



independent competition and regulatory commission

Issues Paper
**Retail Prices
for Non-contestable
Electricity Customers –
2009-2010**

**Report 1 of 2009
February 2009**

The Independent Competition and Regulatory Commission (the Commission) was established by the *Independent Competition and Regulatory Commission Act 1997* to determine prices for regulated industries, advise government about industry matters, advise on access to infrastructure and determine access disputes. The Commission also has responsibilities under the Act for determining competitive neutrality complaints and providing advice about other government-regulated activities. Under the *Utilities Act 2000*, the Commission also has responsibility for licensing utility services and ensuring compliance with licence conditions.

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Foreword

The Attorney-General has made a reference to the Independent Competition and Regulatory Commission (the Commission) to provide a price direction for the supply of electricity to non-contestable franchise ('transitional franchise tariff' or TFT) customers for the period from 1 July 2009 to 30 June 2010. The Minister's reference dated 23 December 2008 is made under sections 15 and 16 of the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act).

This reference makes the fifth price control arrangement for TFT customers following the introduction of full retail contestability (FRC). The four regulatory periods and the maximum regulated transition tariffs are listed below:

- A regulated maximum tariff was applicable to TFT customers for a period of three years from 1 July 2003 to 30 June 2006 (this included a 4.5% real increase in the first year and a 0.5% real increase for the remaining two years).
- The regulated maximum tariff applicable to TFT customers was extended for a period of one year from 1 July 2006 to 30 June 2007 (there was a zero real increase in this year).
- The regulated maximum tariff applicable to TFT customers was further extended for a period of one year from 1 July 2007 to 30 June 2008 (there was a 12.9% real increase in this year).
- The regulated maximum tariff applicable to TFT customers was extended once more for a period of one year from 1 July 2008 to 30 June 2009 (there was a 4.67% real increase in this year).

The current reference requires a regulated maximum tariff applicable to TFT customers for a further period of one year from 1 July 2009 to 30 June 2010.

In developing the price direction for the regulated maximum TFT applicable to customers eligible for these transition arrangements for the period from 1 July 2009 to 30 June 2010, the Commission is required to have regard to a number of matters, including:

- the requirements of section 20 of the ICRC Act 7
- the need to have a final report in sufficient time to allow ActewAGL Retail to make necessary administrative arrangements to its billing system and to provide information on the new tariff to customers.

This issues paper identifies matters the Commission considers relevant to the determination of the TFT from 1 July 2009 to 30 June 2010. The Commission welcomes comments on these matters as well as comments on any further matters considered by stakeholders to be relevant.

Paul Baxter
Senior Commissioner
February 2009

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1 Introduction

This Chapter:

- discusses the background to the regulation of retail prices for non-contestable ‘franchise’ or TFT electricity customers in the ACT
- summarises the current investigation’s Terms of Reference
- provides an update on the state of the retail electricity market in the ACT
- sets out the Commission’s proposed timeline for the current investigation
- provides information on how interested parties may make a submission on this issues paper.

1.1 Background

In the ACT, the retailing of electricity to customers consuming more than 160 megawatt hours (MWh) per year, predominantly large businesses, was made contestable from 1998. The electricity supply industry in the ACT was opened for retail competition to customers consuming more than 100 MWh/year, mainly medium sized businesses, from 1 July 2001.¹ Following the Commission’s recommendation that full retail contestability (FRC) be introduced for all customers in the ACT,² the government opened the market for customers using less than 100 MWh/year, largely small businesses and households, to competition from 1 July 2003.³

While the government decided to open the market to all customers, certain transitional arrangements were maintained. These were intended to ensure that customers consuming less than 100 MWh/year were able to remain on non-negotiated contracts with the incumbent retailer, ActewAGL Retail.

In December 2002, the Commission received a reference from the Treasurer, instructing it to provide a price direction for the supply of electricity to franchise customers (i.e. those on non-negotiated contracts) for a transitional period from 1 July 2003 to 30 June 2006. The Commission’s first price direction was made at the time of the initial opening of the retail electricity market to competition for small customers (those consuming less than 100 MWh/year). Thus, at the beginning of that price direction all small customers were on the regulated retail tariff.

The initial reference to the Commission instructed it to provide a three-year price direction. The Commission termed the resulting tariff from that price direction the ‘transitional franchise tariff’ (TFT). Customers who chose to remain on the regulated tariff are called ‘franchise customers’, and customers who opted for a negotiated tariff with an alternative retailer or with the incumbent retailer are called ‘non-franchise customers’.

The Commission’s first price direction allowed a 4.5% real increase in the franchise maximum tariffs for the first year and a 0.5% real increase for each of the remaining two years.⁴ The Commission made this determination based upon a rigorous examination of the costs incurred by

¹ Utilities (Non-Franchise Electricity Customers) Declaration 2001 (Disallowable instrument 2001–93).

² ICRC, *Final report: Full retail contestability in electricity in the ACT*, July 2002.

³ Utilities (Non-Franchise Electricity Customers) Declaration 2003 (No 1) (Disallowable instrument 2003–20).

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

ActewAGL Retail in the provision of retail electricity services to franchise customers. That price direction also allowed for a variety of pass-through events, including changes in network operating costs.

During this first designated transitional period, the government undertook to consider whether these arrangements would need to be extended for an additional period. In that investigation, the Treasurer sought advice from the Commission on the need for the transitional arrangements to continue and, if so, the form of price protection that should apply to franchise contracts in future and the duration of such protection.

The Commission issued its final decision in April 2006. In this report, the Commission recommended that the TFT cease to exist. The Commission concluded that there was evidence that the retail market in the ACT was sufficiently competitive to support the removal of the TFT.

However, the Commission was concerned at that time that the removal of the TFT could affect the status of the standard customer contract that covered all franchise customers by default. Thus, the Commission determined that the TFT should continue for the period from 1 July 2006 to 30 June 2007 to allow the ACT Government to make any necessary legislative changes to preserve the conditions of the standard customer contract.

The Commission's final decision, released in April 2006, allowed for a Consumer Price Index (CPI) increase in franchise revenue for the period from 1 July 2006 to 30 June 2007.⁵ Thus, customers could expect no real increase in prices at that time. The final decision did not contain a complete build-up of the costs of retail electricity services in the ACT. The Commission's analysis at that time was that the offer of only a CPI adjustment to franchise revenue was reasonable, and that the CPI increase for 2006–07 represented an appropriate balance between the retail margin to sustain a competitive market and a reasonable outcome for consumers.

Before the second regulatory period expired on 30 June 2007, the Commission received a further reference from the Attorney-General,⁶ instructing the Commission to provide a price direction for the supply of electricity to franchise customers for a further transitional period from 1 July 2007 to 30 June 2008.⁷ In undertaking this review, the Commission reverted to an analysis based on a rigorous examination of the costs incurred by ActewAGL Retail in the provision of retail electricity services to franchise customers. This was required because of the length of time since the first cost study during early 2003, coupled with evidence of large changes in the wholesale electricity charges which were a major cost input for ActewAGL Retail in supplying services to these franchise customers.

In its final report released in June 2007, the Commission allowed for a 12.9% real increase in the franchise maximum tariff for the period from 1 July 2007 to 30 June 2008.⁸ The Commission also noted its concern that the reference required the TFT to be set for a 12-month period only. Then current market data exhibited a large increase in the electricity pool price resulting from supply–demand imbalances in the wholesale electricity market which, in turn, led to increases in energy purchase costs. The short reference period constrained the Commission in how it was able to allow cost changes resulting from that imbalance to be passed through to franchise customers by the

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

⁶ Under the ACT Government's administrative arrangement orders, the Attorney-General assumed portfolio responsibility for the *Independent Competition and Regulatory Commission Act 1997* in 2006.

⁷ ICRC (Price Direction for the Supply of Electricity to Franchise Customers) Terms of Reference Determination 2007 (No 1) (Disallowable instrument DI2007-96).

⁸ ICRC, *Final decision and price direction: Retail prices for non-contestable electricity customers*, Report 7 of 2007, June 2007.

incumbent retailer. This meant the Commission was unable to transition any price changes over a longer period, as was decided in other jurisdictions—for example, the Independent Pricing and Regulatory Tribunal (IPART) in NSW and the Essential Services Commission of South Australia (ESCOSA)—at around the same time.

A further reference was received by the Commission on 7 February 2008 to determine any change to the TFT for the period 1 July 2008 to 30 June 2009. In response, the Commission undertook another detailed build-up of the costs incurred by ActewAGL Retail in providing electricity to franchise customers. The final report was released in June 2008 and allowed for a real increase in the TFT of 4.67 %.⁹

Table 1-1 summarises (in real terms) the changes to the TFT since its introduction in 2003-04.¹⁰

Table 1-1 Summary of real changes to the TFT

2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
4.5%	0.5%	0.5%	0%	12.9%	4.67%

1.2 Current Investigation

The Attorney-General issued a further Terms of Reference on 23 December 2008.¹¹ This Terms of Reference require the Commission to provide a price direction for the supply of electricity to franchise customers for the period from 1 July 2009 to 30 June 2010.

In providing the price direction, the Commission is required to have regard to the requirement of section 20 of the Act and it must produce its final report in time sufficient to allow ActewAGL Retail to make any necessary changes to its billing system and to provide information on the new tariff to customers.

The full Terms of Reference are available in Appendix 1.

1.3 State of the Market

The TFT does not apply to all electricity customers in the ACT. Rather, it applies only to those small customers (those consuming less than 100 MWh/year) who have not elected to enter into a negotiated contract with either the incumbent retailer, ActewAGL Retail, or an alternative electricity retailer.

⁹ ICRC, *Final Decision and Price Direction: Retail prices for non-contestable electricity customers*, Report 4 of 2008, June 2008.

¹⁰ Nominal increases can be calculated by increasing the real figure to allow for any increase in inflation.

¹¹ ICRC (Price Direction for the Supply of Electricity to Franchise Customers) Terms of Reference Determination 2008 (No 2) (Disallowable instrument DI200-305).

Currently, licensed electricity retailers in the ACT (other than the incumbent) are:

- Australian Power and Gas Pty Ltd
- AGL Sales Pty Ltd
- AGL Sales Queensland Electricity Pty Ltd
- Aurora Energy
- Country Energy
- Dodo Power and Gas Pty Ltd
- Energy Australia
- ERMPower Retail Pty Ltd
- Integral Energy Australia
- Jackgreen Pty Ltd
- Origin Energy Electricity Ltd
- Powerdirect
- Red Energy
- SUN Retail
- TRUenergy Pty Ltd
- TRUenergy Yallourn Pty Ltd.

However, the Commission understands that few of these retailers are currently active in servicing the residential customer market.

The number of residential customers who have entered into negotiated contracts with either the incumbent or an alternative retailer increased steadily in the initial years following the introduction of retail contestability. Approximately 27,000¹² customers had entered into negotiated contracts by 30 June 2006 and 34,000¹³ by 30 June 2007. However, the number of customers on negotiated contracts fell to approximately 30,000¹⁴ by 30 June 2008 indicating that a number of customers have taken the opportunity to return to the regulated tariff.

The total number of small electricity customers in the ACT is approximately 137,500.¹⁵ As such, the TFT continues to be the tariff from which around 107,500 customers purchase their electricity.

While the Commission is encouraged by the level of competition in the market, it has concerns regarding the role it plays in determining the competitive prices on offer. Typically, the competitive market offers consist of a discount below the TFT. Thus, whatever decision is taken by the Commission in setting the TFT is replicated in the prices offered to both franchise and (after a discount) non-franchise customers. As such, there are potentially significant impacts should the Commission get the TFT price incorrect.

¹² ICRC, *Licensed Electricity, Gas and Water and Sewerage Utilities: Performance Report for 2005-06*, December 2008, pg 7.

¹³ Based on licensed retailer responses to performance report questionnaire. Previously unpublished data.

¹⁴ Based on licensed retailer responses to performance report questionnaire. Previously unpublished data.

¹⁵ Based on licensed retailer responses to performance report questionnaire. Previously unpublished data.

Should the TFT price be set too high, franchise customers will pay too much for their electricity. In addition, it is likely that non-franchise customers will also face higher prices than they might otherwise face given that competitive offers are linked to the TFT price.

Conversely, should the Commission set the TFT price too low, it may result in retailers withdrawing from the competitive market temporarily or, in the extreme case, leaving the industry altogether. This in turn reduces the competitiveness of the market and is therefore contrary to the best interests of consumers.

Victoria offers an interesting example of how this matter may be addressed. Victoria has recently adopted an electricity retail market model which removes the role of a regulator in setting a TFT-equivalent price. The new regime requires electricity retailers to publish widely the prices they individually offer. In addition, prices cannot change more frequently than once every six months. The decision to adopt this approach in Victoria was made in response to a finding by the Australian Energy Market Commission (AEMC) that the market was effectively competitive, and as a consequence, a recommendation that the retail market barriers to FRC should be removed.

Should the relevant Victorian Minister be concerned about the continuing effectiveness of competition in the retail electricity market, the Minister can request the AEMC to conduct a further review. Should the review find that conditions in the market have changed such that it is no longer effectively competitive, a recommendation can be made that the Minister once again regulate retail prices.

Studies similar to that undertaken in Victoria by the AEMC are to be carried out in other jurisdictions over the coming years. A review in the ACT is currently expected in 2010.

The approach adopted in Victoria perhaps provides a starting point for consideration of what should be the next step to facilitating full retail competition in the ACT. The current arrangements whereby the Commission plays such a significant role in determining the price for both negotiated and non-negotiated contracts in the market is not sustainable or economically efficient and may in fact be reducing the long-term competitiveness of the market.

1.4 Timeline

The Commission intends adopting the following timeline for the current investigation.

Activities	Dates
Release of the issues paper	Wednesday 11 February 2009
Submissions on issues paper	Friday 6 March 2009, 5.00pm
Release of draft report	Friday 3 April 2009
Submissions on draft report	Friday 8 May 2009, 5.00pm
Final report and final price direction	Friday 5 June 2009
ActewAGL Retail implementation of tariff changes	From 1 July 2009

The release of the final report by early June will allow ActewAGL Retail sufficient time to make necessary changes to its billing system and provide information to customers as required by the Terms of Reference.

1.5 Making a submission on the Issues Paper

Submissions may be mailed to the Commission at:

The Independent Competition and Regulatory Commission
GPO Box 296
CANBERRA CITY ACT 2601

Alternatively, submissions may be emailed to the Commission at icrc@act.gov.au.

The secretariat may be contacted at the above addresses, by telephone on 6205 0799, or by fax on 6207 5887. The Commission's website is at www.icrc.act.gov.au.

1.6 Structure of the Issues Paper

The remainder of the issues paper is structured as follows.

- Chapter 2 discusses technical matters related to the methodology adopted by the Commission in determining the TFT.
- Chapter 3 considers non-technical aspects of the inquiry such as the Commission's responsibilities under Section 20 of the *Independent Competition and Regulatory Commission Act 1997*.
- Appendix 1 contains a full transcript of the Terms of Reference.
- Appendix 2 outlines the weighted average price cap formula.
- Appendix 3 is a glossary.

2 Technical Matters

This Chapter provides a description of:

- the methodology adopted by the Commission in determining the TFT
- the individual cost elements that contribute to the TFT.

2.1 Description of Methodology

The Commission determines the retail electricity price for the TFT by estimating the economically efficient cost base of an incumbent electricity retailer providing retail electricity supply services to a regulated customer segment. It does this by estimating the individual cost components incurred by ActewAGL Retail in the provision of electricity supply services to TFT customers.

Once these individual cost components are estimated, they are added together to produce an overall price (in \$/MWh). This price is then compared to the price calculated for the previous year and an allowable percentage change determined. ActewAGL Retail then applies this percentage adjustment to a weighted average basket of tariffs that apply to customers who have not taken up separate contracts for the supply of electricity (franchise customers).

In estimating the individual cost components, the Commission draws on benchmark cost information available in the marketplace or in other regulatory decisions within the retail electricity sector in Australia.

It should be noted that the TFT is not a single tariff. Rather, it applies to a range of non-negotiated tariffs offered by ActewAGL Retail. As such, the Commission adopts what is referred to as a weighted average price cap. Under a weighted average price cap, ActewAGL Retail is able to rebalance the individual non-negotiated tariffs offered to franchise customers as long as the adjustment in the weighted average price does not exceed the percentage change in the overall price determined by the Commission. The weighted price cap formula is contained in Appendix 2.

The Commission reviews the movement in the final suite of tariffs offered by ActewAGL Retail to ensure that any adjustment in prices remains reflective of the movement in the TFT as calculated by the Commission.¹⁶

2.2 Description of Cost Elements

The individual cost components incorporated into the derivation of the TFT can be grouped into the following categories:

- energy costs:
 - energy purchase costs
 - energy hedging, contract and management costs
 - green costs

¹⁶ The Commission approves a schedule of tariffs attached to the standard customer contract (see e.g. Utilities (Variation of Terms – Standard Customer Contract) Approval 2008 (No 1) - Notifiable Instrument NI2008-242.

- energy losses
- NEM Fees
- retail costs:
 - retail operating costs
 - retail margin
- network costs:
 - transmission and distribution network costs.

These components are discussed briefly in turn. A more detailed description of the components and the methodology can be found in the Commission's *Final Decision and Price Direction: Retail Prices for Non-contestable Electricity Customers* (Report 4 of 2008). This report can be found on the Commission's website at www.icrc.act.gov.au/icrcreportsandpapers.

This discussion is followed by a summary of the Commission's most recent finding on each of the cost categories.

2.2.1 Energy Purchase Costs

Energy purchase costs represent the costs incurred by the incumbent retailer in purchasing electricity from the market (that is, from electricity generators) to supply TFT customers.

The Commission cannot readily observe directly the actual cost of electricity to the incumbent retailer as this cost is comprised of a myriad of contracts and supply arrangements which are negotiated at various points in time in advance or over the year for which the TFT is set. However, this cost can be estimated using publicly available market data on historical and future electricity prices combined with a range of assumptions aimed at mimicking the purchasing activities of an electricity retailer. A brief description of the approach adopted in previous years by the Commission follows. The key elements of the methodology relate to the:

- source of data
- forward purchasing strategy
- load profile shape.

The Commission sources its data from d-cyphaTrade, an electricity trading house. The Commission purchases data from d-cyphaTrade on electricity futures and swap prices and uses this information to estimate average peak, shoulder and off-peak electricity prices.

The Commission then assumes a forward purchasing strategy whereby the retailer begins to build its portfolio 24 months in advance. It is assumed that the forecast load is hedged for each 6 month period of future delivery. For example, Table 2-1 shows the position of a retailer at 30 June 2008 and illustrates how forward purchases are built-up over the following 24 month period. It is assumed that the retailer hedges to 105% of forecast load at the beginning of the delivery period. This is a conservative estimate and ensures that the retailer is unlikely to be exposed to spot market prices.

Table 2-1 Assumed forward purchasing strategy (as at 30 June 2008)

Six-month delivery period (ending date)	31 December 2008	30 June 2009	31 December 2009	30 June 2010
Forecast load hedged by contract (%)	105%	80%	50%	25%

The load profile shape assumed by the Commission is shown in Table 2-2. The load profile shape is used to estimate the relative proportion of purchases of peak, shoulder and off-peak electricity.

Table 2-2 Assumed load profile shape

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

The methodology developed by the Commission is necessarily a simplification of what is a complex forward purchasing strategy adopted by the retailer. However, while a more sophisticated model could be developed, the Commission has taken the view that the ‘reasonableness’ of any additional complexity can be questioned.

The Commission recognises that the model it has developed has a range of limitations. These are discussed below and relate to the:

- reliability of the data used
- assumptions regarding the timing of forward purchases
- assumptions regarding the load profile shape.

The d-cyphaTrade data upon which the Commission relies represents only a proportion of the market for electricity sales. Many sales are undertaken directly between generators and retailers, that is, bi-laterally. As such, the prices of these bi-lateral sales are not revealed directly to the market. It has been argued that the market data provided by d-cyphaTrade is therefore unreliable. However, it may be reasonable to expect that any significant differences in prices between the market managed by d-cyphaTrade and that undertaken bi-laterally would develop opportunities for arbitrage and would subsequently be traded away.

The assumptions regarding the timing of forward purchases may also not reflect accurately the actual market for forward purchases. It is unrealistic to expect that in a competitive market, a retailer would undertake its purchases in such a regimented fashion. Rather, a more realistic approach would see the retailer enter into forward purchases when it considers prices to be most favourable. This may well result in a large degree of variability in forward purchases not reflected in the Commission’s assumptions.

In addition, forward purchases may be affected by matters other than purely price. It has been suggested that the market for forward purchases has on occasion been relatively thin, that is, there are few generators willing to enter into forward purchase contracts. Possible reasons suggested for this apparent thinness relate to future uncertainty due to the introduction of the Commonwealth Government’s Carbon Pollution Reduction Scheme (although the details of the scheme have now

been announced which should reduce such uncertainty) and the potential sale of retail businesses by the NSW Government.

The load profile shape assumption adopted by the Commission may also not reflect the true load shape of an ACT retailer (although the Commission has had regard to the load profile of ActewAGL Retail in deriving this estimate). In addition, there may be costs associated with purchasing the ACT's load profile shape which are not captured in the approach adopted by the Commission. For example, if the ACT load profile does not match that of the remaining market, there may be differences in prices between purchasing electricity for the ACT relative to the rest of the market.

2.2.2 Energy Hedging, Contract and Management Costs

Energy hedging, contract and management costs represent the costs incurred by the incumbent retailer in managing an energy trading desk. An energy trading desk is necessary to manage electricity purchases, which are typically bought using a forward looking portfolio approach, and the associated financial risks.

This component may also include costs associated with purchasing energy which are not captured elsewhere in the Commission's methodology. Such costs may include factors such as any premium paid to generators, relative to the market price, to provide electricity in the ACT due to the Territory's unique load profile.

The Commission needs to consider the range of costs and charges that are attached to the forward purchasing of electricity to meet the ACT's needs. Each of these costs need to be accounted for separately and included in the cost build-up.

2.2.3 Green Costs

There are a range of obligations imposed by government which impact on the cost of electricity. These include the Commonwealth Government's Mandatory Renewable Energy Target (MRET) scheme and the ACT Government's Greenhouse Gas Abatement Scheme (GGAS).

In addition to these pre-existing schemes, the ACT Government's newly announced feed-in tariff regime is due to commence 1 March 2009. The feed-in tariff regime is initially aimed at households and small business and is capped at 30 kilowatts (kW). Those producing up to 10 kW will receive 50.05 cents per kilowatt hour (kWh) while those producing between 10kW and 30 kW will receive 40.04 cents per kWh.¹⁷ In announcing the scheme, the Minister for the Environment, Climate Change, Energy and Water foreshadowed a possible increase in the eligibility of the scheme to allow larger producers the opportunity to take advantage of the scheme. An announcement clarifying this possibility is expected by June 2009.¹⁸

The introduction of the scheme may impose costs on the incumbent retailer. It is intended that the cost of this scheme be passed onto the electricity distributor which will then seek to recover these costs through distribution charges (which are in turn recovered from retail customers – see Section 2.2.8 for a further discussion). However, to the extent that there may be costs incurred by the

¹⁷ Department of the Environment, Climate Change, Energy and Water, *Fact Sheet: Proposed ACT Electricity feed-in tariff scheme*, released 10 February 2009.

¹⁸ Speech from Minister Corbell announcing the feed-in tariff scheme, 10 February 2009.

retailer which it is unable to pass through to distribution charges, there may be a need to allow an increase in green costs to take these into account.

Unavoidable costs associated with such schemes are a legitimate component of the cost build-up.

2.2.4 Energy Losses

Electricity is generated typically far from where it is consumed. For example, only 2% of the electricity consumed in the ACT is produced within the Territory. The remaining 98% is sourced from various generators along the east coast of Australia.

The transportation of electricity through transmission and distribution networks results inevitably in a degree of energy loss. This loss imposes a cost on the retailer as it must purchase more electricity than it is able to sell.

Before the beginning of each financial year, the National Electricity Market Management Company (NEMMCO) publishes a report in which it identifies these loss factors. These loss factors are then used to determine this cost.

2.2.5 National Electricity Market Fees

The National Electricity Market (NEM) is the interconnected electricity grid which covers most parts of Queensland, New South Wales, the ACT, Victoria, Tasmania and South Australia. The NEM is managed by NEMMCO which is funded via user fees which are ultimately borne by customers. These fees cover a range of functions provided by NEMMCO which are necessary for the safe and reliable delivery of electricity to all consumers.

2.2.6 Retail Operating Costs

Retail operating costs are the costs incurred by the incumbent retailer in providing retail services to TFT customers. These costs include:

- billing services, including meter reading
- call centre costs
- customer information costs
- general operating overhead costs.

As part of the determination of the 2008-09 TFT, the Commission considered whether or not the cost of acquiring new customers should be included in the retail operating costs. This followed from a requirement by the NSW Government that the Independent Pricing and Regulatory Tribunal (IPART, the NSW regulator) consider the costs associated with a 'mass market new entrant' when determining electricity prices for non-contestable customers in NSW. Given this requirement, IPART included customer acquisition costs as part of its cost build-up. However, at the time of the previous investigation, the Commission chose not to include such costs in the ACT cost build-up as under the Terms of Reference it was required to focus on determining a price direction for the supply of electricity to franchise customers, not a retailer competing for additional customers.

2.2.7 Retail Margin

The retail margin represents the return the incumbent retailer earns on the investment it must undertake to provide retail services. Without a retail margin, the incumbent retailer would be unable to attract the necessary funds required to provide these services. In addition, the existence of a retail margin together with an allowance for other legitimate costs of providing the retail service allows room for other retailers to enter the market and competitively offer alternative electricity supply contracts assuming they are able to operate more efficiently or are able to achieve other economies (including savings on the retail margin) which can be passed through to customers in the form of lower prices.

2.2.8 Transmission and Distribution Network Costs

Transmission and distribution network costs cover the costs paid by the retailer to transport electricity over the transmission and distribution network. The costs which the transmission and distribution network owners charge are determined by the Australian Energy Regulator (AER).

The AER released a draft decision regarding ActewAGL Distribution's electricity distribution network in November 2008.¹⁹ The draft decision contained a real price increase in distribution charges of 13.82 % in 2009-10. If this increase is confirmed in the final AER report, it will flow through into retail prices. If the TFT was to remain unchanged from its 2008-09 level, other cost elements would need to fall to offset this increase in distribution charges.

As noted in Section 2.2.3, the ACT Government has introduced a feed-in tariff scheme, the costs of which are to be recovered from consumers through electricity distribution charges. Any future possible modification to this scheme would alter its cost.

The possibility of altering the current feed-in tariff scheme was foreshadowed by the Minister for the Environment, Climate Change, Energy and Water at the launch of the scheme when he noted that the ACT Government was reviewing the scheme with a view to adjusting the existing 30 kW cap to allow larger producers the opportunity to take advantage of the feed-in tariff rates. An announcement clarifying this possibility is expected by June 2009.²⁰ The timing of any such changes to the feed-in tariff scheme could be relevant in the setting of the TFT and the inclusion of possible pass-through arrangements (see Section 3.3).

A further matter related to proposed network charges for 2009-10 is the timing of their announcement. At the time of the release of the TFT draft report, network charges for 2009-10 are not expected to be finalised by the AER. As such, an estimate will have to be used in the draft report which will subsequently be adjusted to take into account actual network costs in the final report. The Commission proposes to use the final AER approved distribution charges for 2009-10 in the setting of the TFT.

¹⁹ The draft decision can be accessed on the AER's Homepage; www.aer.gov.au

²⁰ Speech from Minister Corbell announcing the feed-in tariff scheme, 10 February 2009.

2.2.9 Summary of Recent Findings

The Commission's most recent price direction covers the period from 1 July 2008 to 30 June 2009. The individual cost components as discussed above are shown in Table 2-3.

Table 2-3 Composition of TFT retail price for 2008/09

	2008-09
Energy purchase costs (\$/MWh)	
Electricity purchase cost (\$/MWh)	68.90
Energy contracting cost (\$/MWh)	0.72
Green costs (\$/MWh)	4.87
NEM fees (\$/MWh)	0.72
Energy losses	4.86%
Total energy purchase cost (\$/MWh)	78.86
Retail operating costs (\$/MWh)	9.94
Customer acquisition costs (\$/MWh)	-
Total retail costs (\$/MWh)	9.94
Network costs (\$/MWh)	56.06
Total retail + network costs (\$/MWh)	144.86
Retail margin (EBITDA % of Sales,)	5.00%
Total retail price (\$/MWh)	152.10

A more detailed discussion of each item can be found in the Commission's Report 4 of 2008.

The Commission seeks comments on the technical approach used to determine the TFT, and on the values that might be used in the cost build-up to be adopted to prepare the 2009-10 TFT.

3 Non-technical Matters

This Chapter considers non-technical matters. These include:

- Section 20 of the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act)
- Social Impacts
- Pass-through arrangements.

3.1 Section 20 Criteria

The Terms of Reference state that the Commission must have regard to the requirements of Section 20 of the ICRC Act. Section 20 states that:

- (1) At the conclusion of an investigation on a reference authorising the commission to make a price direction in a regulated industry, the commission must decide on the level of prices for services in relation to the period specified in the reference and give a price direction accordingly to each person providing regulated services.
- (2) In making a decision under subsection (1), the commission must have regard to—
 - (a) the protection of consumers from abuses of monopoly power in terms of prices, pricing policies (including policies relating to the level or structure of prices for services) and standard of regulated services; and
 - (b) standards of quality, reliability and safety of the regulated services; and
 - (c) the need for greater efficiency in the provision of regulated services to reduce costs to consumers and taxpayers; and
 - (d) an appropriate rate of return on any investment in the regulated industry; and
 - (e) the cost of providing the regulated services; and
 - (f) the principles of ecologically sustainable development mentioned in subsection (5);
 - (g) the social impacts of the decision; and
 - (h) considerations of demand management and least cost planning; and
 - (i) the borrowing, capital and cash flow requirements of people providing regulated services and the need to renew or increase relevant assets in the regulated industry; and
 - (j) the effect on general price inflation over the medium term; and
 - (k) any arrangements that a person providing regulated services has entered into for the exercise of its functions by some other person.
- (3) Also, in making a decision under subsection (1), the commission must allow a declared fee under section 4C (Declared fees to be passed on to consumers) to be passed on in full to consumers of the service.

- (4) In a price direction, the commission must indicate to what extent it has had regard to the matters referred to in subsection (2).
- (5) For subsection (2) (f), *ecologically sustainable development* requires the effective integration of economic and environmental considerations in decision-making processes through the implementation of the following principles:
 - (a) the precautionary principle—that if there is a threat of serious or irreversible environmental damage, a lack of full scientific certainty should not be used as a reason for postponing measures to prevent environmental degradation;
 - (b) the inter-generational equity principle—that the present generation should ensure that the health, diversity and productivity of the environment is maintained or enhanced for the benefit of future generations;
 - (c) conservation of biological diversity and ecological integrity;
 - (d) improved valuation and pricing of environmental resources.

The Commission intends addressing these matters as part of the current investigation.

3.2 Social Impacts

The Commission is required under Section 20(2)(g) of the ICRC Act to address matters relating to the social impacts of its decisions on vulnerable customers. In doing so, the Commission is guided by organisations such as the ACT Civil and Administrative Tribunal, Care Financial Counselling Service, the ACT Council of Social Service and other support agencies.

In considering the need to address the social impacts of its decisions and the need to protect consumers from any abuses of market power, the Commission is conscious of the range of ACT Government concession programs aimed specifically at assisting more vulnerable customers. These concession programs include rebates on electricity, water and sewerage, general rates, public transport and a range of health care items.

These programs are all designed to assist those in particular need, while the pricing decisions of the Commission, which must balance the wider socioeconomic impacts and the ability of the regulated entity to supply regulated services, are not capable of being as finely targeted.

The Commission supports the use of targeted concession arrangements such as those offered by the ACT Government. In general, these are the preferable way of providing assistance to vulnerable customers rather than global price restrictions which can distort market signals encouraging inefficient and environmentally damaging use of electricity. In addition, global price restrictions do not necessarily provide the desired financial benefit to the most needy in the community.

With specific reference to the TFT, the Commission has stated previously that the TFT was never intended to be a safety net measure for more vulnerable customers.²¹ The Commission is still of this view.

²¹ ICRC, *Final report: Retail prices for non-contestable electricity customers*, Report 8 of 2006, April 2006, p. 2 and Section 4.4.1, pp. 25–28; ICRC, *Final decision and price direction: Retail prices for non-contestable electricity customers*, Report 7 of 2007, June 2007, p. 43; ICRC, *Final Decision and Price Direction: Retail prices for non-contestable electricity customers*, Report 4 of 2008, June 2008, pp 53-54.

In other industries and for other goods and services, an efficient competitive retail market is usually considered to offer a better guarantee against price gouging or exploitation of consumers than a regulated pricing arrangement. In a market where there is a degree of volatility, as there is in the electricity market, a competitive retail market will help to smooth out that volatility as retailers will seek to minimise the churn of customers that can occur if price changes were to be made rapidly and frequently.

A consequence of continually resetting the TFT for a period of a single year is that the Commission is unable to adopt a methodology to smooth year-to-year fluctuations in price as has been done in other jurisdictions. Rather, based on the consistent application of the Commission's current TFT regulatory model, fluctuations in the cost build-up components necessarily flow through directly into the next year's TFT prices. Volatility in the cost components, which subsequently influence price, may affect vulnerable customers disproportionately as they often have limited ability to take action to limit their use of electricity in response to significant price shifts. In these circumstances, the ability of government concession programs to respond rapidly to volatility in price can be muted by the administrative and bureaucratic nature of these concession programs. This is of concern to the Commission and will be a matter that the Commission will consider in the context of the outcome of its cost build-up determination of the TFT.

The Commission seeks comments on possible responses to any change in the TFT in as much as it has social impact consequences.

3.3 Pass-through Arrangements

Pass-through arrangements are often included in regulatory decisions to allow for an adjustment to prices should unforeseen events occur during the life of a price path. If a pass-through trigger event occurs, a new investigation is possibly undertaken to update the prices, or an automatic adjustment may be made.

Pass-through arrangements typically apply to events that are unforeseen, or whose extent is uncertain, and which are outside the ability of the regulated entity to control. As such, the need to include pass-through event triggers increases with the length of the price path. For a price path of only 12 months, as in the TFT, there is a reduced likelihood of requiring such an arrangement.

However, at the time of finalising the 2008-09 price determination, there was a degree of uncertainty regarding the possible introduction of an emissions trading scheme by the Commonwealth Government and a feed-in tariff arrangement by the ACT Government. As such, the Commission included a pass-through mechanism which applied specifically to these two events.²²

Since the release of the 2008-09 price determination, the uncertainty surrounding these two events has diminished. The Commonwealth Government has stated that the Carbon Pollution Reduction Scheme will commence from 1 July 2010 while the ACT Government has set a start date for its feed-in tariff of 1 March 2009.²³ As such, the need for the inclusion of pass-through arrangements in the price direction for 2009-10 may therefore have been reduced.

²² ICRC, *Final Decision and Price Direction: Retail prices for non-contestable electricity customers*, Report 4 of 2008, June 2008, pp 55-57.

²³ Speech from Minister Corbell announcing the feed-in tariff scheme, 10 February 2009.

However, in announcing the introduction of the ACT Government's feed-in tariff scheme, the Minister for the Environment, Climate Change, Energy and Water, foreshadowed that the regime will be adjusted to allow for larger scale projects during the 2009-10 financial year. While the current scheme is capped at 30 kW, the Minister suggested that the scheme will be altered to allow for larger scale projects. An announcement is expected by June 2009 with a possible implementation date during the 2009-10 financial year.²⁴

Any move to increase the cap to allow for larger scale projects during the 2009-10 financial year would in turn increase the costs incurred by the distribution business and raises the question of how these costs might be recovered.²⁵ Any decision on this may need to await a decision by the AER on any possible pass-through of additional costs in the distribution charges in 2009-10. The Commission will need to consider to what extent it needs to allow a pass-through trigger should the AER in turn decide that it will allow a pass-through of any resultant higher distribution charges in 2009-10.

The Commission seeks comments on whether there is a need for pass-through arrangements in the TFT determination for 2009-10.

²⁴ Speech from Minister Corbell announcing the feed-in tariff scheme, 10 February 2009.

²⁵ The introduction of the feed-in tariff regime on 1 March 2009 feed-in tariff may also have pass-through implications for the 2008-09 year, although the setting of a threshold cost impact may mean that the trigger is not activated in the 2008-09 year.

Appendix 1 Terms of Reference

Australian Capital Territory

Independent Competition and Regulatory Commission (Price Direction for the Supply of Electricity to Franchise Customers) Terms of Reference Determination 2008 (No 2)

Disallowable instrument DI2008–305

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)

Reference for investigation under Section 15

Pursuant to subsection 15(1) of the Act, I refer to the Independent Competition and Regulatory Commission (the 'Commission') the provision of a price direction for the supply of electricity to franchise customers for the period 1 July 2009 to 30 June 2010.

Terms of reference for investigation under section 16

Under the Act, section 16(1), I require that the Commission consider the following matters in relation to the conduct of the investigation:

1. In undertaking the review, the Commission should have regard to the requirement of section 20 of the Act.
2. The Commission must produce its final report in time sufficient to allow ActewAGL Retail to make any necessary changes to its billing system and to provide information on the new tariff to customers.

Simon Corbell MLA

Attorney-General

23 December 2008

Appendix 2 Weighted Average Price Cap Formula

The following is the formula used in 2008 to translate the percentage change in the TFT as calculated by the Commission (expressed as $(1 + \text{CPI}) * (1 + \text{X})$) to the change in individual tariffs offered to franchise customers.

The maximum price charged by ActewAGL Retail for the provision of electricity services to franchise customers during the period was calculated in accordance with the following formula:

$$\sum_{i=1}^n \sum_{j=1}^m P_{ij}^t Q_{ij}^R \leq \sum_{i=1}^n \sum_{j=1}^m P_{ij}^{t-1} Q_{ij}^R \times (1 + \text{CPI}) \times (1 + \text{X})$$

Where:

P_{ij}^t was the proposed 2008-09 price for component j of the regulated retail tariff i

P_{ij}^{t-1} was the actual 2007-08 price charged by ActewAGL Retail for component j of the regulated retail tariff i

Q_{ij}^R is the reference quantity for component j of the regulated retail tariff i defined as the actual quantity (in both customer numbers or MWh) as reported by ActewAGL Retail for the 12-month period ending 31 March 2008.

The Commission intends using a similar form of adjustment to translate the movement in the TFT to the tariffs to be charged by ActewAGL Retail in 2009-10.

Appendix 3 Glossary and Abbreviations

ACT	Australian Capital Territory
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
Commission	Independent Competition and Regulatory Commission (ACT)
ESCOSA	Essential Services Commission of South Australia
FRC	full retail contestability
GGAS	Greenhouse Gas Abatement Scheme (ACT) Greenhouse Gas Reduction Scheme (NSW)
IPART	Independent Pricing and Regulatory Tribunal (NSW)
kW	kilowatt
kWh	kilowatt hour
MRET	mandatory renewable energy target
MWh	megawatt hours
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company
TFT	transitional franchise tariff