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AGL

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The Independent Competition and Regulatory Commission
GPO Box 296
CANBERRA CITY ACT

By email: icrc@act.gov.au

Dear Commissioners,

Issues Paper – Retail prices for franchise electricity customers from 1 July 2014, October 2013

AGL welcomes the opportunity to comment on the Independent Competition and Regulatory Commission (**ICRC**)'s Issues Paper (the **Issues Paper**) on *Retail prices for franchise electricity customers from 1 July 2014*.

ActewAGL is the franchise electricity retailer in the ACT. AGL is a joint venture partner in ActewAGL Retail but does not directly retail electricity in the ACT.

AGL's comments on a number of points raised in the Issues Paper are provided below.

Regulatory approach

Weighted average price cap

AGL supports the continuation of the weighted average price approach for setting regulated prices. This allows the standard retailer to adjust prices in a more cost reflective manner and is also consistent with IPART's approach.

Length of the regulatory period

AGL considers that a regulatory period should be no more than three years. If the current price model is continued to be used, the inputs to the model will required to be updated annually in any case. Setting a regulatory period more than a year however will 'lock in' other components of the cost stack, namely, retail costs and retail margin. The risk of a regulatory period of more than one year is that benchmark for retail costs and retail margin may not remain a relevant benchmark.

Cost pass-through arrangements

AGL considers that cost pass through arrangements are an integral part of a regulated pricing framework to enable retailers to recover unplanned and uncontrollable costs. However, AGL recommends that the materiality threshold should be removed as the administrative costs of preparing and supporting an application will impose a commercial threshold.

The cost pass-through arrangements, subject to timing issues, can be an appropriate mechanism for ensuring that regulated prices can be amended in the event that the carbon pricing mechanism is repealed during the regulatory period.

Energy purchase cost

The ICRC has raised three specific issues relating to its energy purchase cost model (EPC model):

- whether the EPC model is still relevant,
- use of forward contract prices instead of futures prices, and
- whether to consider long run marginal cost (LRMC).

EPC model

The EPC model uses a market based approach to determine wholesale energy costs. It has been used by the ICRC since 2010 with adjustments in 2012. Whilst AGL continues to promote the use of LRMC, if the ICRC prefers to use a market based approach, in AGL's view, the ICRC should continue to apply this model and any adjustment factors for consistency.

The ICRC considers the hedging strategy applied in the EPC model is conservative by assuming purchasing of forward contracts in excess of the historical maximum load. In AGL's view, it is reasonable that this approach is taken in setting a regulated price which will in effect become the price cap or the maximum price in an FRC environment. AGL notes that while a particular hedging strategy might be considered 'conservative', the assumption that the incumbent retailer would hedge its entire load through a single market (i.e. futures or OTC contracts) does not represent a conservative approach to modelling retail portfolio risk.

The EPC model is dependent on the historical load shape and load ratio. Due to the increase in rooftop solar installations in the ACT, the ACT Net System Load Profile (NSLP) data shows that the retail load is getting peakier especially in Quarter 1. AGL notes that the load ratio, which measures the peakiness of the retail load, has been increasing over a medium term trend, although there are significant changes from one year to another depending particularly on weather conditions. In AGL's view, the increasing peakiness should be allowed for in the EPC model.

Carbon uncertainty and the forward price

Given the continuing uncertainty over the future price on carbon and the necessary legislative changes, AGL considers that it is appropriate to continue to use forward contract prices which are carbon exclusive plus an adjustment for the carbon price. This will provide flexibility when dealing with any pass-through arrangements associated with any change in existing carbon legislation.

LRMC

As in previous submissions to the ICRC, AGL maintains that a long run marginal cost (LRMC) model is the preferred methodology for setting the EPC for the purpose of setting a regulated retail price. The LRMC model better reflects the costs which a vertically integrated retailer would incur and will also provide more stable wholesale energy costs.

LRET

AGL is of the view that in determining the cost allowance for LRET, the ICRC should consider the range of costs that would be experienced by a retailer sourcing LGCs. They will not only be sourced from the market. Therefore AGL considers, that, in setting the allowance for the cost of compliance with the LRET scheme, using the LRMC of compliance with the scheme is the most appropriate approach in setting the LRET allowance within the regulated retail electricity price.

SRES

AGL notes that the nature of the SRES makes it very difficult for regulators to accurately forecast an SRES allowance for a future period. AGL does not support the use of market prices to set a future cost of scheme compliance for retailers. Numerous changes in the market and other regulatory decisions have meant that fundamentals of the STC market have changed over time. In recent months, the STC has tended toward the $40/STC clearing house price indicating that the final STP is more likely to clear the market of certificates.

Retail operating costs

The ICRC has raised two key issues relating to retail operating costs (ROC):

- Objective of regulation and whether a headroom allowance is required over and above efficient retail operating costs to promote competition in a regulated market, and
- Whether there are economies of scale in the provision of retail electricity services.

These issues are considered below.

Objective of regulation

Full retail contestability (FRC) commenced over 10 years ago in the retail electricity market in ACT from 1 July 2003. However, retail electricity prices for small customers have continued to be regulated. In AGL's view, it is fundamentally contradictory to have a policy of FRC and continued price regulation based on benchmark costs which precludes the entry of competition in the market.

In November 2012, the Standing Committee on Energy Reforms (SCER) in a report to COAG has expressed support for "the need for retail energy markets characterised by strong competition that offer innovative products and services to the benefit of consumers".

The objective of regulation should be considered in the context of FRC and the long term interests of consumers. In recent determinations, IPART and QCA have considered this issue.

In the 2013 review of retail electricity prices, IPART has stated:

> *"In our view the best way to support the long-term interests of consumers is by facilitating increased competition in the market. We consider an effectively functioning competitive market offers customers the best protection from higher than efficient prices in the short term. It can also deliver better customer outcomes in the long term, including better 'value for money' service through reduced costs and/or innovation.*
>
> *... In our view, the focus for regulators, consumer groups and Governments in this context should be on promoting competitive market conditions rather than determining market outcomes.*
>
> *However, for such a competitive market to develop while regulation exists, regulated prices must be high enough to create incentives for retailers to enter the market and compete for customers, and for customer to seek out better offers in the competitive market. If regulated prices are set too low – for example, to recover the short-term efficient costs of supply only – the incentives may not be sufficient for retailers to contest customers and for customers to enter into the market."*[1]

Similarly, the QCA has considered its role in setting notified (regulated) prices:

> *"... the Authority considers that part of its role in setting notified prices is to provide a transition to effective competition and eventual price deregulation ...*
>
> *Notified prices may provide a level of protection for customers until the Government is satisfied that competition provides a sufficient constraint on prices such that price regulation is no longer required. In the meantime, the Authority considers that notified prices should not act as a constraint on the development of effective competition. In particular, the Authority considers that notified prices should not act as a barrier to retailers entering the market and competing vigorously to acquire and retain customers. Notified prices should also encourage customer to exercise market choice and seek out the best deal in the competitive market. Greater customer engagement should further*

[1] Review of regulated retail prices and charges for electricity from 1 July 2013 to 30 June 2015, Electricity – Final Report, June 2013, IPART, p 25

incentivise retailers to compete vigorously to make the best offers to attract and retain customers."[2]

Based on IPART and QCA's considerations, it can be concluded that the regulated prices should be set at levels that promote competition which is in the long term interests of consumers. In adopting this view, there is acknowledgement by IPART and QCA that regulated prices will need to be sufficiently high to provide an incentive for new retailers to develop offers that will encourage customers to switch.

This objective to price regulation is also consistent with the AEMC's recommendation[3]:

> *"In promoting the long-term interests of customers, retail price regulation should determine electricity prices for small customers, which:*
>
> - *Reflect the efficient costs of providing retail electricity services; and*
> - *Facilitate the development of competition in retail electricity markets, where competition may be feasible."*

Definition of a benchmark retailer, CARC and headroom allowance

The ICRC has stated in the Issues Paper that by using the incumbent retailer benchmark, rather than that of a mass market new entrant, has resulted in the exclusion of costs associated with customer acquisition and retention (CARC) and a headroom allowance. However, IPART and QCA's approaches have shown that this definition of a retailer does not mean that CARC and headroom allowance should be excluded.

IPART[4] and QCA[5] have defined the benchmark retailer in similar ways. Both have considered the benchmark retailer to have the following characteristics:

- an incumbent retailer that has achieved economies of scale (i.e. has efficient costs)
- a standalone retailer that is not vertically integrated,
- serves retail customers across the NEM,
- has a mix of regulated and market contract customers.

Despite defining the retailer as an incumbent, IPART and QCA have allowed for CARC and headroom allowance, although each regulator has considered them in a different way.

IPART has explicitly used the CARC allowance as the mechanism for ensuring that regulated prices are set at a level that facilitates the continued development of competition. In the 2013 review, IPART[6] has redefined the CARC allowance by combining two components:

- direct acquisition cost of around $150 per new customer or approximately $40 per customer per annum, and
- indirect cost in terms of ongoing market discount of around 8% off regulated prices (usage rate only)

To recover these costs over 4 years, IPART assessed that regulated prices would need to be approximately $29/MWh above the short-term efficient cost of supply.

QCA has treated the direct acquisition cost as CARC while the indirect cost is comparable to the headroom allowance. For 2013-14, the QCA has allowed a CARC of $44.25 per customer after maintaining the CARC allowance used in the previous year. The QCA has maintained a headroom allowance of 5% since its 2012-13 determination. In comparison, IPART's indirect cost of 8% off the usage rate represents a discount of about 7% off the total bill.

Therefore, IPART and QCA are consistent in that the acquisition costs and headroom allowance are included when setting regulated retail prices.

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[2] Final Determination – Regulated Retail Electricity Prices 2013-14, May 2013, QCA, p 56

[3] Final Report – Advice on best practice retail price methodology, 27 September 2013, AEMC, p 19

[4] IPART, ibid, p 99

[5] Final Determination – Regulated Retail Electricity Prices 2012-13, May 2012, QCA, p 53

[6] IPART, ibid, p 117

Similarly, the AEMC has recommended that the ROC be based on the incumbent retailer "who is required to offer the regulated retail price in a particular jurisdiction"[7] plus the inclusion of a headroom allowance:

> *"The Commission considers that effective competitive markets are generally the best means of promoting customers'' long-term interests. For competitive prices to develop, regulated retail prices must not create barriers to retailers efficiently entering the market and competing for customers. Accordingly, where jurisdictions consider competition to be feasible, a form of "headroom" should be included to facilitate competition."*[8]

The competition allowance will also "reflect increased retail operating costs that new entrants face, largely driven by increased marketing costs..."[9]. Therefore, the competition allowance is similar to the CARC allowance set by IPART in 2013.

Economies of scale

As the incumbent retailer, ActewAGL has about 150,000 small electricity customers in the ACT. In contrast, the incumbent retailers in NSW (Origin Energy and EnergyAustralia) have over 1 million electricity customers in NSW. AGL, who is not an incumbent retailer in NSW, has acquired over 700,000 small electricity customers in NSW by June 2013.

Including natural gas customers, in total, the three largest retailers in Australia have the following number of customers nationally at June 2013:

- Origin Energy 3,961,000
- AGL Energy 3,517,000
- Energy Australia 2,848,000

In comparison, including natural gas customers, ActewAGL has less than 300,000 customers in the ACT and NSW country regions. This is less than a tenth of the customer base of each of the two largest retailers.

Both IPART and QCA have defined the benchmark retailer as an incumbent retailer. Given that the ICRC has also defined the retailer as an incumbent, to be consistent, the ROC allowance for the ACT must be significantly higher than the IPART and QCA's benchmarks as the small customer base in the ACT will not have similar economies of scale.

Retail margin

In the 2013 review, IPART has increased the retail margin allowance to 5.7%. The QCA has adopted the same retail margin allowance for 2013/14.

In AGL's view, in relation to the retail margin allowance, there is merit in maintaining consistency with regulatory benchmarks in NSW and QLD.

If you have any questions in relation to this submission, please contact me on (02) 9921 2221 or mgoh@agl.com.au.

Yours sincerely,

Meng Goh
Manager Regulated Pricing

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[7] AEMC, ibid, p 59
[8] AEMC, ibid, p iv
[9] AEMC, ibid, p 81