

ISSUES PAPER

Standing offer prices for the supply of electricity to small customers from 1 July 2024

Report 5 of 2023, August 2023



The Independent Competition and Regulatory Commission is a Territory Authority established under the *Independent Competition and Regulatory Commission Act 1997* (the ICRC Act). We are constituted under the ICRC Act by one or more standing commissioners and any associated commissioners appointed for particular purposes. Commissioners are statutory appointments. Joe Dimasi is the current Senior Commissioner who constitutes the Commission and takes direct responsibility for delivery of the outcomes of the Commission.

We have responsibility for a broad range of regulatory and utility administrative matters. We are responsible under the ICRC Act for regulating and advising government about pricing and other matters for monopoly, near-monopoly and ministerially declared regulated industries, and providing advice on competitive neutrality complaints and government-regulated activities. We also have responsibility for arbitrating infrastructure access disputes under the ICRC Act.

We are responsible for managing the utility licence framework in the ACT, established under the *Utilities Act 2000* (Utilities Act). We are responsible for the licensing determination process, monitoring licensees' compliance with their legislative and licence obligations and determination of utility industry codes.

Our objectives are set out in section 7 and 19L of the ICRC Act and section 3 of the Utilities Act. In discharging our objectives and functions, we provide independent robust analysis and advice.

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Correspondence or other inquiries may be directed to the commission at the following address:

Independent Competition and Regulatory Commission
PO Box 161
Civic Square ACT 2608

We may be contacted at the above address, or by telephone on (02) 6205 0799. Our website is at www.icrc.act.gov.au and our email address is icrc@act.gov.au.

How to make a submission

This issues paper provides an opportunity for stakeholders to give feedback and evidence to inform the direction and outcome of the investigation. It will also ensure that relevant information and views are made public and brought to the commission's attention.

Submissions on the issues paper close on **31 August 2023**.

Submissions may be mailed to the commission at:

Independent Competition and Regulatory Commission
PO Box 161
Civic Square ACT 2608

Alternatively, submissions may be emailed to the commission at icrc@act.gov.au. The commission encourages stakeholders to make submissions in either Microsoft Word format or PDF (OCR readable text format – that is, they should be direct conversions from the word-processing program, rather than scanned copies in which the text cannot be searched).

For submissions received from individuals, all personal details (for example, home and email addresses, and telephone and fax numbers) will be removed for privacy reasons before the submissions are published on the website.

The commission is guided by the principles of openness, transparency, consistency and accountability. Public consultation is a crucial element of the commission's processes. The commission's preference is that all submissions it receives be treated as public and be published on the commission's website unless the author of the submission indicates clearly that all or part of the submission is confidential and not to be made available publicly. Where confidential material is claimed, the commission prefers that this be under a separate cover and clearly marked 'In Confidence'. The commission will assess the author's claim and discuss appropriate steps to ensure that confidential material is protected while maintaining the principles of openness, transparency, consistency and accountability.

The commission may be contacted at the above address, by telephone on (02) 6205 0799 or via the commission's website at www.icrc.act.gov.au.

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1. Introduction

1.1 Purpose of the investigation

The Independent Competition and Regulatory Commission (commission) is the Australian Capital Territory's (ACT) independent economic regulator. We regulate prices, access to infrastructure services and other matters in relation to regulated industries in the ACT.

On 1 June 2023, we received the terms of reference (TOR) from the ACT Government to determine a price direction for standing offer prices for the supply of electricity by ActewAGL to small customers.¹ The TOR covers the three-year regulatory period commencing 1 July 2024.² The current price direction sets the maximum prices that ActewAGL can charge for its regulated retail tariffs from 1 July 2020 to 30 June 2024.

The TOR requires us to ensure the methodology for determining standing offer prices has regard to a reasonable pricing offer for small customers. The methodology must not unduly disadvantage those customers who do not actively engage in the energy market, while balancing the competitiveness of the retail electricity market. We must also consider changes to the timeframe for the yearly standing offer approval process. These changes are required to ensure adequate time is available for determination of the subsequent reference price by Ministers, and for retailers to fulfill their legal obligations under the *ACT Retail Electricity (Transparency and Comparability) Code* and *National Energy Rules*.

This issues paper begins the consultation process to determine retail electricity prices from 1 July 2024 to 30 June 2027. The paper alerts stakeholders of the commission's investigation into retail electricity prices, and it seeks input on any issues they consider relevant. In addition, the issues paper informs stakeholders of the key issues we have identified, based on the TOR and recent developments in the electricity market and regulatory arrangements.

¹ A small customer consumes less than 100MWh of electricity over any period of 12 consecutive months.

² See appendix 2 for a full copy of the terms of reference.

1.2 Commission's role and objectives

Our objective, as set out in section 7 of the ICRC Act, is to promote effective competition in the interest of consumers while facilitating an appropriate balance between economic efficiency, environmental and social considerations. When making price directions, section 19L of the ICRC Act also requires us to consider the interests of consumers in promoting efficient investment in, and operation of, regulated services into the future. These objectives, as well as the more detailed requirements of section 20 of the ICRC Act, guide our decision making.

We balance the objectives and requirements of the Act by ensuring that the regulated prices for electricity services are set at no more than the level of prudent and efficient costs of providing those services. This approach is in the interests of consumers as it ensures they pay no more than required for their electricity services. It also accommodates the needs of the regulated business by allowing the recovery of efficiently incurred costs, including a reasonable margin. It encourages efficient operation and investment, as costs that are inefficient cannot be recovered through regulated prices. By allowing full cost recovery, and no more, the commission's approach also encourages effective competition in retail electricity. Any retailer, with estimated costs equal to or below that of an efficient operator in the position of ActewAGL Retail (ActewAGL) should be able to set competitive prices. However, a retailer's ability to compete will also depend on a range of other factors including service quality and innovation.

Our objectives under sections 7 and 19L of the ICRC Act and the provisions we must consider under section 20(2) of the ICRC Act are provided in appendix 3.

1.3 Terms of reference

In summary, the TOR requires us to consider the following matters in this investigation:

- consider the direct impact on electricity costs of government policies and pass through of costs and savings to regulated prices
- consider the efficient and prudent costs of managing risk in the cost of purchasing electricity for the period of the price direction
- identify and report on the efficient costs of complying with the *Energy Efficiency (Cost of Living) Improvement Act 2012* for the period that the determination is being made
- identify and report on the cost allowance of the ACT Feed-in Tariffs (small and large scale) for the period that the determination is made.
- ensure the methodology for determining standing offer price has regard to a reasonable pricing offer for small customers that does not unduly disadvantage those who do not actively engage in the energy market, while balancing the competitiveness of the retail electricity market
- consider changes to the timeframe for the yearly standing offer approval process, such that adequate time is available for determination of the subsequent reference price by Ministers, and for retailers to fulfill their legal obligations under the *ACT Retail Electricity (Transparency and Comparability) Code* and the *National Energy Rules*.

We are required to release a final report within the period of 1 March 2024 to 5 June 2024.

As specified in the terms of reference, the price direction will be for the three-year period from 1 July 2024 to 30 June 2027.

1.4 Timeline for the investigation

Our timeline for the investigation is set out in Table 1.1.

Table 1.1 Indicative timeline for the retail electricity price investigation

Task	Date
Terms of reference notified	5 June 2023
Release of issues paper for public consultation	1 August 2023
Submissions on issues paper close	31 August 2023
Release of draft report for public consultation	Late January 2024
Public hearing	Early February 2024
Submissions on draft report close	Late February 2024
Final report and price direction	May 2024

The closing date for submissions on the issue paper is 31 August 2023. We will consider written submissions received by the closing date in the development of the draft report and the proposed price direction. We are required under section 17(4)(b) of the ICRC Act to conduct a public hearing for all price regulation investigations. We intend to conduct a hearing after the release of the draft report to give interested stakeholders an opportunity to ask questions and provide feedback on the draft report.

1.5 Structure of the issues paper

The remainder of this paper is structured as follows:

- Chapter 2 examines market outcomes to assist stakeholders in providing feedback on the methodology for setting standing offer prices that provides a balance between reasonable prices and the competitiveness of the retail electricity market.
- Chapter 3 discusses the commission's approach to regulating retail prices in the ACT.
- Chapter 4 describes each of the cost components of our retail electricity price model and identifies potential issues for the inquiry.
- Chapter 5 sets out a list of consolidated questions.
- Appendix 1 provides an overview of the electricity market in the ACT.
- Appendix 2 reproduces the terms of reference.
- Appendix 3 lists our roles and objectives.

2. Balancing reasonable pricing and competition

The inquiry must ensure the methodology for determining standing offer prices has regard to a reasonable pricing offer for small customers, that does not unduly disadvantage those not actively engaged in the market, while balancing the competitiveness of the retail electricity market.

To assist stakeholders in providing feedback on this matter, this chapter discusses some of the price and competition outcomes in the retail electricity market in the ACT. We provide further details of the ACT electricity market in appendix 1.

2.1 Price outcomes in the ACT

We set regulated retail prices for the supply of electricity to small customers on ActewAGL's regulated standing offer tariffs. These regulated standing offer tariffs influence the level of market offer rates. In the ACT around 23% of residential and small business customers were on standing offers in the March quarter of 2023.

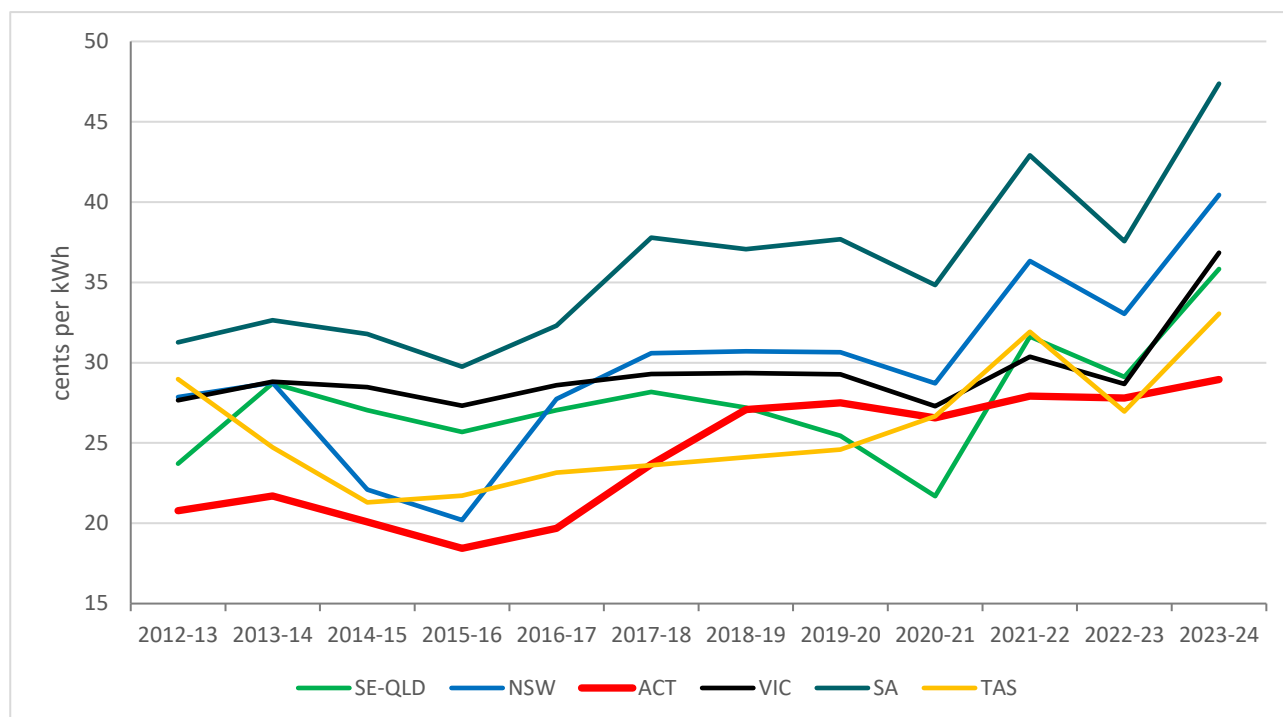
Figure 2.1 shows that electricity prices for residential customers in the ACT have been among the lowest in Australia over the past decade.³

In 2023-24, regulated retail prices in the ACT are the lowest among standing offers regulated across the National Electricity Market. ACT prices for 2023-24 are particularly low due to the rebate from the large-scale feed-in tariff (LFIT) scheme operating in the ACT (Figure 2.2). While regulated offers in most other jurisdictions increased by between 20% and 27% for residential customers in 2023-24, the average increase in standing offer prices in the ACT was 4.15%.

Even excluding the LFIT rebate, regulated retail prices in the ACT would have remained the lowest of all jurisdictions. It is worth noting that the LFIT scheme is applied equally across all retailers in the ACT so does not impact competition.

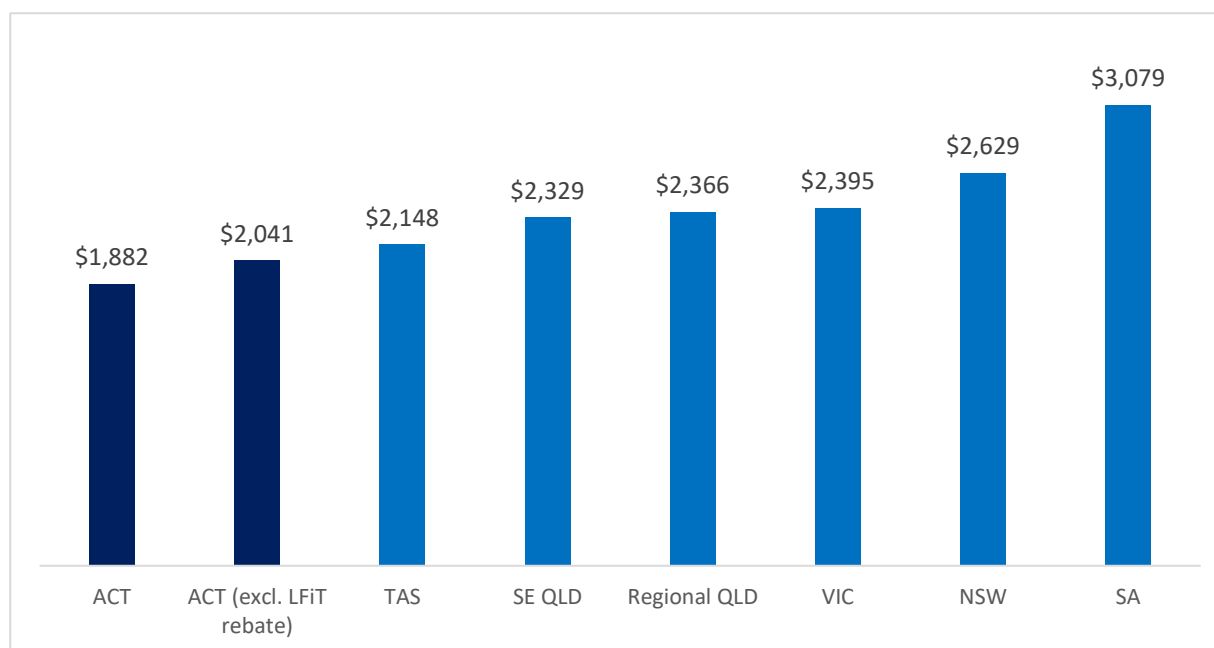
³ The figure presents regulated prices for the ACT compared with market offers in most other jurisdictions. Therefore, to the extent that market offers in the ACT have been below regulated prices over the period reported by the AEMC, the ACT prices would have been relatively lower than other states except for Tasmania where regulated prices are also presented.

Figure 2.1 Residential electricity price trends, 2012-13 to 2023-24



Sources: AEMC various reports and our calculations based on ICRC 2023.

Figure 2.2 Maximum annual residential standing offer electricity bills as at 1 July 2023 using 6,500 kWh



Sources: Our calculations based on ESC 2023a, OTTER 2023, QCA 2023 and AER 2023a.

Note: Bill estimates are based on annual usage of 6,500 kWh and exclude GST. NSW and Victoria bill estimates are the weighted average of the bills across the distribution zones within those states, weighted by customer numbers in the corresponding distribution zone.

While regulated prices in the ACT are below those in other jurisdictions, we are also conscious of the cost-of-living pressures facing consumers, making any increase in electricity prices difficult to manage for some customers.

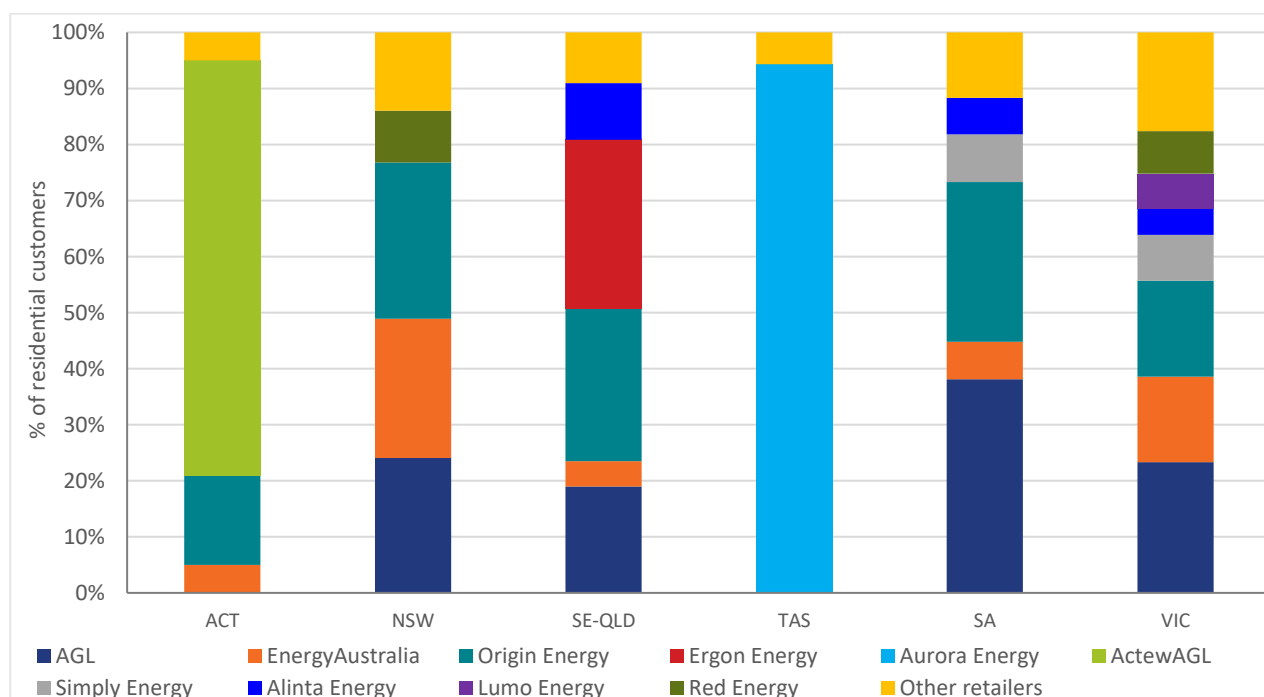
We note that the ACT Government offers a range of schemes to help consumers improve the energy efficiency of their homes and concessions to help low income and vulnerable consumers in managing their electricity expenditure.⁴ For example:

- an annual utilities concession of \$750 to eligible concession card holders on their electricity, gas, water and sewerage costs, with an additional one-off rebate of \$50 for 2023-24
- an energy bill rebate of \$175 for eligible households through the Commonwealth’s Energy Bill Relief Fund for 2023-24
- an 10-year interest free loan for eligible homeowners and community groups to help with the costs of energy-efficient upgrades in their homes, including rooftop solar panels, hot water heat pumps, electric heating and cooling systems, electric stove tops, and electric vehicles
- a rebate of up to \$5,000 for eligible homeowners to help with the upfront costs of installing energy efficient products, with an opportunity to access the zero interest loan

2.2 Competitive landscape

Unlike other states (apart from Tasmania and regional Queensland) the ACT remains dominated by a single retailer, ActewAGL, which held 74% market share in March quarter 2023. While ActewAGL’s market share has declined from 88% in 2017-18, the experience in the ACT contrasts with most other jurisdictions, with ActewAGL serving the majority of residential customers (see Figure 2.3). Other retailers have had limited success gaining market share in the ACT with only Origin Energy and Energy Australia making significant inroads.

Figure 2.3 Retail electricity market share by region (residential customers), March quarter 2023



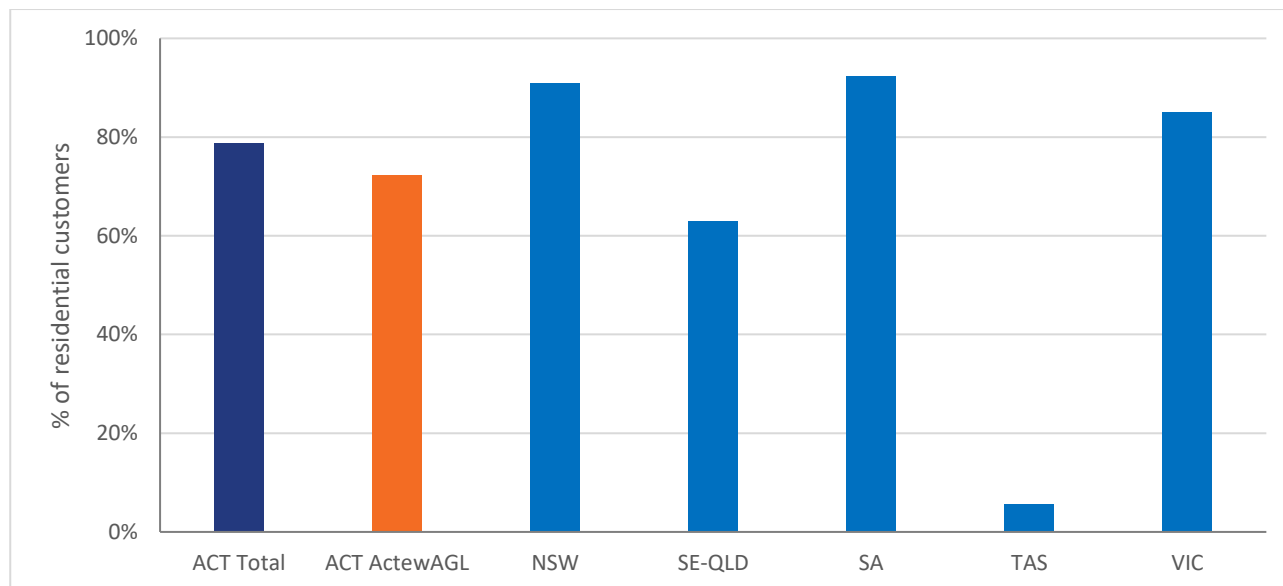
Sources: AER 2023b and ESC 2023b.

⁴ Detailed information is available at the ACT Government website <https://www.act.gov.au/assistance/housing-and-rates>.

ActewAGL also has a lower share of customers on market offer contracts compared with other jurisdictions. At the end of March 2023, the Australian Energy Regulator (AER) reports that ActewAGL had 72% of residential customers on market contracts compared to over 90% in NSW and South Australia (see Figure 2.4). The Essential Services Commission of Victoria (ESC) reports that 15% of residential customers are on the regulated offer in Victoria, implying the remaining 85% are on market contracts.

Further indicators of competition are discussed in section A.1.2 of appendix 1.

Figure 2.4 Share of customer on market contracts, March quarter 2023



Sources: AER 2023b and ESC 2023a.

Since our last investigation, the ACT Government and the AEMC introduced several measures that may contribute to improving overall competition in the ACT.

The ACT Government directed that we implement measures that improve transparency and comparability of electricity offers. We introduced the *ACT Retail Electricity (Transparency and Comparability) Code* (the Code) in 2021. The Code requires retailers to:

- advertise their prices against a benchmark to make it easier for consumers to compare offers,
- tell their customers about plans that might save them money, and
- give their customers tailored information to help them choose the best plan for them.

The Code intends to make it simpler and faster for ACT residents to compare electricity plans and choose the best plan. The Code should also assist in promoting competition by improving consumer engagement. For example, it encourages more 'sticky' customers to engage with the market and either move to a new retailer, or at least to a better offer with their current retailer.

In 2019, the AEMC reforms established a process that allows customers to transfer retailers within two days after the end of the cooling off period. Under the old arrangements, customers had to wait until the next periodic meter read, which meant up to 90 days for the transfer to occur. Speeding up the transfer process allows customers to move to new offers quickly and limit the time available for 'losing' retailers to conduct save activity.

In addition to these measures, retailers will also be required to make bills easier for small customers to understand under the Better Bills Guideline. By no later than 30 September 2023, the Guideline requires retailers to use simple language, make the structure and design of the bill easy to understand and make the

most important information most prominent. It also requires retailers to include a message in the bill identifying whether a better offer is available to the customer.

In Victoria, energy companies are already required to tell customers how much they could save by switching energy plans. The Victorian Energy Compare website provides information to customers about the best priced electricity offers available to them and provides customers that use the process a \$250 bonus, even if they choose not to switch retailers⁵.

1. Do you have any comments on electricity prices and competition in the ACT or on other measures that could improve the balance between them to improve outcomes for ACT consumers?
2. Do you consider that the implementation of the ACT Reference Price and requirements in the Code have been useful in keeping consumers informed and more confident in choosing a retail electricity plan?

⁵ <https://compare.energy.vic.gov.au/>

3. How we regulate retail electricity prices in the ACT

This chapter discusses the controls that we use to regulate electricity prices in the ACT. Regulatory controls refer to the arrangements by which regulated retail electricity prices are set and adjusted during the regulatory period. They include:

- using a cost-index method to set a maximum for the average price change across ActewAGL's basket of regulated tariffs
- adjusting prices from one year to the next using a weighted average price cap (with a 2% side constraint)
- annual price reset process
- using the pass-through arrangements to provide for the treatment of certain unexpected events, beyond the control of ActewAGL.

3.1 We set standing offer prices for ActewAGL

The regulated standing offer rates only apply to ActewAGL customers. We use a hypothetical incumbent retailer in the same position as ActewAGL as the benchmark (benchmark retailer). This means that we estimate the prudent and efficient costs of an incumbent business providing the regulated retail service rather than the efficient costs of a new entrant or small retailer.

3.2 Our method for setting regulated prices

We use a cost index approach to set regulated electricity prices in the ACT. Under this approach, we estimate the likely change in the costs of supplying electricity to small customers. In broad terms, we derive an index (the maximum allowable percentage change) for a particular year by comparing the total cost of supplying electricity in this year with the cost of supplying electricity in the preceding year.

To derive this index, we estimate the individual cost components that would be incurred by a benchmark retailer when providing electricity supply services to small customers on regulated tariffs. We do so by modelling wholesale energy costs, including hedging and environmental schemes, using a pass through of network costs from the AER's regulatory decisions and providing an allowance for retail operating costs and a retail margin. We discuss the individual components of our model in section 4.

The index then determines the amount by which ActewAGL can change its regulated prices. Under the current weighted average price cap form of regulation, ActewAGL can decide how to adjust the individual prices for its different standing offers, as long as the total adjustment does not exceed the maximum allowable percentage change for the overall price cap.

This means that it is not the level of the costs included in our pricing model that determine the regulated prices in the ACT. Rather, it is the year-on-year change in costs. This distinction is important, as our form of control differs to that in other Australian jurisdictions, where the level of costs (not the change in costs) determine the regulated price (see appendix 1 for further details). Therefore, for some cost components

that are escalated by Consumer Price Index (CPI) year on year, the absolute level of costs is less important under the ACT's current form of control than it is in other jurisdictions.

3.3 We undertake annual reviews of cost components

We will be required to undertake two annual resets for the regulatory period commencing 1 July 2024. The first will determine regulated retail electricity prices for 2025–26 and the second will determine prices for 2026–27.

The annual recalibration process involves updating certain parameters of the retail electricity cost-index model to determine regulated retail prices. This process draws on more recent forecasts of wholesale energy costs and expected demand, updated network costs and green scheme costs. The reset process can also incorporate additional costs from a pass-through event.

3.4 We use cost pass-through arrangements to manage unexpected costs

Pass-through arrangements apply to events that are unexpected, or whose extent was uncertain, and that are beyond the control of the regulated entity. We currently allow for pass-through arrangements for a range of regulatory change and tax change events.⁶ Pass-through reviews for these regulatory and tax change events are undertaken as part of the annual reset process.

In the 2010-2014 retail price determination, we noted the need for a materiality threshold for pass-through applications and introduced a threshold of 0.25 per cent of annual regulated revenue. We considered a range from 0.25 per cent to 1 per cent and determined that the lower level was appropriate. The rationale was that pass-throughs introduce administrative and regulatory burdens in addition to the annual price resets and therefore only events that had substantial cost impact should be passed through.

However, we removed the materiality threshold in the 2014-17 decision, as the annual recalibration of the cost-index model parameters does not have a materiality consideration. We did not find it appropriate for consistency reasons to apply it to possible pass-throughs that occur as part of an annual reset process.

We are now reconsidering our decisions on a materiality threshold for pass through applications.

3. Do you have any comments on how we regulate retail electricity prices?
4. Should we reinstate a materiality threshold for pass-through applications? If so, what threshold level is appropriate?

⁶ The details of the current pass-through provisions are contained in ICRC 2020.

4. What are the components of retail electricity costs

This section describes the key elements of our pricing model. It details the approach we used in setting retail electricity prices in the current regulatory period and identifies possible changes and updates that could be implemented in the next regulatory period.

4.1 Overview of the pricing model

Our pricing model determines the maximum average percentage change that ActewAGL can apply to its suite of regulated tariffs on an annual basis. It does so by estimating the individual cost components that would be incurred by an efficient standalone incumbent retailer in the same position as ActewAGL when providing electricity supply services to customers on the regulated tariff.

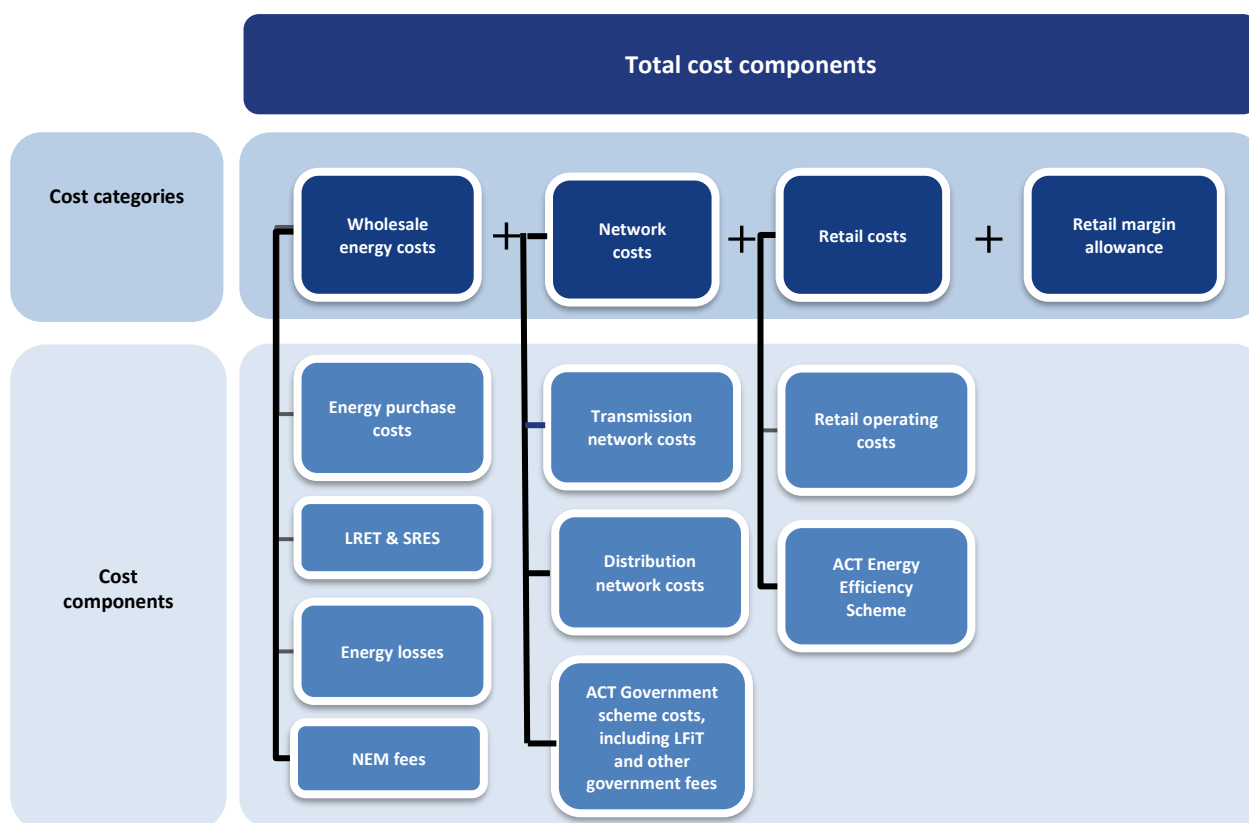
Our pricing model contains four cost categories:

- *wholesale electricity costs*: which comprise energy purchase costs, Large-scale Renewable Energy Target (LRET) and Small-scale Renewable Energy Scheme (SRES) costs, energy losses, and National Electricity Market (NEM) fees
- *network costs*: which include transmission and distribution costs and jurisdictional scheme costs (which include the feed-in-tariff schemes). Transmission and distribution costs are regulated by the AER and ACT Government scheme costs are passed through in the network costs approved by the AER⁷
- *retail costs*: which comprise retail operating costs such as customer service and billing, smart meter costs and Energy Efficiency Improvement Scheme (EEIS) compliance costs
- *Retail margin allowance*: which provides a profit allowance to retailers for providing electricity services.

Once these cost categories are estimated, they are added together to produce total costs to be recovered in dollars per megawatt hour (\$/MWh). The total costs are then compared to the total costs calculated for the previous year. This produces a maximum allowable percentage change that ActewAGL can apply to its regulated retail tariffs. The cost categories are shown in Figure 4.1 and the relative share of total costs that each category accounts for is shown in Figure A1.2 in appendix 1.

⁷ In 2023-24, network costs also included a rebate for the negative reasonable cost determination made by the ACT Government for the Large-scale Feed-in Tariff (LFIT) scheme.

Figure 4.1 The commission's electricity pricing model



4.2 Components of the current pricing model

This section briefly describes the cost components of our pricing model and discusses specific issues relevant to the next regulatory period.

4.2.1 Energy Purchase Cost

Energy purchase costs are the costs incurred by the benchmark retailer in purchasing electricity from the wholesale electricity market. Due to the high volatility inherent in the wholesale electricity market, retailers typically hedge their exposure to risk by forward purchasing electricity in the contract market or by taking positions in the futures market. This reduces the risk of price volatility for the retailer, contributing to financial stability.

Our current approach to estimating energy purchase costs has 4 key steps:

1. determining an appropriate contract position, or the efficient hedging strategy
2. determining the contract price
3. developing the half-hourly profile of load and spot prices
4. calculating settlement payments and difference payments

We discuss each of these steps below:

Step 1: Determine an appropriate contract position

While there are different ways that retailers can hedge their exposure to spot prices, we assume that the benchmark retailer will use exchange-traded financial derivatives. This method of hedging is available to any retailer of a reasonable size and because trading is done on the Australian Securities Exchange (ASX), it is also transparent. Our current energy purchase cost model assumes that the retailer's hedging strategy uses base swap, peak swap, and base cap contracts. We determine the mix of contracts that a benchmark retailer will use by estimating a prudent hedging strategy and we then apply this to the ACT electricity load to determine the contract position.

We note some changes in the hedging models used by other regulators as a result of changes in demand, such as exclusion of peak contracts from the hedging strategy. As part of this investigation, we intend to review the approach adopted by other regulators and update the hedging strategy and contract position.

5. Do you have any comments on our assumption that prudent retailers will hedge their exposure to risk by purchasing hedging contracts on the ASX?
6. Do you have any comments on the approach to determining an appropriate contract position, and specifically on the treatment of peak swap contracts?

We do not expect large changes in the load profile to occur within relatively short periods of time and therefore do not consider annual updates to the hedging strategy are warranted. However, the contract position will change annually as the ACT load data is updated.

Step 2: Determine contract prices

The contract price refers to the forward price of the particular hedging instrument (base swap, peak swap and base cap contracts). We use the 23-month average of forward prices from ASX market data. This averaging period reflects the fact that retailers typically hedge in advance of the year in which they supply customers. It also smooths out both upward and downward fluctuations in forward prices and consequently in wholesale energy purchase costs and retail prices. This approach provides a balance between economic efficiency and social considerations as required under the ICRC Act.

We note that the ESC uses a 12-month trade weighted average of ASX Energy contract prices, while the AER uses trade weighted average contract prices based on a book build period from the date of the first trade.

We currently use the 23-month averaging period between 1 June to 30 April. Continued use of this averaging period will allow us to finalise the cost-index model ahead of the release of the commission's final decision, which must be released between 1 March 2024 and 5 June 2024. This averaging period is also consistent with the TOR which requires the commission to ensure that adequate time is available for determination of the subsequent reference price by Ministers, and for retailers to fulfil their legal obligations.

7. Do you have any comments on the length of the averaging period or the proposed dates for the averaging period?

Step 3: Develop the half-hourly profile of load and spot prices

To determine energy purchase costs, load and spot price data are required. We use the most recent five calendar years of load and spot price data from AEMO. The five-year period is updated annually as part of

the annual price recalibrations. We use calendar year data because complete financial year data is not available before each annual price recalibration.

Both the AER and ESC use simulated load profiles to determine a distribution of estimated wholesale energy costs and then from this distribution adopt a particular cost estimate. The AER adopts the 75th percentile wholesale energy cost. The ESC takes the load from the median simulated year when these years are ranked by wholesale energy cost.

The net system and load profile (NSLP), published by AEMO, is created using basic meter data only. This may not accurately represent the load shape, due to the rollout of advanced meters and replacement of old basic meters. We note that the Queensland Competition Authority (QCA) incorporated smart meter data in addition to the NSLP data in its recent determination. The AER will investigate the inclusion of advanced meter data to estimate load profiles in its next DMO decision. We will monitor the development of AER's investigation and consider the necessary changes as part of this investigation.

The half-hourly spot prices for each quarter are scaled up to the average base swap forward price for the quarter less the forward price margin. This ensures that spot prices are in line with future expectations. We use an averaging period of 23 months for calculating an average forward price for the purpose of scaling spot prices. The forward price margin (also known as a contract premium) is set at five per cent in the commission's model.⁸

8. Do you consider that the current approach of using actual load data for 5 calendar years remains appropriate?
9. Do you have any comments on the approach to calculating spot prices?

Step 4: Calculate settlement payments and difference payments

The final step is to use the data described above to calculate settlement and difference payments for each half-hour trading interval of the full five-year period to determine the total cash flow. The total cash flow is then divided by the total load for the same five years to determine the energy purchase costs on a dollar per megawatt hour basis.

4.2.2 Volatility Allowance

A typical hedging strategy adopted by the benchmark retailer leaves some residual level of exposure to volatile spot prices because buying contracts to cover all possible spot price and demand scenarios can be very expensive. The residual risk can be accounted for by holding some working capital (i.e. cash) to fund spot market purchases in the event that electricity demand is larger than accounted for by the hedging strategy. The cost of holding this working capital is known as a volatility allowance.

The allowance is currently determined by:

- taking the simple average of the ESC's volatility allowance across the five Victorian distribution zones, separately for residential and business customers; then

⁸ According to Frontier Economics 2023 (p.21), the ESC adopts a 40-day averaging period (up to 28 April 2023) and a contract premium of 5%.

- taking the weighted average volatility allowance between residential and business customers (weighted by ActewAGL's residential versus business electricity demand).

Based on the ESC's final decision on the VDO applying from 1 January 2020, we currently set the volatility allowance at \$0.30 per MWh. For 2023-24, the volatility allowance for the VDO ranges from \$0.63 to \$0.77 per MWh for residential customers and \$0.57 to \$0.67 per MWh for business customers.⁹

10. Are changes required to the estimation of the volatility allowance? If so, how should we determine the volatility allowance?

4.2.3 LRET and SRES costs

The LRET and the SRES are national environmental obligations imposed by the Australian Government that create financial incentives for investment in renewable energy sources. The schemes require electricity retailers to purchase and surrender Large-scale Generation Certificates (LGC) and Small-scale Technology Certificates (STC) to the Clean Energy Regulator in percentages set by the regulator each year.¹⁰

We apply a market-based approach for determining efficient LRET and SRES costs. The model determines LGC and STC prices based on publicly available spot price data averaged over an 11-month period. We add a holding cost to the certificates to account for the financing costs associated with holding these certificates between the purchase date and surrender date.

To estimate average LGC and STC prices, we are required to source daily spot prices from ICAP for the period from 1 July to 31 May each year under the current price direction. Continuing to use the same average period would hold up the finalisation of our cost-index model until early June, which does not meet our TOR. As such, we will consider the average period for calculating the LGC and STC prices as part of this price investigation.

We note that the ESC consultant, Frontier Economics, used a 12-month trade weighted average LGC price to 28 April in its model for the recent VDO determination; and ACIL Allen estimated average LGC price by using pricing information up to 10 May (from the date it started trading) in the recent DMO 5 decision.

11. Do you have any comments on our proposed changes to the timing of LRET and SRES cost estimates?

4.2.4 Energy Losses

Some electricity is lost in transporting from generators to customers via transmission and distribution networks. Retailers purchase additional electricity to allow for these losses. The loss factors are calculated by AEMO and are used by all regulators to determine the energy loss allowances where regulated tariffs apply. We determine the energy losses component by applying AEMO's transmission and distribution loss factors to the energy purchase cost component, LRET and SRES costs and the NEM fees. We have been applying this approach since 2014.

⁹ Frontier Economics 2023, p.46

¹⁰ More information on the LRET and the SRES schemes can be found on the Clean Energy Regulator's website: www.cleanenergyregulator.gov.au/Renewable-Energy-Target/Pages/default.aspx.

4.2.5 NEM fees

The NEM is managed by AEMO, which recovers its costs from market participants. Its costs relate to running market institutions and procuring services to fulfil its obligations under the National Electricity Rules, which are recovered through NEM fees and ancillary services fees, respectively.

We currently calculate ancillary fees for the first year of the regulatory period using AEMO's ancillary service payments data averaged over a 52-week period. For subsequent years of the regulatory period, these costs are indexed to the CPI.

We note that other regulators including the AER, ESC, QCA and the Office of the Tasmanian Economic Regulator (OTTER), use AEMO's budget fees and charges to set NEM fees annually.

12. Do you have any comments on the approach we should use for determining NEM fees?

4.2.6 Network costs

The network costs are the transmission and distribution charges paid by ActewAGL. Transmission and distribution charges are determined by the AER and released each year around mid-May. We pass through these charges.

Network costs also include ACT Government scheme costs (referred to as jurisdictional scheme costs). In 2023-24, the AER did not include the LFiT scheme in its approved network charges because the ACT Government made a negative cost determination. Instead, the LFiT amount was returned to ACT customers via a rebate determined by Evoenergy, which applied a separate, downwards adjustment to the AER's approved network charges for 2023-24.¹¹

4.2.7 Retail operating costs

Retail operating costs are the efficient costs incurred by the retailer in providing retail services to its customers. We use a benchmark retail operating cost determined by the Independent Pricing and Regulatory Tribunal (IPART) in 2013¹², which is indexed annually by CPI. The IPART analysis is 10 years old, and we believe that it is appropriate for the retail cost benchmark to be updated.

In Victoria, the ESC, which previously also relied on the 2013 IPART benchmark, updated its approach for the 2023-24 VDO and now relies on actual costs provided by Victorian retailers. In addition to retail costs, the ESC separately calculates customer acquisition and retention costs. In total, including customer acquisition and retention costs, the ESC's retail operating costs for the VDO are \$183.52 per annum.

The AER uses the Australian Competition and Consumer Commission's (ACCC) Inquiry into the National Electricity Market report as their base estimate of retailers' operating costs for the DMO and makes necessary adjustments for bad and doubtful debts and advanced meter costs¹³.

¹¹ Evoenergy 2023, p.16

¹² IPART 2013, p 97-107.

¹³ The Federal Government has directed the ACCC to report on prices, profits and margins in the supply of electricity in the NEM. For retail operating costs, these include an analysis of total and average cost-to-serve retailer costs and Customer Acquisition and Retention Costs. The terms of reference require the ACCC to provide its reports every six months from 31 March 2019 until 31 August 2025.

The AER's approach results in a separate retail cost benchmark for residential customers and small business customers. The resulting annual retail costs (excluding smart meter costs, which we capture separately) are between \$164 and \$172 per residential customer and between \$184 and \$221 for small business customers.¹⁴

The ESC and AER retail operating cost estimates are well above our benchmark of \$143 per customer for 2023-24.

13. What benchmarks should the commission consider in determining the retail operating cost allowance?

We update the retail operating cost component as part of the annual price recalibrations to account for changes in ActewAGL's customer numbers and the CPI.

4.2.8 EEIS costs

The ACT Government's EEIS places a mandatory obligation on all active retailers in the ACT to promote energy efficiency measures in households and small businesses. The current EEIS, which was initially legislated to expire in 2020, has been modified and extended to 2030.

We determine the EEIS cost allowance using cost estimates provided by ActewAGL, subject to a forward-looking prudence and efficiency assessment. Since our methodology relies on forecast and estimated costs in advance of the actual cost being incurred, provision is made for an ex-post adjustment (that is, a true up to account for the actual costs of complying with the EEIS).

4.2.9 Retail margin

The retail margin represents the return on the investments made by the benchmark retailer in providing retail electricity services. Once all the other cost categories of the model are estimated, they are added together and multiplied by the retail margin to produce the total cost.

We set the retail margin in the last two regulatory periods drawing on research undertaken by Strategic Finance Group for IPART in 2013.¹⁵ In our 2020–24 price investigation, we applied a retail margin of 5.6% throughout the regulatory period.

The retail margin relies on a study that is now 10 years old, and we consider it appropriate to update this benchmark. In considering alternative benchmarks, we will review how other regulators currently set the retail margin.

In addition to the level of the retail margin, there is also the issue of how the margin is applied. The retail margin is currently applied to the total cost stack to convert it from a percentage margin to \$/MWh. This means when costs are relatively stable so is the retail margin. However, when there are large movements in other costs components, either upwards or downwards, the retail margin in \$/MWh may also increase or decrease significantly. These changes are unlikely to reflect changes in costs faced by retailers.

¹⁴ For comparison with our benchmark retail costs, we have used the same inflation rates as in our annual recalibration model to convert the VDO and DMO retail costs from 2021-22 dollars to 2023-24 dollars.

¹⁵ IPART 2013, p 89-96

14. Do you have any comments on the approach we should adopt for determining the retail margin?

5. Consolidated list of questions

For ease of reference, the full list of questions posed throughout this consultation paper are listed below. In preparing a submission, you may choose to respond to some or all of these questions, or provide additional comments.

1. Do you have any comments on electricity prices and competition in the ACT or on other measures that could improve the balance between them to improve outcomes for ACT consumers?
2. Do you consider that the implementation of ACT Reference Price and requirements in the Code have been useful in keeping consumers informed and more confident in choosing a retail electricity plan?
3. Do you have any comments on how we regulate retail electricity prices?
4. Should we reinstate a materiality threshold for pass-through applications? If so, what threshold level is appropriate?
5. Do you have any comments on our assumption that prudent retailers will hedge their exposure to risk by purchasing hedging contracts on the ASX?
6. Do you have any comments on the approach to determining an appropriate contract position, and specifically on the treatment of peak swap contracts?
7. Do you have any comments on the length of the averaging period or the proposed dates for the averaging period?
8. Do you consider that the current approach of using actual load data for 5 calendar years remains appropriate?
9. Do you have any comments on the approach to calculating spot prices?
10. Are changes required to the estimation of the volatility allowance? If so, how should we determine the volatility allowance?
11. Do you have any comments on our proposed changes to the timing of LRET and SRES cost estimates?
12. Do you have any comments on the approach we should use for determining NEM fees?
13. What benchmarks should the commission consider in determining the retail operating cost allowance?
14. Do you have any comments on the approach we should adopt for determining the retail margin?

Appendix 1 The ACT retail electricity market

A.1.1 Key features of the ACT electricity market

A.1.1.1 Supply of electricity in the ACT

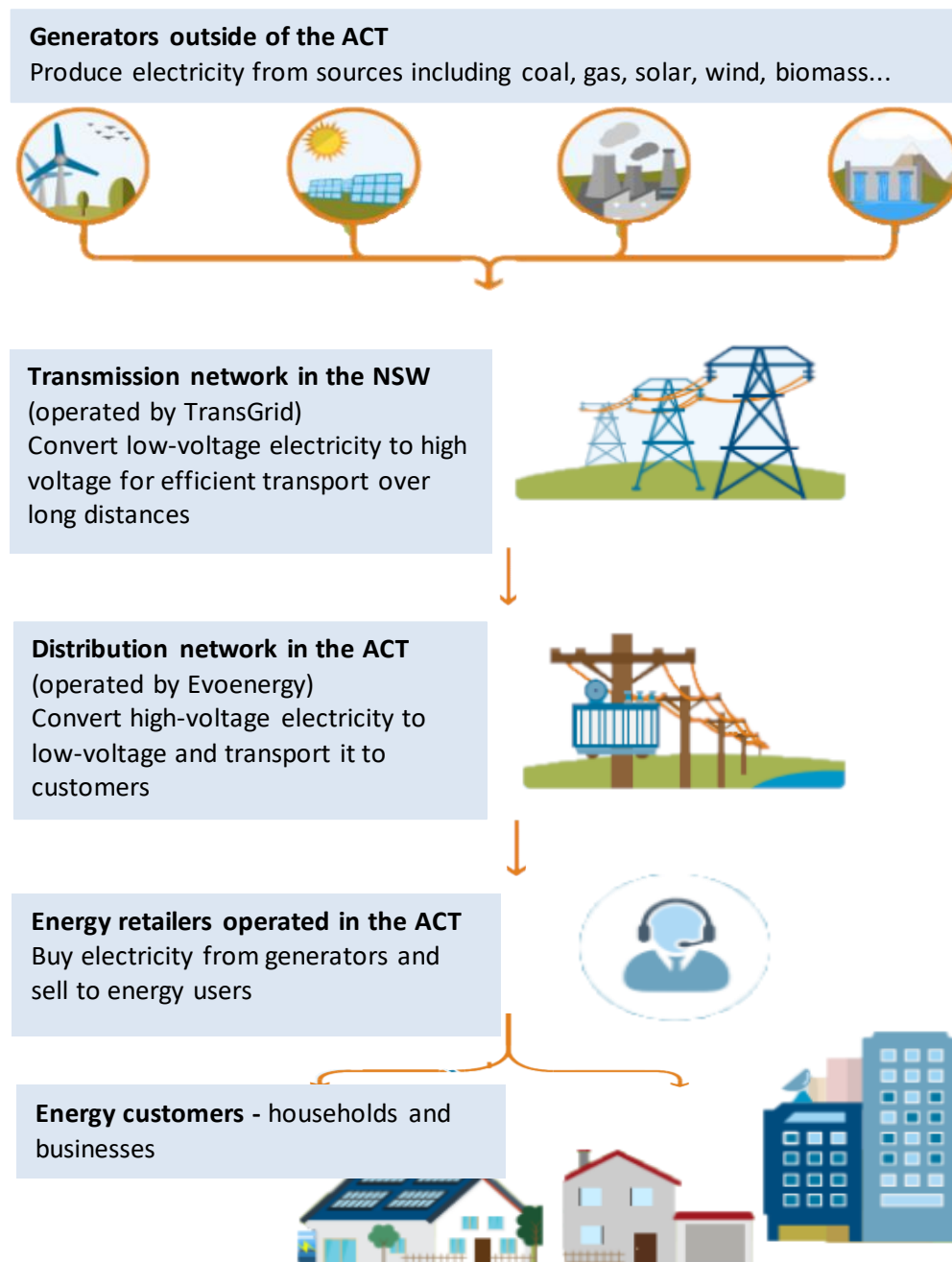
All east coast states and territories, including the ACT, are connected to the NEM – a system that allows electricity to be generated, used and shared across borders. Unlike other states and territories, only a very small amount of the ACT's electricity is generated within its border, by a few solar farms and rooftop panels on Canberra homes. The rest comes from the NEM, which is largely powered by non-renewable energy sources, like coal and gas.

Under its large-scale feed-in-tariff scheme, the ACT Government sources renewable electricity from large-scale wind and solar farm generators around Australia, to feed into the national grid to make up for what Canberra consumes.

This way, together with the ACT Government's mandatory contribution to the national renewable energy target, the ACT achieved its 100% renewable electricity targets from October 2019.

As shown in Figure A1.1, electricity is produced outside of the ACT, and transported to the ACT by the New South Wales transmission network operator TransGrid. Within the ACT, electricity is distributed by Evoenergy, which holds the territory's only electricity distribution network licence. Like other distributors in the NEM, Evoenergy's charges are regulated by the AER.

Figure A1.1 Electricity supply chain



A.1.1.2 ACT specific environmental schemes

There are jurisdictional requirements that are specific to operating in the retail electricity market in the ACT. Two ACT government policy schemes are particularly worth noting in this regard. These are the EEIS and the feed-in tariff scheme.

The EEIS, under the *Energy Efficiency (Cost of Living) Improvement Act 2012*, places a mandatory obligation on all active retailers in the ACT to promote energy efficiency measures in households and small businesses. It requires energy retailers to either undertake energy efficiency programs on behalf of their customers or pay a fee per tonne of carbon emitted for electricity sold in the ACT. Some examples of the energy efficiency programs are installation of high efficiency air conditioning heat pump and water heater,

decommissioning and disposal of a refrigerator or freezer, and installation of insulated space conditioning ductwork.

Under the *Electricity Feed-in (Renewable Energy Premium) Act 2008*, households and businesses can install solar rooftop panels to generate renewable energy, which is fed into the distribution network. The feed-in tariff scheme determines the rates at which these consumers are compensated for the electricity generated.

Under the *Electricity Feed-in (Large-scale Renewable Energy Generation) Act 2011*, the ACT Government granted feed-in-tariff entitlements to large-scale renewable energy generators around Australia. This arrangement allows the contracted generators to receive a fixed price for the electricity they feed into the grid.

A.1.1.3 Retail price regulation in the ACT

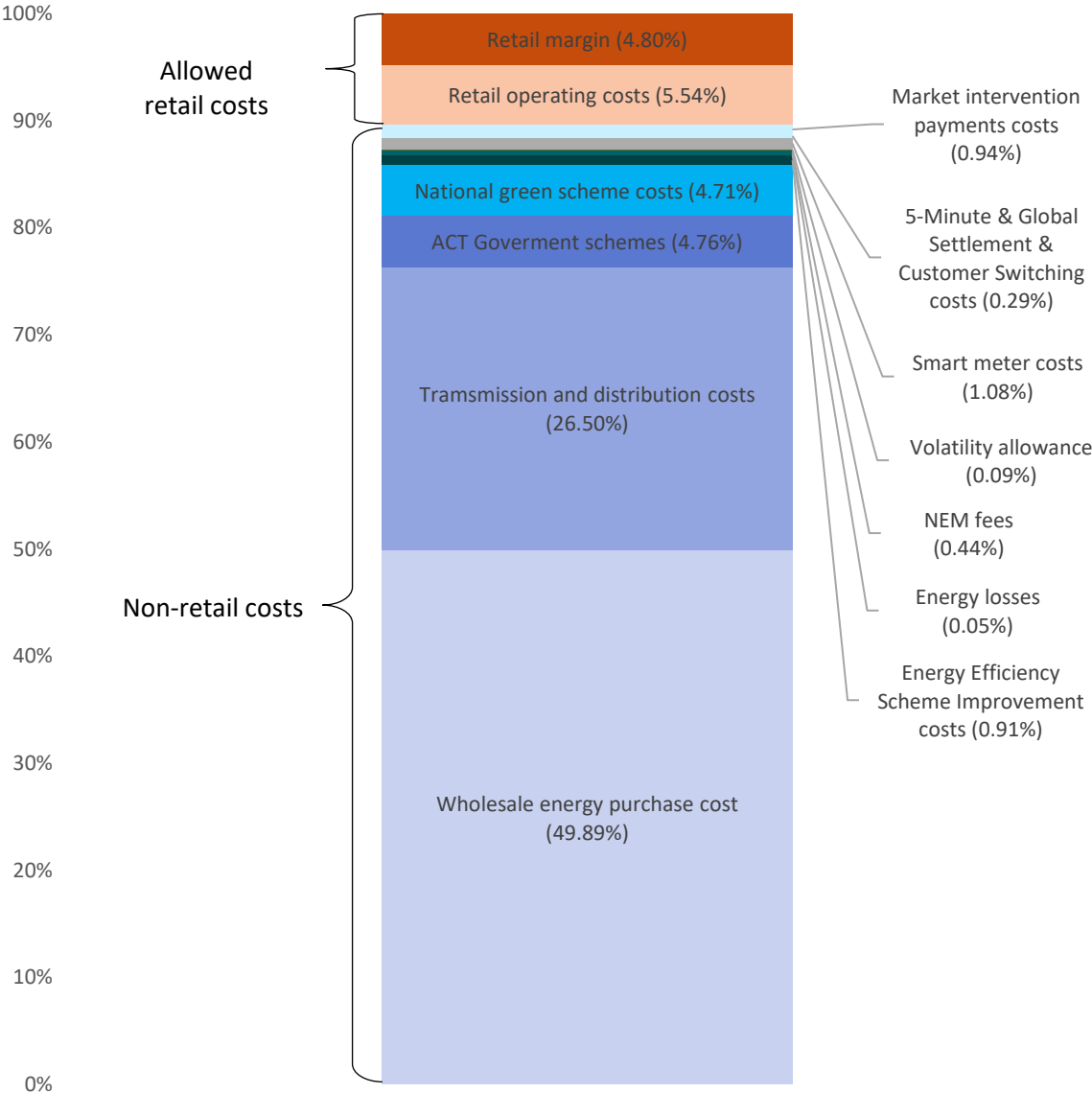
Regulated price caps apply to standing offers for ActewAGL in the ACT. We determine a maximum percentage change each year that ActewAGL can apply to its regulated tariffs. ActewAGL offers a suit of regulated tariffs and so, provided the weighted average change in those tariffs does not exceed the maximum allowable percentage change (set by us), it will have complied with regulation. In other word, we do not place constraints on the overall levels of individual regulated prices; rather, ActewAGL retains some discretion to alter the levels of its various regulated tariffs, provided that it stays within the overarching constraint of the weighted average price cap. Figure A1.2 presents the cost components that we estimate to calculate the allowable percentage change in regulated tariffs and their relative value for 2023-24.

Other forms of price regulation have been applied in other jurisdictions, such as the DMO in NSW, South East Queensland and South Australia, and the VDO in Victoria.

- The DMO prices are indicative prices based on the AER's assumed annual usage. They are specified as an annual bill in dollar amount with retailers free to determine usage and supply charges. That is, retailers must structure their tariffs to not exceed the DMO price based on the AER's assumed annual usage.
- In Victoria, the VDO price consists of a daily supply charge (\$/day) and usage charges (\$/kWh). It also reported as an indicative annual bill, based on average consumption. Retailers must offer the VDO tariffs as an option for customers who don't want to or are unable to engage in the market to find a competitive market offer.

To improve the transparency and comparability of retail electricity offers, the *ACT Retail Electricity (Transparency and Comparability) Code 2021* takes effect from October 2021. The Code requires energy retailers to advertise their prices against a benchmark to make it easier for consumers to compare offers, tell their customers about plans that might save them money and give their customers tailored information to help them choose the best plan for them.

Figure A1.2 Cost components as share of total costs, 2023-24



A.1.2 Competition in ACT electricity retail market

Effective competition is yet to fully emerge in the ACT, mainly due to the limited size of the ACT electricity market. However, there are increasing signs of competition in the ACT market, such as the increase in number of retailers and increase in customers on market contracts over the past 5 years.

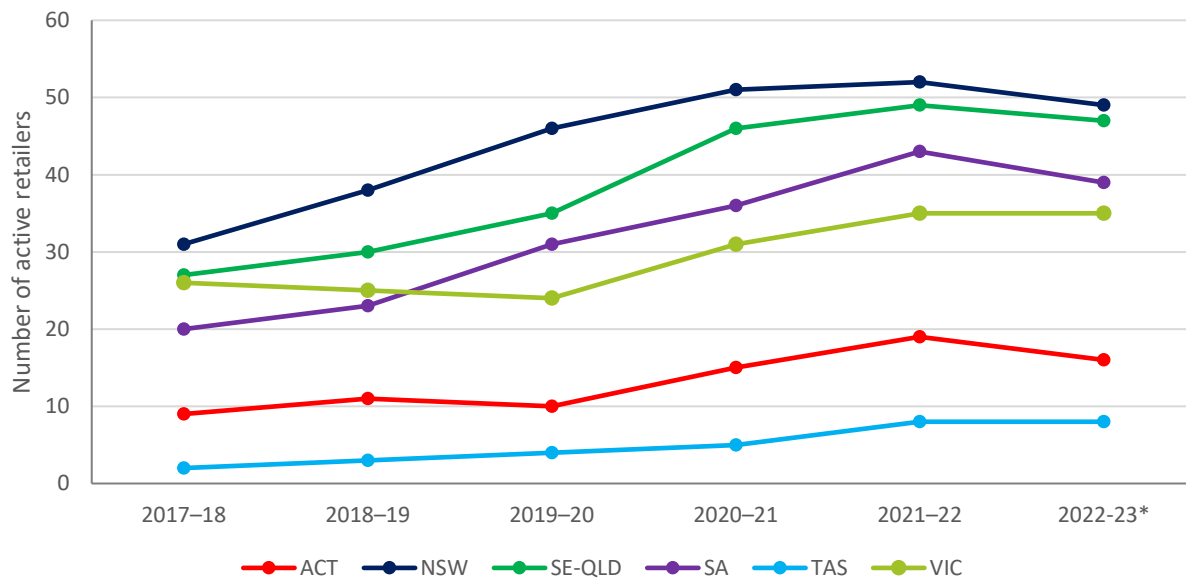
The ACT retail market is small relative to other retail markets in the NEM, with around 205,000 small customers, both residential and small business customers, as at 31 March 2023 (see Figure A 1.3). Small customers include residential and small business electricity consumers.

Figure A 1.3 Electricity customer numbers, 31 March 2023

Source: AER and ESC data.

A.1.2.1 Active electricity retailers

At the end March 2023, there was 16 active retailers (retailers with customers) in the ACT. Comparing with large states, the ACT has low numbers of active retailers. However, the ACT was experiencing an increasing trend in the number of active retailers, from only 9 in 2017-18 to 16 in March quarter 2022-23.

Figure A 1.4 Number of active retailers, 2017-18 to 2022-23

Source: AER and ESC data.

Note: The number of active retailers includes both retailers serving residential and/or small business customers. For 2017-18 to 2021-22 data as at 30 June; for 2022-23, data as at 31 March 2023.

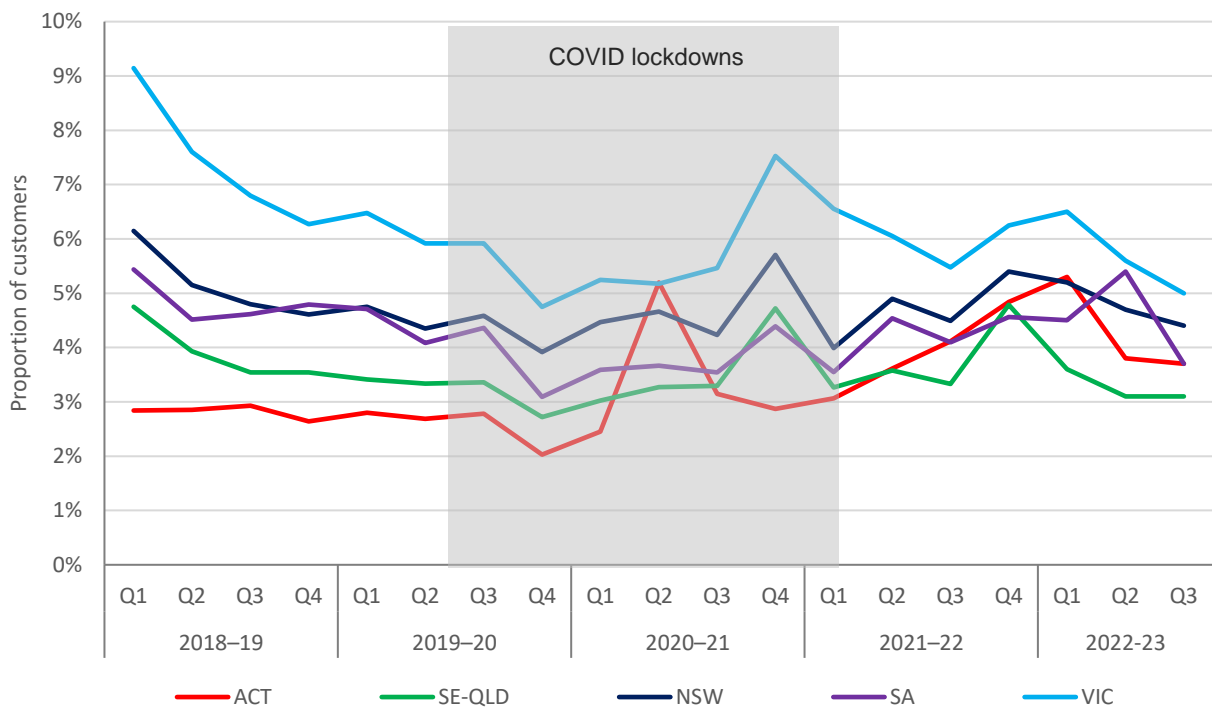
A.1.2.2 Customer switching

The rate at which customers switch between energy retailers provides some indication of how actively customers engage with the retail market. The data does not capture the customers switching from one offer to another within the same retailer.

Figure A 1.5 shows the percentage of electricity customers that switched retailers over the past 5 years across jurisdictions. Switching rates are generally higher in jurisdictions considered more competitive, such as Victoria, NSW, South-East Queensland and South Australia.

The switching rates in the ACT remained relatively stable at around 3% until Q4 2019-20. The sharp drop in this quarter may be due to the impacts from the start of the COVID-19 pandemic. Across 2020-21 quarterly switching rates have slowly started to increase to the pre-COVID level, while in Q2 2020-21 it increased sharply. From 2021-22 switching rates trended up significantly to 5% in Q1 2022-23 and then down to 4% in Q3 2022-23, approaching similar levels in other jurisdictions.

Figure A 1.5 Electricity switching rates, 2018-19 to 2022-23



Source: AER data.

Appendix 2 Terms of reference

Independent Competition and Regulatory Commission (Price Direction for the Supply of Electricity to Certain Small Customers on Standard Retail Contracts) Terms of Reference Determination 2023

Disallowable instrument DI2023– 97

Made under the Independent Competition and Regulatory Commission Act 1997 ('the Act'), Section 15 (Nature of Industry References) and Section 16 (Terms of Industry References).

1 Name of instrument

This instrument is the *Independent Competition and Regulatory Commission (Price Direction for the Supply of Electricity to Small Customers on Standard Retail Contracts) Terms of Reference Determination 2023*.

2 Interpretation

In this instrument:

"National Energy Retail Law (ACT)" has the same meaning as in the *National Energy Retail Law (ACT) Act 2012*.

"small customer" has the same meaning as in the *National Energy Retail Law (ACT)*.

"standing offer prices" has the same meaning as in the *National Energy Retail Law (ACT)*.

"ActewAGL Retail" means the partnership of Icon Retail Investments Limited (ACN 074 371 207) and AGL ACT Retail Investments Pty Ltd (ACN 093 631 586).

2 Commencement

This instrument commences on the day after it is notified.

3 Reference for investigation under Section 15

In accordance with section 15(1) of the Act, I provide a reference to the Independent Competition and Regulatory Commission (the 'Commission') to

determine a price direction for the standing offer prices for the supply of electricity to small customers who consume less than 100MWh of electricity over any period of 12 consecutive months.

The price direction will be for the period of 1 July 2024 to 30 June 2027. The price direction must make provision for annual recalibrations to be undertaken and the determination of the reference price.

In accordance with 15(4) of the Act, the price direction determined by the Commission under this reference is to only apply to the electricity retailer **ActewAGL Retail**.

4 Terms of reference for investigation under section 16

In accordance with 16(1) of the Act, I require that the Commission must consider the following matters in relation to the conduct of the investigation.

1. The Commission must consider:
 - a. The direct impact on electricity costs of government policies and pass through of costs and savings to regulated prices including, but not restricted to:
 - i. the ACT retailer obligations under the Energy Efficiency Improvement Scheme;
 - ii. the Commonwealth Government's Large-scale Renewable Energy Target and Small-scale Renewable Energy Scheme;
 - iii. any other schemes implemented to address climate change relevant to electricity pricing; and
 - iv. any other policies or schemes that may directly impact on pricing in the retail or wholesale electricity market.
 - b. The efficient and prudent cost of managing risk in the cost of purchasing electricity for the period of the price direction.
2. The Commission must identify and report on the efficient costs of complying with the Energy Efficiency (Cost of Living) Improvement Act 2012 for the period that the determination is being made.
3. The Commission must identify and report on the cost allowance of the ACT Feed-in Tariffs (small and large scale) for the period that the determination is being made.
4. The Commission will ensure the methodology for determining standing offer price has regard to a reasonable pricing offer for small customers that does not unduly disadvantage those who do not actively engage in the energy market, while balancing the competitiveness of the retail electricity market.
5. The Commission must consider changes to the timeframe for the yearly standing offer approval process, such that adequate time is available for determination of the subsequent reference price by Ministers, and

for retailers to fulfill their legal obligations under the *ACT Retail Electricity (Transparency and Comparability) Code* and the *National Energy Rules*.

6. The Commission must release its final report within the period of 1 March 2024 to 5 June 2024, to provide sufficient time to allow ActewAGL Retail to make any necessary changes to its billing system, and to provide information on the new tariff to customers in time for implementation effective 1 July 2024.



Andrew Barr MLA Treasurer

June 2023

Appendix 3 Our roles and objectives

Under the ICRC Act, we have the following objectives as set out in section 7 and 19L (Box 1).

Box 1 Sections 7 and 19L: Commission objectives

Section 7:

- (a) to promote effective competition in the interests of consumers;
- (b) to facilitate an appropriate balance between efficiency and environmental and social considerations;
- (c) to ensure non-discriminatory access to monopoly and near-monopoly infrastructure.

Section 19L:

To promote the efficient investment in, and efficient operation and use of regulated services for the long term interests of consumers in relation to the price, quality, safety, reliability and security of the service.

When making a price direction, in addition to the terms of reference and legislative objectives, we need to consider the provisions set out in section 20(2) of the ICRC Act (Box 2).

Box 2 Section 20(2): Commission's considerations

- (a) the protection of consumers from abuses of monopoly power in terms of prices, pricing policies (including policies relating to the level or structure of prices for services) and standard of regulated services; and
- (b) standards of quality, reliability and safety of the regulated services; and
- (c) the need for greater efficiency in the provision of regulated services to reduce costs to consumers and taxpayers; and
- (d) an appropriate rate of return on any investment in the regulated industry; and
- (e) the cost of providing the regulated services; and
- (f) the principles of ecologically sustainable development mentioned in subsection (5);
- (g) the social impacts of the decision; and
- (h) considerations of demand management and least cost planning; and
- (i) the borrowing, capital and cash flow requirements of people providing regulated services and the need to renew or increase relevant assets in the regulated industry; and
- (j) the effect on general price inflation over the medium term;
- (k) any arrangements that a person providing regulated services has entered into for the exercise of its functions by some other person.

Abbreviations and acronyms

ACCC	Australian Competition and Consumer Commission
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASX	Australian Securities Exchange
CPI	Consumer Price Index
DMO	Default Market Offer
EEIS	Energy Efficiency Improvement Scheme
HHI	Herfindahl-Hirschman Index
ICRC	Independent Competition and Regulatory Commission
IPART	Independent Pricing and Regulatory Tribunal
kWh	Kilowatt hour
LGC	Large-scale Generation Certificates
LFiT	Large-scale Feed-in-Tariff
LRET	Large-scale Renewable Energy Target
MWh	Megawatt hour
NEM	National Electricity Market
OTTER	Office of the Tasmanian Economic Regulator
QCA	Queensland Competition Authority
STC	Small-scale Technology Certificates
SRES	Small-scale Renewable Energy Scheme
TOR	Terms of reference
VDO	Victorian Default Offer



ICRC

independent competition and regulatory commission

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