People intending to make a submission should be aware that the Commission publishes all submissions made to its inquiries unless there is a specific claim for information to be treated as confidential and the Commission agrees with that claim. Submissions are published on the Commission's website and are available for scrutiny at the Commission's offices.

For further information about making a submission or about the inquiry in general please contact the Chief Executive Officer of the Commission, Ian Primrose, on 62050779 or by fax on 62075887.

Paul Baxter
Senior Commissioner
20 December 2003

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Background

In 1995 the ACT Government, together with other Australian Governments, signed three agreements which constitute the National Competition Policy.

A major commitment in the National Competition Policy was to undertake development of a competitive national electricity market delivering benefits to the economy and consumers. It was agreed that the national electricity market would be more effective by separating the generation, transmission, distribution and retail supply sectors, establishing a central management body for the national grid and creating an independent but consistent approach to the establishment of regulated prices.

The market was to be developed gradually with targets for the structural separation of transmission, distribution and retail services being met by 1996 and the opening of the east coast grid incorporating Queensland, New South Wales, ACT, Victoria and South Australia by the end of 1997. Governments also agreed to a phased opening of the retail market to competition in accord with the assessed benefits to be derived by each jurisdiction.

In the ACT, only large volume consumers, above 160 Megawatt/hour (MWh) per annum, were initially made contestable from 1998. The threshold was lowered to 100MWh per annum from July 2001. The ACT market was to be fully opened to retail competition, by making consumers below the 100MWh per annum (essentially households and small businesses) threshold contestable, from 1 January 2002. The timetable was in line with FRC in Victoria and New South Wales.

Victoria and New South Wales made their markets fully contestable from that date. However a decision in the ACT was delayed pending the ACT Legislative Assembly Standing Committee on the Urban Services Portfolio inquiring into the potential benefits of FRC. The Legislative Assembly wished to consider whether there would be a net benefit to the community in exposing consumers using less than 100 MWh per annum of electricity a year to competition. The Committee could not complete its inquiry before the Legislative Assembly rose for the election in October 2001.

The Treasurer subsequently issued a reference to the Commission on 18 December 2001 to conduct an inquiry into full retail contestability in electricity for consumers using less than 100MWh of electricity per year. The Commission's inquiry found that there were positive (albeit small) net benefits for ACT consumers arising from the introduction of FRC.

The Terms of the Reference

The Terms of Reference (ToR) have been issued by the Treasurer of the Australian Capital Territory (ACT) under section 15 of the Independent Competition and Regulatory Commission Act 1997 (ICRC Act). The terms of the of reference seek to

have the Commission determine “a price direction for the supply of electricity to franchise customers for the three-year period from 1 March 2003.”

The reference has specific requirements, established under section 16 of the ICRC Act, to be met in the course of the investigation. These include having regard to the following:

- The requirements of Section 20 of the Act;
- The impact of the National Electricity Law and the National Electricity Code;
- The impact of FRC including arrangements for Retailer of Last Resort and the Commission’s 1999 Price Direction;
- The retail prices ActewAGL charges in other jurisdictions; and
- The retail prices charged by incumbent retailers in other jurisdictions.

In undertaking the investigation the Commission is required to consult widely, including key stakeholders such as consumer groups, small business representatives, social welfare groups and electricity suppliers and retailers. This issues paper forms part of that consultation requirement.

The Commission is to conclude its investigation in order that a retail price is in place for the opening of the contestable market on 1 March 2003.

Issues

Timing of Full Retail Contestability

The ACT Government has declared under Section 18(1) of the *Utilities Act 2000* (the Utilities Act) that electricity customers who are currently deemed to be franchise customers (ie: are non-contestable) will be able to choose their retail electricity supplier from 1 March 2003. This tranche of currently non-contestable customers consume less than 100MWh pa of energy¹, and rely on retail tariffs provided by ActewAGL which are regulated by the Commission.

It deciding to make available choice of retail supplier to this final tranche of franchise customers, the Government has given consideration to the benefits to smaller customers of a right to choose a retailer on the basis of a variety of retail tariff and service offerings. Given there are 13 licensed retail suppliers in the ACT, and many of these retail suppliers may seek to secure customers from the tranche consuming less than 100MWh pa, it may take some time for these newly contestable customers to decide which retail supplier they would prefer.

Regulated Transition Franchise Tariff – Method of Tariff Setting

To assist these newly contestable customers in exercising their right of choice in a less pressured manner, the ACT Government has decided to provide a period of three

¹ The Commission “*Declaration Under Section 18(1)*” of 21 April 2001 specifies the exact criteria for contestability above the 100MWh pa benchmark energy consumption.

years in which the current franchise customers consuming less than 100MWh pa, will be able to avail themselves of a regulated Transition Franchise Tariff (TFT) provided by ActewAGL, until such time as they opt to exercise their choice and move to contestable retail tariff offerings provided by licensed ACT retailers.

The TFT is a regulated electricity tariff which will only be available to customers who are currently franchise customers and consume less than 100MWh pa. The TFT will be available only for the period 1 March 2003 to 28 February 2006. Customers who choose to move to an alternative tariff offered by a licensed ACT retailer, will be able to stay with that competitive tariff, or to move to an alternative contestable tariff offered by another licensed ACT retailer. They will also be able to return to the TFT while this tariff remains in force.

In a general sense, electricity tariffs are structured to recover the following costs:

- Transmission use of service (TUoS) charge;
- Distribution use of service (DUoS) charge;
- Cost of electricity divided into the following categories;
 - Demand or Energy charges under hedging contracts with generators, entrepreneurial interconnectors, or other market participants, including vesting, bi-lateral, swap, futures and other firm electricity contracts;
 - Demand or Energy charges relating to the pool price in the National Electricity Market (NEM); and
 - Demand or Energy charges relating to the provision of Ancillary Services under contract or via the respective ancillary services market;
- Retail costs divided into the following categories:
 - Customer care and call centre costs;
 - Billing costs;
 - Sales and marketing costs;
 - Collection and Default costs;
 - Administration costs (business overheads such as finance, human resource management, regulatory administration, and other); and
 - Costs associated with the introduction of FRC such as churn costs, advertising for new FRC customers from the last contestable tranche; and
- Retail margin, or return to the shareholder, at a reasonable level commensurate with the level of investment required and the risks associated with running a retail business.

Apart from using cost recovery methods to set tariffs, there are other approaches that the Commission might consider. Such approaches include taking the current franchise tariff(s) and using these as the TFT with appropriate cost escalation factors over the three year period. Alternatively, the Commission could adopt some form of average tariff drawing upon contestable retail tariffs quoted in surrounding areas outside the ACT.

The Commission seeks comment on the following:

- Is this the full list of costs which a retail electricity business will experience?
- What other costs might be relevant? Why?
- What costs which are listed are not relevant to TFT customers? Why?
- Should the Commission use a cost based approach to tariff setting, or is another approach more appropriate? Why?
- Should the TFT tariff be based on an existing franchise tariff escalated by CPI or another escalator? Which existing tariff? Why is this approach preferred?

Allocation of Costs to Recover from Transition Franchise Tariff

While the cost pools listed above are the total of the costs to be recovered to ensure the retail electricity business remains financially viable, these costs need to be divided between the two primary customer groups which are serviced by any electricity retailer.

Prior to the introduction of FRC these two groups are:

- Contestable customers; and
- Non-contestable customers.

Following the introduction of FRC and without the introduction of the TFT, the second group would normally disappear and all customers would become contestable and have to choose their licensed ACT retailer in order to continue to receive supply.

With the introduction of the TFT, the second group of customers, who will become contestable, will continue to have access to the TFT until such time as they choose to receive service under a contestable retail tariff, or until 28 February 2006, whichever is the earliest. As franchise customers, if a customer is not satisfied with the contestable arrangements that customer may return to the regulated franchise arrangement. While that provides security to customers it creates risks for retailers, particularly the incumbent retailer who will have an uncertain load. That uncertainty should be recognised in setting a tariff.

In order for the Commission to set a reasonable regulated tariff (ie: the TFT) for these customers, it must consider which of the above costs should form the cost base for the current franchise customers who remain on the TFT.

In most instances, the TUoS and the DUoS charges for each customer segment are relatively easy to identify and are considered on a straight pass-through to the customers within that customer segment.

The energy recovery charge can be treated as a pool of costs to be allocated out between each customer segment on either a uniform basis or by using a relevant cost

driver. For example costs may be allocated on the basis of the total energy (ie: measured in MWh) consumed by each segment, which forms the basis for energy cost recovery. With respect to franchise customers, it could be argued that their energy costs relate solely to the remaining vesting contracts, and the costs of energy provision related to the energy market are not relevant for recovery of costs from the franchise customers, or in this case the remaining TFT customers.

Likewise the recovery of retail costs should be allocated out to each customer segment in an equitable manner. The allocation factor could be based on one of the following measures:

- The total energy consumed by each segment;
- The revenue generated from each segment;
- The number of customer calls from each segment;
- The number of customers in each segment; or
- The coincident or non-coincident peak demand measured for each customer segment; or
- Another measure.

The Commission seeks comment on the following:

- What allocation method should be used to allocate costs between TFT customers and other customers? Why?
- Should the allocation method differ between particular cost pools? Why?
- What, if any, cost escalators should be used over the period of the regulation of TFT?

Methodology for Setting Energy Price for TFT Customers

In its Price Direction of 1999, the Commission used a particular methodology to determine the energy purchase costs which were passed through to the remaining franchise customers. Because ActewAGL had and retains ready access to supply from any generation company attached to the interconnected transmission grid constituting the NEM, the Commission considered that the best way to provide ActewAGL with an incentive to purchase wisely is to let it retain the benefits if it outperforms the market, and bear the cost if it under performs. In this way the ActewAGL franchise customers were protected from adverse purchasing decisions.

To achieve this the Commission required ActewAGL to approach the market at the commencement of the regulatory control period to obtain indicative competitive bids for the purchase of electricity for franchise customers over suitable contract periods. Following consideration of the competitive outcomes, the Commission agreed a pass through of electricity purchasing costs for the relevant regulatory period.

Given the reasonable competitive price outcomes which have resulted from this approach to energy pricing for franchise customers in the period to date, a similar approach could be adopted for the TFT customers from 1 March 2003 to 28 February

The Commission seeks comment on the following:

- Should it follow the same approach to energy prices for TFT customers as it did with franchise customers in its 1999 Price Determination?
- What other approaches might the Commission consider? Why?
- How will the Commission ensure that energy prices to the TFT customers are not excessive?

2006.

Benchmarks of Franchise Retail Margins

With respect to the regulated retail margin, it is important to recognise that the Commission does not seek to regulate the margin associated with the provision of retail electricity services to contestable customers. The margin associated with service provision to this broader contestable customer segment is controlled by the balance of supply and demand in the electricity market, and the combination of pool and hedged electricity charge which is within the control of the licensed ACT retailer.

However, the regulated margin which is allowed on the provision of services to the customers utilising the TFT will need to be set by the Commission. At this point the Commission is mindful of the benchmark margins which have been used in other jurisdictions for earlier decisions on retail franchise tariffs.

In its 1999/2000 direction the Commission allowed a “*gross margin of \$7.5m for ACTEW’s regulated retail electricity business*”², on an electricity revenue base derived from an estimated average energy tariff of “*3.652 c/kWh*”³. In “*subsequent years, the Commission determines that the margin should be increased by the CPI until such time as full retail contestability is introduced in the ACT.*”⁴

In NSW the Independent Pricing and Regulatory Tribunal (IPART) indicated a “*1.5 – 2.5% net profit margin*” was included in the cost base for regulated retail tariffs⁵.

Thus one of the decisions the Commission will need to make is to determine the reasonable regulated retail margin that should be included into the TFT arrangements.

² IPARC, ACTEW’s Electricity, Water & Sewerage Charges for 1999/2000 to 2003/2004, Price Direction, May 1999, page 4.

³ See Table 5.2 of IPARC, May 1999 Price Direction.

⁴ See page 24 of IPARC, May 1999 Price Direction.

⁵ IPART, Regulated Retail Prices for Electricity to 2004, December 2000, Final Report, Table 2.2, page 10.

The Commission seeks comment on the following:

- Should benchmarks of regulated retail tariffs be used as a proxy for reasonable margins to apply to the Transition Franchise Tariffs?
- Should these regulated margins be escalated by CPI over the duration of their existence?
- What other basis might be used to set these regulated retail margins?

Effect on ICRC's May 1999 Price Control Direction

The Commission's current price direction carefully considered the impact of price changes on contestable and non-contestable segments of the ACT electricity consumers. With the implementation of FRC the current price direction will cease and the direction arising from this inquiry will come into force. With the early cessation of the current direction relating to the retail price, the Commission will need to consider whether there are elements of the current direction that need to be sustained and what opportunity exists for issues arising since the last direction was determined to be addressed.

The Commission seeks comment on the following:

- What elements of the Commission's 1999 Price Direction will need to be modified or deleted in order for the ACT Government's requirements for a Transition Franchise Tariff to be effective?
- Are there any inconsistencies between the Price Direction and potential approaches to the Transition Franchise Tariff?

Ring Fenced Retail Costs

ActewAGL has been required to produce ring fenced accounting reports for its electricity, water and sewerage businesses. Further its ring fenced accounting reports should distinguish between the costs associated with its electricity distribution and retail businesses.

The Commission seeks comment on the following:

- Whether ActewAGL's ring fenced business information should be considered as a basis for the costs the Commission should use to determine the cost base for the TFT?

Retail Supplier of Last Resort

The Commission has just released its guidelines on the operation of retailer of last resort provisions⁶. In these guidelines the prime focus of the Commission has been to ensure that electricity consumers continue to receive supply of electricity, in the event that their chosen retailer defaults or ceases to provide services. In its guidelines the Commission indicates the following:

“The Retailer of Last Resort arrangements provide an effective means by which customers continue to be supplied with electricity while the retailer failure is managed. Customers are not required to do anything to ensure that there is continuity of supply, transfers will be made by NEMMCO and the Retailer of Last Resort. Customers affected by the failure of [their chosen licensed ACT retailer] will be able to choose a new retailer of electricity at any time or otherwise remain with the Retailer of Last Resort for up to 3 months. Customers can expect to receive offerings from other electricity retailers licensed in the ACT.

Importantly, electricity customers should note that while considering offers from other retailers their electricity supply will continue at a regulated price under the Retailer of Last Resort arrangements. The regulated price will be higher than alternative prices available in the market.

Advice on choosing a new retailer, prices and other information to assist customers make new choices, and about the management of the market generally, will be published [shortly after the retailer of last resort process comes into effect].”

The Commission seeks comment on the following:

- What relationship is there, or should there be, between the tariffs offered by the Retailer of Last Resort and the Transition Franchise Tariffs to be offered by ActewAGL?
- What inter-relationships between these two tariffs (ie: RoLR Tariff and TFT) should be considered by the Commission?

⁶ ICRC, Retailer of Last Resort Guidelines, December 2002.

Appendix A – Detailed Terms of Reference

INDEPENDENT COMPETITION AND REGULATORY COMMISSION (REFERENCE FOR INVESTIGATION) (DETERMINATION 2002 (No 3))

Disallowable instrument DI2002

made under the
**INDEPENDENT COMPETITION AND REGULATORY COMMISSION ACT
1997,**
**Section 15 (Nature of industry references) and Section 16 (Terms of industry
references)**

Reference for Investigation Under Section 15

Pursuant to subsection 15(1) of the Act, I refer to the Independent Competition and Regulatory Commission (the “Commission”) the provision of a price direction for the supply of electricity to franchise customers for the three-year period from 1 March 2003.

Reference for Requirements in Relation to Investigation Under Section 16

Pursuant to subsection 16(1) of the Act, I specify the following requirements in relation to the conduct of the investigation:

1. The Commission is to review and provide a price direction for the supply of electricity to franchise customers for the three-year period from 1 March 2003.
2. In undertaking the review, the report should have regard to the requirements of Section 20 of the Act, as well as the following:
 - (a) any applicable requirements of the National Electricity Law and the National Electricity Code;
 - (b) the impact of the introduction of Full Retail Competition for Electricity in the Territory, having regard to matters including but not limited to the arrangements for Retailer of Last Resort;
 - (c) the retail prices charged by ActewAGL in other jurisdictions; and
 - (d) the retail prices charged by incumbent retailers in other jurisdictions.

Ted Quinlan
Treasurer

December 2002