Retail Prices for Non-contestable Electricity Customers 2012-2014

ActewAGL Retail Response to the Independent Competition and Regulatory Commission Issues Paper: Retail Prices for noncontestable electricity customers - 2012-2014





Contents

Introduction	3
ActewAGL responses to major issues	4
Regulatory approach	6
Methodology	8
Cost elements	9
Energy purchase cost	9
Energy contracting costs	
Green costs	
Market (NEM) fees	19
Energy losses	
Retail operating costs	
Customer acquisition costs	
Network and transmission costs	
Retail margin	
Cost pass-through arrangements	22
Mid-term review arrangements	25
List of abbreviations	26
References	28



Introduction

This submission by ActewAGL Retail (ActewAGL) responds to the *Issues Paper: Retail prices for non-contestable electricity customers* — 2012-14¹ (the issues paper) released by the Independent Competition and Regulatory Commission (ICRC or the Commission) on 23 December 2011.

In September 2011, the ACT Government issued terms of reference (ToR) requiring the ICRC to provide a price direction for the supply of electricity to ACT franchise customers. The price direction is to apply for the period 1 July 2012 to 30 June 2014, with provision for a review, where appropriate, by 30 June 2013.

This will be the seventh Transitional Franchise Tariff (TFT) determination since 2003 when Full Retail Contestability (FRC) for electricity supply came into effect in the ACT.

ActewAGL has long held the view that maintaining a regulated price in a competitive environment stifles competition, product innovation and delivers less than optimal outcomes to consumers. The removal of electricity price regulation in the ACT has been supported by the ICRC² and more recently recommended by the Australian Energy Market Commission (AEMC) from 1 July 2012 in tandem with the introduction of a 3-year price monitoring program.³ The ACT Government did not adopt the AEMC recommendation.⁴

As acknowledged by the Commission,⁵ the task of setting a regulated tariff in such a volatile market is becoming increasingly complex. The Energy Supply Association of Australia (ESAA) noted in its submission to the Queensland Competition Authority (QCA) review of regulated electricity tariffs and prices that:

Retail price regulation in contestable electricity markets is an inherently fallible and risk-laden exercise that can be self-fulfilling. Regulating prices in potentially competitive markets whereby regulated tariffs may be set below the cost of supply impedes the efficient operation of the market. It creates financial pressure for industry participants forced to absorb costs that cannot be passed on and removes incentives for energy companies to enter the market and compete for small-use customers. Conversely, in the event that prices are set above the cost of supply—including an

¹ ICRC 2011

² ICRC 2010, p 7

³ AEMC 2011, pp i-ii

⁴ Corbell 2011

⁵ ICRC 2010, p 7



appropriate retail margin—competition will erode margins back to efficient levels. The risks are thus asymmetric, with greater adverse consequences arising from setting the regulated price too low.⁶

Where a regulated retail price remains, ActewAGL supports a view that the Commission must ensure that the TFT is set at a level that recognises the market based risk that ActewAGL carries operating in a competitive market. The Commission should bear in mind the asymmetry in the consequences of incorrectly setting the regulated tariff. Further below, ActewAGL cites examples of consequences in California and in Western Australia (WA), where tariffs did not accommodate movements in the costs of supplying the market.

A major issue identified by the Commission for this review is the treatment of the impact of the Federal Government's carbon pricing scheme to be introduced from 1 July 2012. On the matter of recovery of carbon costs, ActewAGL points to further comments by the ESAA to the QCA review:

Given the asymmetric risk profile identified above, esaa considers that the risks to the electricity market from the under recovery of carbon costs far outweigh the risk of over recovery in a contestable electricity market. Accordingly, the Association further considers that the Authority should take heed of these risks, particularly in relation to the derivation of the wholesale energy cost component of regulated tariffs, where a lack of historical data from which to derive forecasts is likely to create additional complications.⁷

ActewAGL has noted the Commission's comments on this matter and developed a proposal for full pass through of the carbon cost component.

ActewAGL responses to major issues

The major components of ActewAGL's response to issues raised in the Commission's issues paper are that:

ActewAGL acknowledges the Commission's predisposition to maintain, where
possible, the current approach to the derivation of Energy Purchase Cost (EPC) in
the TFT. However, as recognised by the Commission, the model must pass through
the cost of carbon in energy purchases and reflect the costs of purchasing a prudent
energy portfolio. ActewAGL has developed a proposal for how this could be best
achieved given the inherent difficulty of overlaying a regulatory outcome in an open
market environment;

⁶ ESAA 2011, p 1

⁷ ESAA 2011, p 2



- ActewAGL considers that the retailer operating costs (ROC) in the TFT should, as
 recommended by the AEMC,⁸ be those of a single fuel mass market entrant and not
 limited to the efficient costs of the incumbent retailer (ActewAGL). This includes the
 full inclusion of costs of customer acquisition and retention borne by a mass market
 entrant in a competitive market;
- A margin of at least 6 per cent is required to provide retailers with commercially adequate returns consistent with market benchmarks;
- ActewAGL supports the Commission's view that, where government imposed obligations aimed at achieving environmental outcomes impose a legitimate cost on *electricity retailers*, they should be included in the green cost component of the cost build-up and proposes that, as has been the case in previous years, all Green costs incurred over the 2012-14 period are passed through in prices;
- ActewAGL considers that the existing cost pass through arrangements should continue to apply as present to cost changes outside ActewAGL's control to the servicing of customers under regulated tariffs;
- The ToR allow for consideration of a review of the TFT for 2013-14. ActewAGL supports such a review using the same approach taken in 2011-12.

Rather than nominating a specific date, the ToR direct the Commission to produce its final report in time sufficient to allow ActewAGL to make any necessary changes to its billing system. While the Commission in the issues paper nominates 15 June for release of the final report, ActewAGL would appreciate a final decision date of 8 June 2012 to allow sufficient time for price approval, billing system implementation and arrangement of customer notifications.

ActewAGL is available to discuss in more detail, the important matters raised in this submission.

⁸ AEMC 2011, p 53



Regulatory approach

ActewAGL appreciates the nature of the challenge the Commission faces in determining the final TFT outcome and the risk it bears in this process. The ICRC has itself several times acknowledged the difficulty of the task, as well as the potential "risk of the Commission establishing an inappropriate price that is either too high or too low."⁹ According to the AEMC:

Regulation is intended to mimic outcomes in a competitive market, ... good regulation will reward those ... that deliver value for money and good quality service, while those that provide poor value for money and poor service quality will receive lower returns.¹⁰

Where a regulated price continues to apply in a competitive market, the role of the regulator must be to achieve the outcome of the market, not to set a price at the low end of what the market will support. To do the latter limits the upside available to the business forced to offer the regulated price, and puts it at greater risk from events within the market.

The significant downside associated with setting regulated electricity tariffs below cost have been seen in California¹¹ and, more recently, in WA. In the latter case, retail prices were not allowed to increase from 1997/98 to 2008/09. As a result, WA Government-owned generator, Verve Energy, as incumbent retailer, incurred losses in the order of \$454 million from 2006 to 2009.¹² In February 2009, the WA Office of Energy recommended that power prices for residential customers be increased by 52 per cent in 2009/10.

In its final report on an inquiry into Verve Energy's poor performance, the WA Office of Energy critically noted:

If retail tariffs do not reflect the cost of supplying electricity, including an appropriate margin, then retailing electricity will not be a viable business activity. New entrants will be unlikely to enter the market, and existing retailers may exit (or suffer

- ⁹ ICRC 2010, p 7
- ¹⁰ AEMC 2011a, p 14
- ¹¹ See FERC 2003
- ¹² ESAA 2011a, p 1



substantial losses if the retailer is Government-owned and required to continue to supply).¹³

The WA experience demonstrates the need for retail tariffs to keep pace with, and reflect, commercially-based costs borne by retailers. The ACT market has continued to be subject to price control arrangements following the introduction of retail competition. Over that 9-year period, the regulated tariff has been constrained below levels proposed by ActewAGL, resulting in the under-pricing of the TFT and this was noted by the AEMC at several phases of its assessment and review of retail competition in the ACT market.

Verve Energy, while suffering sustained poor financial performance as a result of the regulated retail tariffs being set below cost reflective levels, is a fully government owned generator with a capacity to carry losses.¹⁴ In the ACT, ActewAGL bears the risk and associated financial impacts if the regulated price is set below commercially-based levels as it is the incumbent supplier with associated Retailer of Last Resort (RoLR) obligations.

In outlining its regulatory approach in the issues paper, the Commission highlights the issue of whether it "should use ActewAGL as the benchmark for the costs components used in the methodology or a hypothetical new entrant".¹⁵

ActewAGL agrees with the Commission that this is a central issue in establishing the Commission's tasks for this review. The Commission has clearly noted that its ToR for the current review differ from those of earlier TFT reviews in not requiring it to "determine the efficient costs of the incumbent retailer";¹⁶ nor do the ToR prevent the Commission from determining the efficient cost of a new entrant retailer—a critical recommendation of the AEMC. Thus the Commission is not constrained from the proper performance of its task to set a market based price in an open market environment.

As a result of the Commission's past adherence to an approach based on the efficient cost base of ActewAGL as the incumbent electricity retailer, the resulting total allowance has not been reflective of the market costs that need to be recovered in the TFT. The AEMC noted in its 2010 report as a result that "the ACT's 2010-11 retail cost allowance is relatively low compared to other jurisdictions."¹⁷.

ActewAGL's position, that benchmarks for the cost components are more appropriately based on those of a new entrant retailer given the form of regulation, is supported by the

¹⁷ AEMC 2010, p 64

¹³ WA Office of Energy 2009, p 6

¹⁴ Deloitte 2009, p 29

¹⁵ ICRC 2011, p 5

¹⁶ ICRC 2011, p 17



recommendations of the previously cited 2011 review of the effectiveness of competition in the ACT retail electricity market undertaken by the AEMC. This would be the prudent and efficient market price.

Methodology

ActewAGL supports the Commission's preference to continue using the CPI plus X formula applied to the weighted average price cap set out in Appendix 3 of the issues paper,¹⁸ consistent with previous determinations. This has the advantage of providing the freedom to rebalance tariffs while ensuring that the overall adjustment to average prices does not exceed the increase that the Commission has determined.

¹⁸ ICRC 2011, p 23



Cost elements

Energy purchase cost

The Commission recognised in its 2010 TFT determination¹⁹ that it is becoming much more difficult for regulators to determine prices in the increasingly complex electricity retail market due to factors such as increased volatility in electricity purchase costs and an increasingly complex set of environmental initiatives that give rise to costs that are very difficult to assess and compensate in a regulatory context.

With price regulation to continue in the ACT for 2012-14, ActewAGL re-affirms its position in favour of the Long Run Marginal Cost (LRMC)²⁰ of generation as a reference point in establishing a deemed purchase cost for electricity. ActewAGL notes that the NSW regulator, the Independent Pricing and Regulatory Tribunal (IPART), continues to reference LRMC in its determinations for regulated tariffs²¹. Given the detailed discussion and conclusion drawn by the Commission on this matter in its 2010 determination, with which ActewAGL did not agree, ActewAGL has provided its views on how the EPC can be better calibrated to reflect the commercial outcomes for a prudent energy market retailer.

In the detailed discussion of the EPC model within the issues paper, the Commission asks two broad questions in the context of its task to consider "the efficient and prudent cost of managing risk in the cost of purchasing electricity".²² The first is whether there are "any recent issues in the wholesale electricity market that would necessitate changes to the wholesale energy purchase cost model."²³ The Commission notes that the "most significant development the model has to deal with is the introduction of a carbon price from 1 July 2012".²⁴ The Commission's analysis of SFE trade data indicates that the introduction of a carbon price has impacted both futures prices and futures trading activity, and suggests that these impacts may require the Forward Price (FP) component of the existing EPC model to be suitably modified.

ActewAGL holds the view that the impact of the introduction of a carbon price on futures prices, in particular, provides a very strong case for changes to be made to the FP component of the EPC model.

- ¹⁹ ICRC 2010, p 7
- ²⁰ ActewAGL 2009, pp 4-5
- ²¹ IPART 2010, p 42
- ²² ICRC 2011, p 8
- ²³ ICRC 2011, p 8
- ²⁴ ICRC 2011, p 9



The FP component of the existing EPC model is evaluated by reference to the average price of electricity futures traded through the Sydney Futures Exchange (SFE). In submissions to the Commission at the time the model was developed, ActewAGL noted that the use of this source before and following the introduction of a carbon price would be problematic.²⁵ The Commission posited that arbitrage between over-the-counter (OTC) and SFE trades should ensure that prices stay closely aligned and it therefore held the view that prices for trades through the SFE, information on which is publicly available, provide a good indicator of prices for futures contracts within the overall wholesale electricity market. Whilst acknowledging the logic of this assumption prior to the introduction of the carbon price, ActewAGL believes that the introduction of a carbon price requires the Commission to reconsider its use of SFE data in 2012-14 determinations.

Specifically, ActewAGL believes that continued use of SFE data in 2012-14 determinations would:

- make impossible the quantification of the underlying value of carbon included in the FP;
- under-recover retailer's carbon cost (contrary to the July 2009 council of Australian Government's (COAG) Amendment to the Australian Energy Market Agreement)²⁶; and
- result in an EPC allowance that fails to fully recover prudent energy purchase costs.

As a practical alternative to use of SFE data for 2012-14 determinations, ActewAGL recommends that the Commission:

- substitute the SFE forward price curve with a third party carbon exclusive curve;
- increase the FP averaging period to 2 3 years in line with a prudent retailer's actual hedging behaviour. If carbon exclusive prices are not available for that period, then the Commission should use as long a period as can be provided by this data; and
- include a separate allowance for carbon based on the industry-standard Australian Financial Markets Association (AFMA) Australian Carbon Benchmark (ACB) addendum.

This is explained in further detail in sections that follow.

²⁵ ActewAGL 2009, p 10

²⁶ Clause 14.17 The Parties agree that, where retail prices are regulated, energy cost increases associated with the Carbon Pollution Reduction Scheme and the Renewable Energy Target shall be passed through to end-use consumers.



The second question asked by the Commission in the issues paper is whether the wholesale EPC model can be improved, with the Commission's discussion focussing on the other major component of the EPC model: the Load Shape (LS) coefficient.

LS is used to estimate the efficient hedging costs of a prudent retailer. The Commission presents a sound case for it to be calculated quarterly rather than on a financial year basis.

ActewAGL notes that this minor change would:

- address the inconsistency in evaluation time periods within the EPC model; and
- at least theoretically, improve the accuracy of the Commission's model.

The impact of carbon on SFE prices

The Commission has assessed that the introduction of a carbon price has increased the price of futures traded through the SFE. Figure 2.1 of the issues paper clearly demonstrates a sharp upward movement in prices following the Australian Government's mid-February announcement of its intention to introduce a carbon price.²⁷ In Figure 2.2 of the issues paper, the Commission shows that further increases in price followed as the introduction of the carbon price became more certain leading up to, and immediately following, the passage of the carbon legislation on 8 November 2011.²⁸

The very significant price movements the Commission observes are evident because the swap contracts traded on the SFE are carbon-inclusive. ActewAGL agrees with the Commission's assessment that the observed increases in futures prices can be seen to be proportional to the market's confidence in the likelihood of the scheme actually commencing.

The sustained uncertainty surrounding the implementation of carbon pricing in Australia led both generators and retailers to take a prudently cautious approach to forward contracting, preferring to trade carbon-exclusive. The AFMA ACB addendum:

- has been established to avoid there being substantial 'winners and losers' from the eventual success or failure of the legislation in the parliament; and, thus
- eliminates this carbon risk to both parties since it takes effect only upon commencement of a Commonwealth statutory carbon scheme.

In its discussion of Figure 2.2 of the issues paper, the Commission notes that, as at the beginning of December 2011, the electricity futures price for the third quarter of 2012 was around \$20/MWh above the price the corresponding quarter of the previous year at the

²⁷ ICRC 2011, p 10

²⁸ ICRC 2011, p 11



same lead time. Whilst ActewAGL sees obvious flaws with this type of comparison (futures prices are a function of a range of variables including weather forecasts, fuel costs and so on) ActewAGL nevertheless acknowledges the essential point being made: that the \$20/MWh difference can be observed to roughly equate to the anticipated cost of carbon, based on the initial fixed carbon reference price of \$23/tonne and the average emissions intensity of electricity within the NEM.²⁹

However, there are fundamental problems associated with FP referencing SFE data:

- at all times prior to December 2011 (at the very earliest) this (carbon) difference is substantially less than a retailer's actual cost for carbon; and, secondly
- the value of included carbon in SFE prices is not quantifiable with any degree of certainty.

ActewAGL sees these issues as critical with respect to the Commission's ability to fully capture the cost of carbon since the existing EPC model evaluates FP over the 23-month period ending 31 May of the financial year preceding the financial year of supply.

It is very clear from Figure 2.2 that futures prices over the 23-month averaging include only a portion of the carbon cost; as a result, the resulting EPC allowance is flawed as it would not fully recover a prudent retailer's actual energy purchase costs.

This would not be a problem for retailers where they had hedged their expected load requirements by purchasing carbon-inclusive contracts through the SFE only. The reality is, however, that the vast majority of electricity futures contracts are traded OTC and are carbon-*exclusive*. The continued use of SFE prices for evaluating FP in the EPC model will **not** provide a good indicator of price levels at which retailers were able to hedge their exposures in 2012-14.

The FP averaging period

Figures 2.5 and 2.6 of the issues paper show the open interest and the cumulative trading volumes for first quarter 2013 as compared to first quarter 2012 and clearly indicate a delay of approximately 7 months between the former and the latter. The Commission has suggested that, as a result, there may be valid reasons for it to consider shortening the averaging period to take account of the lack of distant trading in the market when evaluating the FP component of the EPC model.

This approach might seem reasonable in addressing the issue of significant underrecovery of the carbon cost. However, ActewAGL reiterates the point that prudent retailers generally have been purchasing carbon-exclusive contracts OTC (since, as discussed above, carbon-exclusive contracts have been viewed by both retailers and

²⁹ http://www.aemo.com.au/electricityops/cdeii.html



generators as less risky) and have been building their 2012/13 hedge books over the past 3 years.³⁰

Thus, in summary, implementing a solution based on a significant reduction to the FP averaging period based on the delayed trading activity through the SFE:

- disregards the reality that retailers were actively building their 2012/13 hedge cover with carbon-exclusive swap contracts over the past 2 to 3-year period that the current 23-month FP averaging period approximates; and
- weakens the case that SFE trade data provides a good indicator of price levels at which retailers were able to hedge their exposures in 2012/13.

Proposed changes to the FP component of the EPC model for 2012-14

As a consequence of ActewAGL's assessment of this important matter, ActewAGL recommends that, for the 2012-14 determination, the Commission:

- substitute the SFE forward price curve with a third party carbon exclusive curve (refer to Figure 1);
- increase the FP averaging period to 2 3 years in line with a prudent retailer's actual hedging behaviour - if carbon exclusive prices are not available for that period, then the Commission should use as long a period as can be provided by this data (refer to Figure 1); and
- include a separate allowance for carbon, based on the industry-standard AFMA ACB addendum.

Figure 1 below overlays the forward price curves derived from ICAP, AFMA and *d-cyphaTrade* (SFE) data sets for the 23-month period 1 July 2010 to 31 May 2012. All 3 data sets are carbon-inclusive from 1 July 2010 until the ICAP and AFMA curves are published carbon-exclusive from 1 April 2011 and 4 July 2011, respectively.

After displaying some initial divergence, all 3 data sets converge quite closely in the 2month period leading up to the Australian Government's mid-February announcement of its intention to introduce a carbon price. After 1 April 2011, when the ICAP curve become carbon-exclusive, the AFMA and d-cyphaTrade curves continue to remain highly correlated until the end of May 2011. Since 4 July 2011, when the AFMA curve became carbon-exclusive, both carbon-exclusive curves (AFMA and ICAP) have tracked together very closely. The fact that two independent sources show similar results lends confidence to the robustness of both data sets. Carbon exclusive data from the ICAP source is available from 1 April 2011 providing a 14-month sampling window. The AFMA forward

³⁰ ActewAGL 2009, p 7-8



curve publishes carbon exclusive data from 4 July 2011 providing an 11 month sampling window.

As with SFE data, AFMA and ICAP forward curve data is publicly available by subscription.



Figure 1: Forward price curves for 2012/13 from ICAP, AFMA and d–cyphaTrade

ActewAGL recommends that the third party carbon exclusive portfolio purchase price for 2012-14 be based on ICAP data for the available period. An allowance for carbon should be based on the AFMA ACB addendum, that is, the NEM-average carbon intensity multiplied by a carbon reference price:

- setting the carbon reference price (CRP) based on the fixed carbon price in the *Clean Energy Act 2011* (\$23 per tonne in 2012/13); and
- basing the average carbon intensity (ACI) on the average emissions intensity of sent out generation in the NEM over a full year (to capture seasonality).



Since 19 June 2011 AEMO has published³¹ a Carbon Dioxide Equivalent Intensity Index (CDEII) for sent-out generation in the NEM. Background information and its calculation methodology are available from the AEMO website.³²

In determining an appropriate year-averaged ACI for the 2012/13 price direction, ActewAGL advocates that averaging AEMO's published CDEII over the period 19 June 2011 to 31 May 2012 (348 days) provides a practical, yet representative, alternative.

Energy contracting costs

ActewAGL supports the Commission's view that this cost component be adjusted to reflect the change in the consumer price index (CPI).

Green costs

ActewAGL supports the Commission's view that, where government imposed obligations aimed at achieving environmental outcomes impose a legitimate cost on *electricity retailers,* they should be included in the green cost component of the cost build-up.³³ ActewAGL proposes that, as has been the case in previous years, all Green costs incurred over the 2012-14 period are passed through in prices. At this stage, ActewAGL anticipates compliance costs under the following schemes:

- Renewable Energy Target (RET);
- ACT energy efficiency scheme; and
- the ACT Feed-in Tariff.

ActewAGL understands that the ACT Greenhouse Gas Abatement Scheme (GGAS) will cease to operate upon commencement of a Commonwealth statutory carbon scheme.

Costs arising from RET

ActewAGL anticipates incurring significant costs in meeting retail obligations established under the Australian Government's expanded Renewable Energy Target (RET). From 1 January 2011 the RET scheme was split into two components:

 a Large-scale Renewable Energy Target (LRET) - supporting large renewable generators; and

³¹ http://www.aemo.com.au/electricityops/cdeii.html

³² AEMO, '*Carbon Dioxide Equivalent Intensity Index Procedure*', Version 1.00 (2010) available at http://www.aemo.com.au/electricityops/0910-0009.pdf

³³ ICRC. 2011. p 16



• a Small-scale Renewable Energy Scheme (SRES) – supporting small renewable generators.

The Commission's task of setting appropriate allowance(s) for cost recovery under RET is complicated by the fact that retailer obligations under the scheme are not entirely certain at the time a price determination is made. To address the very significant regulatory risk of over or under-recovery in a given price determination period, ActewAGL supports the continuation of adjustments to a previous year's cost to be applied to the subsequent determination.

With respect to small-scale technology certificates (STCs), for the 2011/12 determination, the Commission assessed compliance costs under SRES with reference to the \$40 per certificate price guaranteed by the Australian Government. ActewAGL notes this was consistent with regulators in all other major jurisdictions and should be continued for price directions in 2012-14.

Uncertainty with future compliance obligations under LRET and SRES

As mentioned above, from 1 January 2011 the RET scheme was split into two components: one to support large-scale generation and a second to support small-scale generation.

The obligation under LRET is underpinned by the parameter known as the Renewable Power Percentage (RPP) which specifies the proportion of electricity that must be supplied from large-scale renewable generators. Similarly, under SRES, the Small-scale Technology Percentage (STP) specifies the proportion of electricity that must be supplied from small-scale renewable generators.

Both the LRET and SRES schemes operate across a calendar year and the Office of the Renewable Energy Regulator (ORER) is required to publish official RPP and STP percentages for a given compliance year by 31 March of that year. Under SRES, ORER also publishes *non-binding* estimates for the following two compliance years. In contrast, ORER is not required to publish non-binding estimates for future RPPs under LRET.

LRET includes provisions to provide partial exemptions to reduce liability for electricity used in defined emissions-intensive trade-exposed (EITE) activities. Future RPPs are based on total annual renewable generation targets and, therefore, should be predictable with certainty. The provision for partial exemptions, however, has an adjustment effect on the RPP and for this reason some uncertainty is attached to future RPPs.

For SRES, the STP for a given compliance year is based, unlike LRET, on forecast Small-scale Technology Certificate (STC) creation for that year *plus* banked certificates at the end of the previous year. Future STPs are highly uncertain as certificate creation is difficult to forecast as it is function of many variables including: solar panel and inverter



costs; the value of the Australian dollar; electricity prices, and, the availability of government incentives such as feed-in tariffs.

Provision for adjustments to SRES and LRET cost recovery

To address the significant risk of over or under-recovery of RET compliance costs, the Commission, in previous price directions, based allowances for cost recovery on the best available estimates of the RPP and STP at the time of the determination, with a provision for adjustments to be applied to the green costs in the following year. ActewAGL strongly supports a continuation of this approach. In 2011/12 the Commission determined allowances for:

- LRET compliance based on ORER's official 2011 RPP (5.62 per cent) and ActewAGL's estimated 2012 RPP (8.62 per cent).
- SRES compliance based on ORER's official 2011 STP (14.8 per cent) and ORER's non-binding estimate 2012 STP (16.75 per cent).

The most recent non-binding estimates of ORER (16 December 2011) forecast 2012 and 2013 STPs at 23.95 per cent and 7.87 per cent respectively. ActewAGL's current estimates for 2012 and 2013 RPPs are 8.8 per cent and 9.6 per cent respectively. It is necessary that the Commission allow for market adjustments to 2011/12 LRET and SRES costs to be applied in the 2012/13 determination as provided in the 2010-12 determination but adjusted for the time-value-of-money.

Model to estimate retailer LGC certificate costs

In the 2011/12 determination, the Commission moved to a market-based approach to establish prices for large-scale generation certificates (LGCs). ActewAGL encourages the Commission to consider the long run marginal cost (LRMC) of large-scale renewable generation as a proxy for the REC price.

The largest acquirers of RECs are retail companies subject to compliance targets under the RET. Retailers of any significant size cannot rely on securing the volume of RECs they are required to surrender on the open market.

In order to provide certainty of meeting their RET obligations, retailers enter into contracts with renewable projects under long term PPAs, to underwrite the development of renewable plant.

If the Commission is predisposed towards a "market-based" model (rather than an LRMC based approach), it should at the very least consider:

- 1. referencing publicly available closing prices of LGCs traded in a liquid market;
- 2. incorporating retailer holding costs (approximately 10 per cent);



- 3. making appropriate allowances to recover costs associated with volume risk, liquidity risk, delivery risk and regulatory risk (approximately 7.5 per cent); and,
- 4. sampling LGC prices so as to reflect a retailer's approach to hedging their liabilities.

The data referenced by this model must be sourced from a sufficiently liquid market and the source disclosed (to ensure model output is replicable).

The model must make appropriate allowances for risks involved with purchasing certificates through the market:

- Volume risk is the risk that a retailer over or under-hedges its requirements due to changes in customer load;
- Liquidity risk is the risk there is insufficient liquidity in the market and the retailer cannot purchase at the regulator's assumed price;
- Delivery risk is the risk associated with third parties that retailers forward contract with failing to fully deliver agreed volumes. If this happens, then retailers may be caught short and forced to buy associated shortfalls from liquid markets at potentially premium prices; and
- Regulatory risk in this context is the risk associated with cost recovery being based on uncertain future obligations (RPP and STP) that give rise to both volume and liquidity risks.

ActewAGL encourages the Commission to consult with the industry on the development of any model for estimating LGC cost.

Costs arising from the proposed ACT energy efficiency scheme

The ACT Government has indicated its intention to implement an ACT energy efficiency scheme with this scheme expected to be implemented within the 2012-14 determination period. The Commission has acknowledged that ActewAGL will incur costs as a consequence and intends to reflect these costs in the Green cost model as appropriate.

ActewAGL understands that the proposed ACT energy efficiency scheme would oblige ActewAGL to undertake energy efficiency measures in households and small businesses. Finer details in relation to the scheme's design, operation and expected costs remain unclear to ActewAGL. ActewAGL proposes that all costs incurred by ActewAGL under the proposed scheme be passed-through as a Green cost item within the period of the next price direction.



Market (NEM) fees

ActewAGL supports the Commission's position that the existing method for determining NEM fees, by way of an annual CPI adjustment, should remain unchanged for the next regulatory period.

Energy losses

ActewAGL supports the Commission's view that the existing method for determining transmission and distribution losses of using loss factors published by the Australian Energy Market Operator (AEMO) should remain in place for the next regulatory period.

Retail operating costs

The retail operating costs allowance should continue to be adjusted by CPI each year.³⁴

Customer acquisition costs

ActewAGL has maintained over several TFT reviews that customer acquisition and retention activities impose legitimate costs borne by ACT electricity retailers which should be incorporated in the benchmark market assessment determined by the Commission. ActewAGL considers that the Commission's total ROC allowance is insufficient, to the extent that the Commission does not allow these costs, for an electricity retailing business operating in a fully competitive market. ActewAGL has previously pointed out that spending on acquisition and retention of customers is a necessary and efficient cost borne by retailers.

The Commission states in the issues paper that:

the distinction between basing the regulatory approach on the efficient costs of an incumbent business and basing costs on a new entrant would face largely comes down to whether to include an allowance for recovery of customer acquisition costs (CAC) or customer acquisition and retention costs (CARC).³⁵

Later in the issues paper, the Commission confirms its intended approach to the treatment of customer acquisition and retention costs in saying:

The Commission's view is that if it were determining the efficient cost of a new entrant retail electricity business, it might be appropriate to include this component

³⁴ ICRC 2011, p 17

³⁵ ICRC 2011, p 6



[CAC/CARC] in total retail costs. However, this is not the Commission's objective. The Commission is determining the efficient costs of the incumbent retailer.³⁶

The AEMC review notes that, in past determinations, the Commission has considered providing a CARC/CAC allowance in its cost build-up, but did not do so because of its legislative requirements and ToR.³⁷

As discussed earlier in this submission (under *Regulatory approach*) the current ToR do not constrain the Commission to consideration of the efficient costs of the incumbent, nor do they prevent the Commission from setting the TFT, as recommended by the AEMC, in line with the costs of a single fuel mass market entrant.

A report prepared for the AEMC by the Allen Consulting Group (ACG) found that the "effective retail margin is still significantly below that used in other jurisdictions"³⁸ and specifically recommended modification to the ICRC approach. The AEMC concluded as a result that, "the ACT's 2010-11 retail cost allowance is relatively low compared to other jurisdictions."³⁹ The AEMC further note the need for retailers to be able to cover costs and earn a return commensurate with the risks involved in operating in the market.⁴⁰

Currently all States and Territories, except Victoria, have price regulation in the electricity retail market. NSW, Queensland, South Australia (SA) and the ACT are the only jurisdictions with price regulation and FRC. The Commission is the only regulator in these jurisdictions not to include CARC in the regulated price where the market is fully open to competition. Tasmanian regulator (OTTER) also does not include CARC in the regulated price; however Tasmania does not yet have full retail contestability (consumers using less than 50 MWh/annum are not yet contestable).

The Commission has argued that "artificially increasing the TFT (on the basis that it may result in vigorous competition) do not outweigh the potential negative impacts, which may include higher prices in the short term"⁴¹ but also "broadly accepts the views of other retailers that the level of the TFT makes it more difficult for them to cover costs and enter the market than in other jurisdictions."⁴² However, although a low regulated price may be beneficial to consumers in the short run, in the long run consumers are better served by a market free of regulatory constraint that encourages a broad range of market offerings.

- ³⁶ ICRC 2011, p 17
- ³⁷ AEMC 2010, p 26
- ³⁸ ACG 2010, p 19
- ³⁹ AEMC 2010, p 64
- ⁴⁰ AEMC 2011, p 66
- ⁴¹ ICRC 2010, p 54
- ⁴² ICRC 2010, p 52



Network and transmission costs

ActewAGL agrees with the Commission's position that the existing arrangement, whereby the network and transmission costs incurred by ActewAGL are passed through in retail prices, should remain in place for the forthcoming regulatory period.

Retail margin

The retail margin represents the return that a retailer requires in order to attract the necessary capital to provide retail services. The retail margin should be commensurate with risks associated with providing retail energy services and should reflect the systematic risk faced by retailers.

In its 2010-11 decision, the Commission took into account the analysis on the retail margin carried out by the Strategic Finance Group (SFG) for IPART's NSW review, and determined that the retail margin in the ACT would be increased from 5.0 per cent to 5.4 per cent.

In determining this retail margin, the Commission decided to give equal weight to the three approaches applied by SFG, in this way mirroring the approach taken by IPART with respect to the NSW retailers. However, IPART in addition determined a substantially higher energy purchase cost allowance for NSW retailers than that allowed to ActewAGL by the ICRC (IPART minimised the risks to NSW retailers by using LRMC as a floor for the EPC).

Had the Commission applied the NSW approach to determining energy purchase costs, it might then have been valid to apply the NSW approach to determining the margin. However, the Commission uses a market based approach to determining the energy purchase costs and should therefore apply a market based retail margin.

The SFG report shows that eight energy retail business segments in Australia, comprising 20 data points in each case, had a median EBITDA⁴³ margin of 5.9 per cent.⁴⁴ Using the international sample of 269 firms (in Australia, United Kingdom and the United States) the EBITDA margin estimated by SFG is 6.4 per cent to 6.9 per cent with a mid-point of 6.7 per cent.⁴⁵

Based on this information, ActewAGL maintains that a margin of at least 6 per cent is required to provide retailers with commercially adequate returns consistent with market benchmarks.

⁴³ Earnings before interest, tax, depreciation and amortisation

⁴⁴ SFG Consulting 2009, p 26

⁴⁵ IPART 2010, p 107



Cost pass-through arrangements

As part of its review, the Commission has said it will consider the necessity of maintaining pass through arrangements, the set of allowable events and the level of the materiality threshold.⁴⁶

ActewAGL believes that pass-through arrangements that applied from 2010-12 need to remain in place so that retailers do not bear the risk of unforeseeable or uncontrollable costs during the regulatory period. ActewAGL further supports the continued allowance for a mid-year pass-through adjustment in order to minimise the impact of cost changes on prices by distributing them among customers earlier and over a longer term.

ActewAGL believes that the Commission should again allow pass-throughs for regulatory change and tax change events as defined in the 2010-12 final decision and below and notes that IPART includes the same pass-through arrangements in its 2010-13 retail electricity price determination for NSW.⁴⁷

Regulatory Change Event

The following definition of a regulatory change event taken from the 2010-12 decision remains relevant for the 2012-14 regulatory period.

A regulatory change event is a decision made on or after 11 June 2012 by any 'Authority' (any government or any minister, agency department, instrumentality or other authority of government and the Commission, the AEMC, the AER or the AEMO) which has the extent of materially varying the nature, scope, standard or risk of providing services to regulated retail tariff customers, or the manner in which those services are provided.⁴⁸

ActewAGL expects that the regulatory change event would encompass obligations in respect of:

- any customer hardship program
- retailer of last resort events
- green energy schemes including the proposed ACT energy efficiency scheme and the Carbon Pricing Mechanism although these are dealt with in the green cost component of the TFT costs build-up (see discussion of Green Costs and EPC above).

⁴⁶ ICRC 2011, p 19

⁴⁷ IPART 2010, p 23

⁴⁸ ICRC 2010, p 67



- changes in distribution or transmission charges although this is discussed as part of the TFT costs build-up in the relevant sections above.
- changes to the ACT Government's feed-in tariff scheme in relation to the extension of that scheme to generators with a capacity greater than 30 kW

The ToR for the current review direct the Commission to examine and pass-through the costs of government policies:

The impact on direct electricity costs of changes in government policies and pass through of those costs to regulated prices including, but not restricted to:

- (i) the Commonwealth Government Carbon Tax;
- (ii) Commonwealth or ACT retailer obligation energy efficiency schemes;
- (iii) the Commonwealth Government's Large and Small Renewable Energy Targets;
- (iv) the ACT Feed-in Tariff; and
- (v) any other schemes to address climate change.⁴⁹

The cost of the policies need to be reflected in the end user's cost of energy as is reflected in the requirement of the Australian Energy Market Agreement of the Council of Australian Governments that such costs in regulated energy prices be the passed through in full.

The additional energy cost created by the Australian Government's carbon price package is addressed through compensation available to households through the tax and welfare systems. In addition to this, energy rebates are payable to identified groups in the ACT and ActewAGL has in place a number of measures to assist customers having difficulty paying their energy bills.

The ACT Feed-in Tariff operates through the electricity distributor in the ACT regulated by the Australian Energy Regulator. ACT retailers bear costs associated with the administration of the Feed-in Tariff scheme, the relevant part of which ActewAGL should be able to pass through in the TFT.

Tax Change Event

The following definition of a regulatory change event taken from the 2010-12 decision remains relevant for the 2012-14 regulatory period.

⁴⁹ Barr 2011, ToR 1.a.



A tax change event means the imposition of a relevant tax, the removal of a relevant tax, or a change in the way a relevant tax is interpreted or calculated. A relevant tax is any tax, levy, impost, deduction, charge, rate, duty or withholding tax which is levied on ActewAGL Retail by any Authority (as defined above) and is payable by ActewAGL Retail, other than:

- income tax and capital gains tax
- stamp duty
- AEMO fees
- fees payable by ActewAGL Retail in respect of its retail licence
- penalties, charges, fees and interest on late payments, or deficiencies in payments, relating to any tax
- any tax that replaces or is equivalent or similar to any of the taxes referred to above (including any state-equivalent tax).⁵⁰

Materiality

For the 2010-12 period, the Commission adopted as a materiality threshold for pass through claims of 0.25 per cent of the previous year's revenue from franchise customers.⁵¹ ActewAGL maintains its position from the 2010-12 review that a materiality threshold is unnecessary since the administrative cost burden of applying to the Commission for recovery of a pass through amount provides sufficient incentive against ActewAGL seeking pass through unless costs are material.⁵² As all the proposed pass through events are related to events outside of ActewAGL's control, it would be unreasonable for a materiality threshold to apply such that ActewAGL is required to bear the risk and face a cost burden for material pass through events occurring in a fully open market environment.

⁵² ActewAGL 2010, p 21

⁵⁰ ICRC 2010, p67

⁵¹ ICRC 2010, p 60



Mid-term review arrangements

The Commission has not addressed in the issues paper "provision where appropriate for a review by 30 June 2013" as specified in the ToR.⁵³ This is an important component that requires clear specification. ActewAGL believes that it would be appropriate to reapply the adjustment mechanism determined by the Commission for the 2011/12 mid-term review. This would be consistent with the Commission's overarching strategy of maintaining the current methodology and approach where possible.

ActewAGL believes that, for 2013/14, the TFT parameters should be set as follows:

- Network costs should be passed through to customers;
- EPC would be calculated according to the existing purchase cost model, with adjustments as proposed for 2012/13 for the impact of the introduction of carbon price on energy prices and using an averaging period of 2-3 years in line with a prudent retailer's actual hedging behaviour or as long a period as can be provided by the data;
- Green costs to be calculated to ensure full cost-pass through;
- Energy contracting costs, NEM fees, ROC and CARC should be increased by CPI;
- Energy losses should be adjusted for the relevant AEMO published loss factors; and
- Retail margin to remain fixed at the market reflective level of at least 6 per cent.



List of abbreviations

Abbreviation	Meaning
ACI	average carbon intensity
ACB	Australian Carbon Benchmark
ACG	The Allen Consulting Group
ACT	Australian Capital Territory
ActewAGL	ActewAGL Retail partnership
AEMC	Australian Energy Market Commission
AEMO	Australia Energy Market Operator
AFMA	Australian Financial Markets Association
CA	carbon adjustment
CAC	customer acquisition costs
CARC	customer acquisition and retention costs
CDEII	Carbon Dioxide Equivalent Intensity Index
CPI	consumer price index
CRP	carbon reference price
EBITDA	earnings before interest, tax, depreciation and amortisation
EITE	emissions-intensive trade-exposed
EPC	energy purchase cost
ESAA	Electricity Supply Association of Australia
FP	forward price
FRC	full retail contestability
GGAS	Greenhouse Gas Abatement Scheme
ICRC	Independent Competition and Regulatory Commission
LS	load shape
IPART	Independent Competition and Regulatory Tribunal of NSW
LGC	large-scale generation certificate
LRET	Large-scale Renewable Energy Target
LRMC	long run marginal cost
NEM	National Electricity Market
NSW	New South Wales
ORER	Office of the Renewable Energy Regulator
OTC	over-the-counter
QCA	Queensland Competition Authority
Qld	Queensland
RET	Renewable Energy Target
ROC	retailer operating costs
RoLR	retailer of last resort
RPP	Renewable Power Percentage



Abbreviation	Meaning
SA	South Australia
SFE	Sydney Futures Exchange
SFG	Strategic Finance Group Pty Ltd
STC	small-scale technology certificate
STP	Small-scale Technology Percentage
SRES	Small-scale Renewable Energy Scheme
TFT	Transitional Franchise Tariff
ToR	terms of reference
WA	Western Australia



References

ActewAGL 2010, ActewAGL Retail Response to Independent Competition and Regulatory Commission Draft Decision: Retail Prices for Non-contestable Electricity Customers 2010-2012, May

______ 2009, Model for Determining the Energy Purchase Cost Component of the Transitional Franchise Tariff: ActewAGL Retail response to ICRC draft technical paper, October

The Allen Consulting Group (ACG) 2010, *Review of the effectiveness of competition in the electricity retail market in the ACT – price and profit margin analysis*, July

Australian Energy Market Commission (AEMC) 2011, Stage 2 Final Report – Review of the effectiveness of competition in the electricity retail market in the ACT, March

_____ 2011a, Strategic Priorities for Energy Market Development: Discussion Paper

_____ 2010, Stage 1 Final Report, Review of the effectiveness of competition in the electricity retail market of the ACT, November

Barr, Andrew MLA, Treasurer 2011, Australian Capital Territory, *Independent Competition and Regulatory Commission (Price Direction for the Supply of Electricity to Franchise Customers) Terms of Reference Determination 2011*, Disallowable instrument DI2011-261, 21 September

Corbell, Simon MLA 2011, Minister for the Environment and Sustainable Development, Australian Capital Territory "ACT to keep electricity price regulation for Canberra households", *Media* Release, 5 September

Council of Australian Governments (COAG) 2009, Notice of amendment to the Australian Energy Market Agreement, 2 July

Deloitte 2009, Verve Energy Review, Commissioned by the WA Minister for Energy

Energy Supply Association of Australia (ESAA) 2011, *Review of Regulated Retail Electricity Tariffs and Prices—Issues Paper*

2011a, Inquiry into the Efficiency of Synergy's Costs and Electricity Tariffs

Federal Energy Regulatory Commission (FERC) 2003, *Final Report on Price Manipulation in Western Markets.*

Government of WA Office of Energy 2009, *Electricity Retail Market Review, Final Recommendations Report, Review of Electricity Tariff Arrangements*, Office of Energy Report to the Minister for Energy



Independent Competition and Regulatory Commission (ICRC) 2011, *Issues Paper: Retail Prices for Non-contestable Electricity Customers 2012-14*, December

_____ 2010, Final Decision: Retail prices for non-contestable electricity customers 2010–12, June

Independent Pricing and Regulatory Tribunal (IPART) 2010, *Final Determination: Review of regulated tariffs and charges for electricity* 2012 – 2013, March

_____ 2009, Issues Paper: Review of regulated retail tariffs and charges for electricity 2010 – 2013, July

Strategic Finance Group (SFG Consulting), 2009, *Estimation of the regulated profit* margin for electricity retailers in New South Wales

Verve Energy 2009, Annual Report 2008/09