



independent competition and regulatory commission

Final Decision
and Price Direction
**Retail Prices
for Non-contestable
Electricity Customers**

Report 4 of 2008

June 2008

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.

The Commission has one part-time Senior Commissioner, Paul Baxter.

Correspondence or other enquiries may be directed to the Commission at the addresses below:

The Independent Competition and Regulatory Commission

GPO Box 296
CANBERRA ACT 2601

Level 2
12 Moore Street
CANBERRA CITY ACT

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 and its email address is icrc@act.gov.au.

For further information on this investigation or any other matters of concern to the Commission, please contact the Commission on 6205 0799.

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 franchise customers for the period from 1 July 2008 to 30 June 2009. The Minister's reference dated 7 February 2008 is made under sections 15 and 16 of the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act).

This reference makes the fourth price control arrangement for 'transitional franchise tariff' (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 current reference requires a regulated maximum tariff applicable to TFT customers for a further period of one year from 1 July 2008 to 30 June 2009, and this report outlines the Commission's final determination of the maximum tariff change.

In developing the price direction for the regulated maximum transitional franchise tariff applicable to customers eligible for these transition arrangements for the period from 1 July 2008 to 30 June 2009, the Commission is required to have regard to a number of matters, including:

- the requirements of section 20 of the ICRC Act
- 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 report sets out the Commission's final price direction and reasons for the particular arrangements embodied in the direction.

Paul Baxter
Senior Commissioner
June 2008

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1 Introduction

1.1 Background

In the ACT, the retailing of electricity to customers consuming more than 160 megawatt hours (MWh) per year 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 from 1 July 2001.¹ Following the Commission's recommendation that full retail contestability (FRC) be introduced for all customers in the ACT², the government opened the market for customers using less than 100 MWh/year 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.

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 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, ActewAGL Retail, 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 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 released an issues paper in November 2005 and considered the submissions received on that paper in reaching its draft decision.

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.

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 legislative changes to the *Utilities Act 2000* 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, the Commission received a further reference from the Attorney-General⁶, instructing the Commission to provide a price direction for the supply of electricity to franchise customers for a 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. 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 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.

The Commission has now received a further reference from the Attorney-General, instructing the Commission to provide a price direction for the supply of electricity to franchise customers for a

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 ICRC Act 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.

transitional period from 1 July 2008 to 30 June 2009. As part of addressing these terms of reference, the Commission has again undertaken a rigorous evaluation of the build-up of retail costs. This was required as the wholesale electricity market had begun to exhibit less volatility and the wholesale electricity prices had begun to reduce towards the long-term averages seen before early 2007. This will have fundamental impacts on the cost structures of an incumbent retailer servicing franchise customers and for new entrant retailers seeking to draw customers away from the TFT tariffs provided by ActewAGL Retail, through application of price discounts and additional service features.

1.2 Structure of the final decision

This final decision outlines the Commission's process for conducting this price direction for the supply of electricity to franchise customers, and explains the context of the review and the key issues the Commission has considered in making the price direction.

Chapter 2 outlines the final decision in terms of the overall cost build-up used by the Commission and some of the major cost movements that have contributed to the Commission's decision on prices.

Chapter 3 provides a summary of the draft decision and discusses the primary issues the Commission has considered in moving to its final decision.

Chapter 4 summarises developments relating to regulated retail tariffs in other states.

Chapter 5 summarises the submissions received by the Commission relating to its draft decision, which was published on 23 April 2008.

Chapter 6 provides in more detail the cost build-up used to determine the TFT.

Chapter 7 reviews other aspects of the TFT and, in particular, safety net provisions and support for vulnerable customers.

Chapter 8 provides the Commission's conclusions and sets out the Commission's final decision on the TFT.

The terms of reference for the Commission's review of the TFT are provided in Appendix 1.

The final price direction is provided in Appendix 2.

The Commission's regard for section 20 of the ICRC Act in its final Direction is summarised in Appendix 3.

2 Overview of the final decision

In the ACT, customers who choose not to use an electricity tariff offered by a competing electricity retailer or opt for a contract from the incumbent retailer, ActewAGL Retail, remain on a regulated retail tariff (the ‘transitional franchise tariff’, or TFT) provided by the incumbent retailer. The obligations imposed on the Commission in determining the charging levels for the TFT are described in the *Independent Competition and Regulatory Commission Act 1997* (the ICRC Act). In particular, the provisions of section 20 of the ICRC Act provide guidance to the Commission on how to balance its regulatory obligations for price directions. A price direction needs to balance a number of conflicting objectives, including the need for reliable supply of services of a defined quality, the need for efficient delivery of services with incentives to reduce costs, the need to encourage participation in the retail electricity sector by allowing financially viable service provision, and the need to have regard to the social impacts of the tariff levels and general price inflation.

The Commission’s approach to the determination of retail electricity prices for ActewAGL Retail customers who choose to stay on the TFT has been to draw on benchmark cost information available in the marketplace or in other regulatory decisions within the retail electricity sector in Australia. This benchmark information has been used to arrive at a reasonable estimate of the economically efficient cost base of an incumbent electricity retailer providing retail electricity supply services to a regulated customer segment. It is worth emphasising that all electricity retailers operate as aggregators of energy demand from small, medium and large consumers of electricity, who benefit from collective purchasing of energy from generators in a competitive electricity market. While the retailer profits from this aggregation, each customer is better off because their collective bargaining power and their ability to hedge energy price volatility is significantly enhanced through joining with a retailer, rather than accessing the electricity market directly.

Having arrived at an economically efficient cost base for the incumbent electricity retailer using the guidance of section 20 of the ICRC Act, the Commission has converted that cost base into an incentive-based regulatory framework which has the form of a weighted average price cap. The weighted average price cap allows ActewAGL Retail to rebalance the TFT towards the efficient cost base underlying each of those tariffs subject to regulation. ActewAGL Retail is allowed to adjust prices for the regulated customer base through the TFT up to the level set by the weighted average price cap defined in the Commission’s price direction for the 2008–09 regulatory year.

In considering the determination of an appropriate TFT for the 2008–09 year, the Commission has revisited the cost build-up and other information used in setting the TFT over the past four years. The following sections of this report describe the various cost components of an incumbent electricity retailer and the economically efficient cost levels which the Commission believes should be incorporated into the weighted average price cap for 2008–09.

2.1 Summary of the retail costs underlying the final decision

The Commission has reviewed the main activities of electricity retailers and, through examination of its previous TFT decisions, publicly available industry information and recent regulatory draft and final decisions, has arrived at an estimate of the economically efficient cost base of an incumbent electricity retailer operating in an environment similar to that of ActewAGL Retail.

Table 2.1 summarises the main retail cost elements and compares them to the values published by the Independent Pricing and Regulatory Tribunal (IPART) in its final determination⁹ for electricity retailers in New South Wales.

Table 2.1 Summary of estimated efficient retail costs, ICRC and IPART

	ICRC 2008–09	IPART 2008–09
Energy purchase costs		
Electricity purchase cost (\$/MWh)	68.90	61.16
Energy contracting cost (\$/MWh)	0.72	–
Green costs (\$/MWh)	4.87	5.29
National Electricity Market fees (\$/MWh)	0.72	0.72
Energy losses	4.86%	9.10%
Total energy purchase cost (\$/MWh)	78.86	73.28
Retail operating costs (\$/customer)	97.12	79.36
Customer acquisition costs (\$/customer)	–	37.03
Adjustment for double-counting (\$/customer)	–	(5.29)
Total retail costs (\$/customer)	97.12	111.10
[Retail margin (EBITDA % of sales)]	5.00%	5.00%

Note: IPART's final decision was released in June 2007, and under an annual review the wholesale energy costs were reviewed in May 2008. No change to the wholesale energy costs in the previously determined glide path were accepted for 2008–09. The numbers shown in Table 2.1 are those for Integral Energy but restated in nominal terms using the Commission's 2.33% per annum inflation assumption.

The estimates of efficient retail costs in Table 2.1 are those costs which are added at the retail level. The additional costs which are recovered in the TFT but are not shown in Table 2.1 are the pass-through of the regulated transmission costs into the regulated distribution costs, and the pass-through of the combined regulated distribution and transmission costs as network use of system costs recovered from all consumers at the retail level. While the overall weighted average price cap applied by the Commission at the retail level for TFT customers allows for the recovery of the efficient costs of retail supply to TFT customers, the nature of the cap allows the retailer to improve its overall productivity through efficiency improvements that result in cost savings. The cost savings are only available from those cost elements that can be influenced by the activities of the retailer. Thus, for example, government taxes and charges placed on the retailer are simply passed-through costs, as are network use of system costs. However, general 'back room' billing costs and costs associated with new customers returning to the TFT can be influenced by the retailer's decisions and behaviour.

One concern of the Commission relating to the reference requirement for the TFT to be set for a 12-month period is that volatility in the wholesale electricity pool price resulting from supply–demand imbalances in the wholesale electricity market must be factored into the analysis on a year-by-year basis. This has led to an increase in the allowed energy purchase cost recovery in the retail cost build-up in 2007–08 and now in 2008–09, and there is an expectation that as the pool price has reduced during the first quarter of 2008, there is a likelihood of a reduction in the energy

⁹ IPART, *Final report and final determination, Promoting retail competition and investment in the NSW electricity industry, Regulated electricity retail tariffs and charges for small customers 2007 to 2010*, June 2007.

purchase cost recovery in the retail cost build-up in 2009–10. Any reduction will be dependent on outcomes in the wholesale electricity market during the remainder of 2008 and early 2009, and whether a further reference from the government is received for development of a TFT for 2009–10.

The continuing short reference period constrains the Commission in how it is able to allow cost changes resulting from wholesale electricity market supply–demand imbalance to be passed through to consumers by the incumbent retailer. The short reference period means the Commission is unable to transition any price changes over a longer period, as has been allowed in other jurisdictions.

In order to meet the legislated requirements of section 20(2) of the ICRC Act¹⁰, the Commission is constrained to allow large increases in energy cost to be passed through immediately without a transition (other than that which occurs automatically as a result of the hedging of electricity purchase arrangements adopted by the retailers), which might otherwise be considered. Indeed, large increases in energy cost that cannot be passed through by the incumbent supplier to TFT customers under the provisions of a particular TFT determination:

- reduce economic efficiency (s. 20(2)(c)) because tariffs no longer allow recovery of efficient costs
- reduce the success of demand-side management (s. 20(2)(h)) by muting the price signals seen by consumers
- inhibit sustainable financial viability (s. 20(2)(i)) by limiting the incumbent retailer from passing through costs which it has limited opportunity to control
- reduce the retailer’s ability to meet its contracted functional obligations in the national electricity market (NEM), which is a breach of the ICRC Act (s. 20(2)(k)).

However, the large increases in energy cost which were included in the previous final decision for 2007–08 and for this final decision for 2008–09, albeit at a reduced rate of growth, are in fact limited when compared to the electricity pool price increases over the same period (see Figure 2.1). The hedging assumptions used by the Commission to mirror the behaviour of retailers have the effect of reducing the amplitude of the electricity price volatility and of delaying the rise and also the fall of the electricity prices. The approach to smoothing the electricity price volatility through the use of hedging assumptions is justified because of the Commission’s consideration of the social impacts of its decisions (s. 20(2)(g)).

A longer reference period would mean the Commission could further smooth the remaining rises and falls in the projected wholesale electricity prices, which might improve the outcomes for consumers on the TFT while at the same time not unduly disadvantaging the retail supplier, ActewAGL Retail.

The issue of the wholesale energy market clearing price is extremely important in the decision about the TFT level. The short-term nature of the terms of reference set for the Commission only

¹⁰ References to ‘section 20’ in this report are to that section of the ICRC Act.

exacerbates the problem faced by the Commission in setting a TFT that meets all the requirements of the Act.

In this context, the Commission believes its final decision on the TFT described in this report is the best balance between the conflicting objectives of section 20(2), taking into account the short-term nature of the terms of reference set by the government.

2.2 Cost changes affecting the final decision

In determining the cost estimates in Table 2.1, the Commission has used the retail operating cost estimates which underlie its earlier decisions for the TFT from 2003–04 to 2005–6 and the separate 2006–07 and 2007–08 outcomes, and escalated those costs by the CPI calculated on a historical basis to arrive at estimates for the 2008–09 financial year.

In its draft decision the Commission excluded potential customer acquisition costs related to the churn off and return of TFT customers. Having considered arguments advanced in some submissions on this matter and considering the requirements of section 20(2), the Commission has decided to continue with its previous position and exclude these costs in the cost base. The Commission notes that in their submissions, ActewAGL Retail proposed a value of \$20.84 per customer per annum and TRUenergy proposed a value of \$35.00 per customer per annum to represent the costs of effectively a new entrant to the market. The Commission notes that under its terms of reference for this review it has not been required to consider the costs of a new entrant as has been the case for some other jurisdictional regulators when making determinations on similar transitional electricity tariffs.

Following receipt of submissions on its draft decision, the Commission has adjusted its previous estimates of the ‘green’ costs, including the mandatory renewable energy target (MRET) and greenhouse gas abatement scheme (GGAS) costs mandated by legislation.¹¹ These costs have been adjusted to be in line with the costs applying in NSW.

The Commission has estimated the NEM fees using public information on the fee structures and estimates of ActewAGL Retail’s likely operating circumstances in 2008–09.

Likewise, the distribution loss factors published by NEMMCO and relied upon for many tariff calculations show a slow reduction in distribution loss factors for ACT distribution tariff consumers.¹²

The Commission has retained the 5% retail margin adopted in its draft decision, following an increase from the 4% used in its final decision for 2007–08. This is the same as the average value used by IPART in its most recent final determination of June 2007, and is now in line with the most recent regulatory decisions in other jurisdictions. The Commission retail margin is applied to total retail sales (including network costs) as it is in Queensland and Tasmania. By comparison, the IPART retail margin is applied to the energy purchase and retail operating costs, but excluding network costs. However, the quantum of allowable cost to be recovered is approximately the same.

¹¹ *Renewable Energy (Electricity) Act 2000* (Cwth) and *Renewable Energy (Electricity) Regulations 2001*.

¹² NEMMCO, *Distribution loss factors for the 2008–09 financial year*, Appendix D.

The major change from the cost structure used in previous price directions prepared by the Commission relates to the large and rapid increase in the wholesale electricity price observed during mid 2007, followed by a slower reduction in the last quarter of 2007, and a slight rise to a higher average value during the first quarter of 2008. Table 2.2 lists the average annual regional reference price (RRP) for New South Wales from 1998–99 to 2006–07.¹³

Table 2.2 Average yearly RRP for New South Wales (\$/MWh)

1998–99	1999–00	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
33.13	28.27	37.69	34.76	32.91	32.37	39.33	37.24	58.72	41.81 (*)

Note (*): Average to 12 June 2008.

While there was a slight increase in the average yearly RRP in 2006, the effect did not become dramatic until 2007. Table 2.3 shows the average and the median monthly RRP for New South Wales for 2007.¹⁴

Table 2.3 Average and median monthly RRP for 2007 (\$/MWh)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
Average (\$/MWh)	55.91	44.76	51.28	78.21	63.28	230.66	77.87	39.94	47.95	40.72	36.01	40.16
Median (\$/MWh)	35.22	36.91	42.08	75.98	59.89	138.76	68.48	40.23	47.54	35.79	35.10	34.72

As can be seen, average prices for 2007 were much higher than previous average RRP, reaching \$230.66/MWh in June 2007. Median prices are also included in the table to demonstrate that the increase in the pool price is driven by a change in underlying fundamentals and not generated by large one-off shocks to the market.¹⁵ Figure 2.1 charts the mean and median average daily RRP by month. The change in underlying median price to a higher value during the price spike period and the settling to a value in the first quarter of 2008 which is higher than the fourth quarter of 2006 suggests a change in the fundamentals of the wholesale electricity market.

Information from NEMMCO and from ActewAGL Retail provided during the TFT review in 2007 suggested that the general uplift in the pool price outcomes in mid 2007 arose from water storages in the Snowy Mountains, Victoria and Tasmania falling nearly to their minimum run capacities. This resulted in the steady withdrawal of capacity from the Snowy, Victorian and Tasmanian hydro plants as the water fuel source neared depletion. In addition, some of the thermal base-load plants in Queensland were required to withdraw capacity from the market because they could not access sufficient cooling water from local rivers and storages to allow full-capacity operation. For example the 1,400 MW Tarong base-load plant was dispatching at around 75% of its rated capacity from the beginning of 2007, and from the end of March 2007 had reduced its available capacity to around 30% of its rated capacity, which is significantly less than in previous years. While some of this plant provides peaking capacity, other facilities provide base load. Both peak

¹³ The 2006–07 prices are through 7 May 2007. Data sourced from NEMMCO and available at <http://www.nemmco.com.au>.

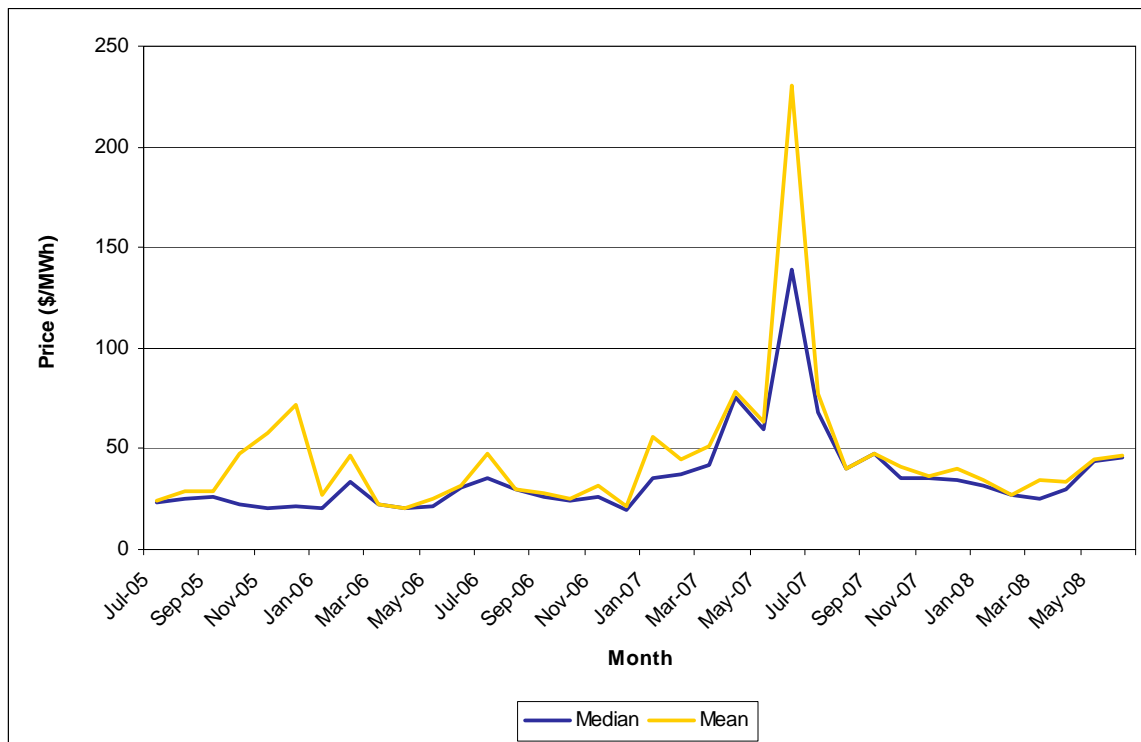
¹⁴ This is the period across which the highest mean and median price spikes occurred.

¹⁵ The average monthly RRP for November 2004 also exceeded \$70/MWh. That high average was driven by an average daily price of \$1,115.75/MWh for 30 November 2004. The median RRP for November 2004 was \$30.85/MWh.

and base-load capacity needed to be replaced by power from higher cost thermal plants using coal, gas or diesel fuels, in order to maintain the safe operation of the NEM.

Subsequently, in the last quarter of 2007 and the first quarter of 2008 there appears to have been an easing of the available generation capacity restrictions, albeit with the potential for further drought issues and current high oil prices (which influence gas and coal prices over time) to place a floor under the wholesale electricity prices which are currently being seen.

Figure 2.1 Average and median of daily RRP by month since July 2005 (\$/MWh)

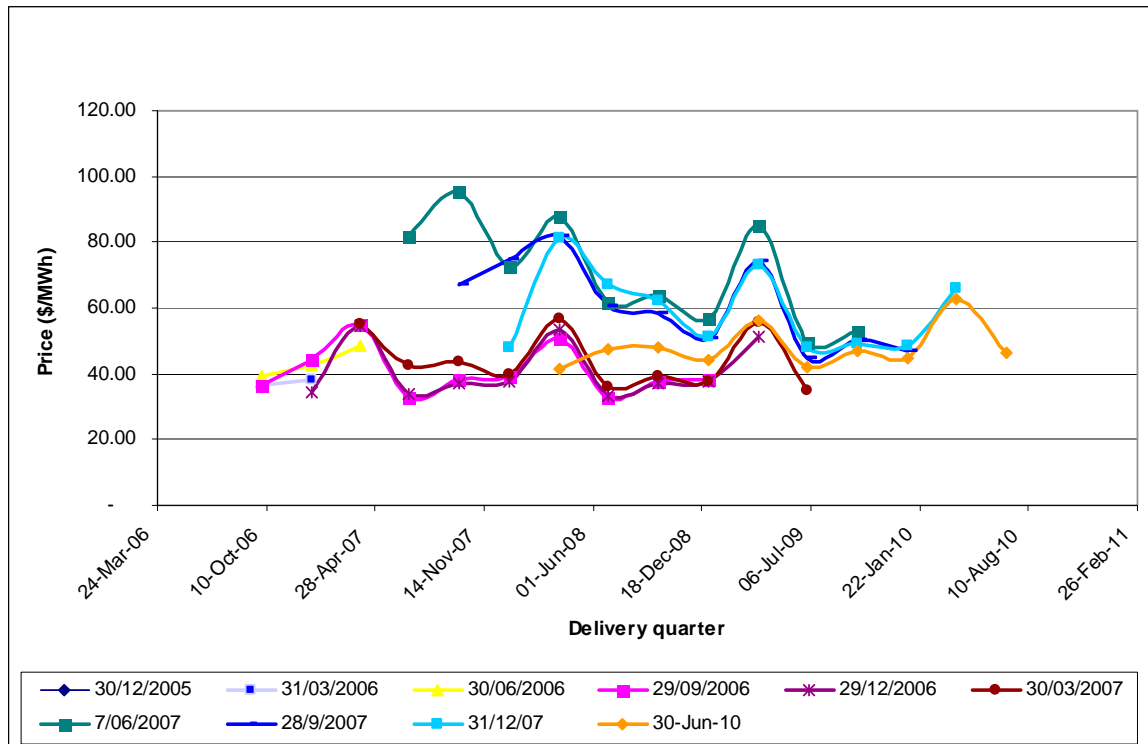


The Commission is aware that good practice in electricity retail business management suggests that electricity pool prices should be hedged to a certain extent by contracts between the retailers and the generation companies (including by bilateral, caps, swaps and other contracts), and in the financial futures markets. While this limited the impact of high pool prices in 2007–08 seen by retailers (even though the Commission’s decision in 2007–08 allowed approximately a 40.9% increase in wholesale electricity cost), the result has been that the spike in pool prices (which was greater than 229% above the average 2006 pool price) will still be seen in the contract prices but reduced in amplitude and lagged over the mid-term (one to two years). As such there is an expectation that the energy cost for ActewAGL Retail (and other retailers in the ACT) will rise somewhat again in 2008–09 and then possibly fall in subsequent years provided there is a continued easing of the drought and its impacts, and oil prices begin to ease over the coming months.

To explore the impact of hedging on the energy purchase cost, the Commission has accessed market data through a subscription data service. While a number of different types of hedging instruments are used between retailers and generators, Figure 2.2 provides the base swap contract prices for future delivery averaged over the quarter in which the contract was written and for different energy delivery dates. The curves have been smoothed to help highlight the trends.

The Commission observes that, in the current quarter up to 12 June 2008, there has been an easing in the price of the written contracts for future delivery compared to the substantial increase seen in mid 2007. Thus the changes seen in the spot market were also reflected in the contract markets as wholesale electricity market participants attempted to hedge to reduce their financial risk and to forestall the increase in energy costs which was seen in mid 2007. The Commission notes the tendency for a reduction in premium for later delivery from the prices seen in mid 2007, but these are still higher when compared to the prices seen in 2006. This suggests that market participants see this change as a mid-term change which could correct to historical averages over time.

Figure 2.2 Base swap contract price averaged by written quarter versus delivery (\$/MWh)



Source: d-cyphaTrade

The Commission has factored these changes into its final decision on the price direction. The approach it has used to calculate an energy cost is described in Section 6.2.1.

2.3 Market outcomes and retail competition

The Commission believes that the development of the competitive, interconnected electricity market at the wholesale level in the eastern and southern states of Australia has delivered significant benefits to electricity consumers and the broader Australian economy. Under the competition and market reforms of the past decade, the balancing of supply and demand for electricity in the wholesale electricity market has provided a mechanism for achieving the lowest reasonable cost of electricity in an economically efficient manner. The outcomes of this market will always depend on the availability of reasonably priced fuels for the generators and on continuing investment in new generation plant as demand begins to outpace supply. If one form of fuel has price rises greater than another, then the generator using cheaper fuel will be ‘dispatched’ for supply purposes before the generator using a more expensive fuel type. Similarly, generator

investment decisions will consider which fuel type would most likely be able to compete in the future marketplace and most likely be dispatched into the electricity pool.

When the pool price for energy (that is, the overall market price set by demand and supply signals) rises, there is a price signal to encourage investment in new generation capacity, the enhancement of existing generation (for example, investment in closed cooling cycles) and/or the replacement of existing generation with alternative, cheaper fuel types.

The Commission has a concern that, after around seven years of stable and generally lower wholesale energy prices, the shortage of water for hydro generation has started a process of re-rating the cost of water as a fuel resource, which may have a medium-term impact on the price of electricity in the NEM. This does not alter the benefits flowing to consumers, who continue to have access to the lowest price available from a market. However, it does mean that prices for electricity will rise.

One concern of the Commission is that the benefits of the energy market need to flow to consumers, particularly small consumers. This is best achieved where consumers directly access the retail market and exercise their right of choice of retailer. Shopping around for a retailer to supply their needs at the lowest price is the best way for smaller consumers to reap the benefits of competition. That is, vigorous competition at the retail level among electricity retailers sourcing electricity from a competitive and hence efficient wholesale market for electricity will be in the best long-term interests of consumers.

All consumers, large and small, need to be active in the marketplace. If there are tariffs on offer at a lower overall expense than the tariff a consumer is currently receiving, TFT or otherwise, the consumer should exercise their right of choice and opt for the lower competitive tariff through a decision to change retail supplier, or to change to a discounted tariff with their incumbent retail supplier. Ultimately, the benefits of competition will not eventuate if most consumers do not become active participants in the market.

As long as the TFT remains in the market and is regulated by the Commission, the Commission will set the TFT to balance the objectives of section 20 of the ICRC Act. However, the regulatory mechanism cannot develop prices which are as responsive to demand and supply signals as prices in a competitive and open marketplace. Where an open market is operating (as it does for the wholesale supply of electricity), prices will fluctuate with changes in factors affecting that market (much as it does for the supply of crude oil or fresh fruit and vegetables). The Commission needs to allow the pass-through of those changes in costs to avoid a situation in which retailers can no longer afford to subsidise the supply of electricity to their customers. Similarly, the Commission would seek to reduce prices where wholesale prices are falling. The issue for the Commission is one of timing, as the regulatory process is time consuming and does not respond as quickly as the marketplace.

The Commission encourages all consumers using TFTs to exercise their choice of retailer and to seek lower prices for electricity supply where they are available. At the same time, it must be recognised that major shifts in the underlying generation costs will flow through to retail prices at all levels.

2.4 Recent regulatory decisions on generator prices

A number of jurisdictional regulators have residual regulated franchise tariff arrangements similar to the TFT. The jurisdictional regulators that undertook processes to review the prices for customers who had not yet exercised their right to enter the contestable retail market during 2007 were the Independent Pricing and Regulatory Tribunal (IPART) in New South Wales, the Queensland Competition Authority (QCA), and the Essential Services Commission of South Australia (ESCOSA). The Office of the Tasmanian Energy Regulator (OTTER) concluded its review in late 2006. As part of these reviews, the regulators had to consider the method to be used in determining the cost of electricity at the wholesale (generator) level, and then address the additional costs that would ultimately be included in the final price that the consumer would pay the retailer. The following discusses some of the issues raised by the decisions on generator costs adopted by these regulators. Section 4 discusses the final retail price composition approved by each regulator where information is made public.

2.4.1 IPART

The IPART final report and final determination was released in June 2007. Table 2.1 summarises the IPART final decision as it relates to Integral Energy.¹⁶ The IPART final report was based on electricity generation forecasts, prepared by Frontier Economics, which pre-date March 2007¹⁷, when there was a notable shift in generation prices (discussed in Section 2.2, above). Table 2.4 shows the peak wholesale prices forecast by Frontier Economics in its March 2007 report. The expectation was high prices in 2007–08 and easing prices in 2008–09 and again in 2009–10.

Table 2.4 Peak energy price changes—Frontier review for 2007–08 to 2009–10

NSW retailer	2007–08 (\$/MWh)	2008–09 (\$/MWh)	2009–10 (\$/MWh)	Change 2007–08 to 2008–09 (%)	Change 2008–09 to 2009–10 (%)
Country Energy	72.9	72.2	64.0	-1.0%	-11.4%
Energy Australia	110.4	109.6	98.7	-0.7%	-9.9%
Integral Energy	120.9	119.9	107.4	-0.8%	-10.5%

Note: Conservative price estimate.¹⁸

These prices are generally higher than the historical averages seen prior to January 2007 in Figure 2.1 and comparable to the high mean RRP seen in December 2005 and the middle of 2007. For 2008–09, Frontier Economics forecast an easing of these prices for peak periods, and a strong reduction in 2009–10. Frontier Economics then went on to estimate the energy cost for each business in NSW based on a contract hedging model, and the final energy costs adopted by IPART in its 2007 review are shown in Table 2.5 below. The outcomes are notably lower than the peak

¹⁶ IPART, *Promoting retail competition and investment in the NSW electricity industry: Regulated electricity retail tariffs and charges for small customers 2007–2010 (Final report and final determination)*, June 2007, extract of Table 6.1, p. 75, escalated to nominal numbers for 2008–09 using the Commission’s inflation assumptions.

¹⁷ Frontier Economics, *Energy costs*, final report, March 2007, Figure 22.

¹⁸ See also IPART, *Promoting retail competition and investment in the NSW electricity industry: Regulated electricity retail tariffs and charges for small customers 2007–2010 (Draft report and draft determination)*, April 2007, Table 6.5, p. 56.

prices because consumption at peak prices is offset by consumption at off-peak times, and through the contract hedging arrangements modelled by Frontier Economics.

Table 2.5 Contracted energy price changes—Frontier reviews for 2007–08 to 2008–09

NSW retailer	2007 review			2008 review	
	2007–08 (\$/MWh)	2008–09 (\$/MWh)	Change 2007–08 to 2008–09 (%)	2008–09 (\$/MWh)	Change 2007 estimate to 2008 estimate (%)
Country Energy	51.1	51.2	0.3%	50.0	-2.3%
Energy Australia	58.4	58.5	0.2%	56.9	-2.8%
Integral Energy	60.9	61.2	0.4%	59.6	-2.6%

Note: Data from IPART 2007 and 2008 reports plus volatility allowance and escalated to nominal numbers using the Commission's inflation estimates.

The IPART final findings on the allowance for energy costs to use in the New South Wales regulated retail tariff controls are much less than the peak prices modelled, which is in line with the Commission's findings as described in section 6.2.1 below.

The IPART final determination called for an annual review of the wholesale energy prices in recognition, among other things, of the volatility in the wholesale energy market that was being displayed around the time that it was required to make its final determination in mid 2007. This annual review provided a trigger level on the change in modelled wholesale energy of +/- 10%, above or below which IPART would consider adjusting the price path it had set in its final determination.

Following its annual review in early 2008, the IPART final report¹⁹ provided updated numbers for 2008–09 based on a further review by Frontier Economics with revised estimates of \$50.0/MWh for Country Energy, \$56.9/MWh for Energy Australia and \$59.6/MWh for Integral Energy for 2008–09 (refer Table 2.5 above). It is important to note that Frontier Economics in its updated modelling of wholesale prices²⁰, indicated a fall in the real price of wholesale electricity for 2008–09 of between 2.3% and 2.8% from those prices modelled the previous year. This is in strong contrast to the Commission's estimation of hedged contract price outcomes based on market data, which shows an increase in real prices of around 6%. Because the 10% trigger level referenced above was not reached, IPART did not reopen its price path for 2008–09. These outcomes are discussed further in section 4.1 below.

2.4.2 QCA

The QCA released a final report on its Benchmark Retail Cost Index for 2006–07 and 2007–08 in June 2007.²¹ In preparing its report, and to meet the requirements of the Queensland legislation, the QCA had to consider the long-run marginal cost (LRMC) of electricity generation in that state. The QCA relied on analysis undertaken by CRA International which pre-dated the peaking of the increases in the wholesale electricity pool price experienced from around mid 2007. In its final decision, the QCA determined a cost of energy of \$56.0/MWh for 2007–08, which includes an

¹⁹ IPART, *Market-based electricity cost purchase allowance—2008 Review*, May 2008, Table 3.1, p. 11.

²⁰ Frontier Economics, *Annual energy cost review: Response to submissions from stakeholders*, May 2008, Figure 1, p. 7.

²¹ QCA, *Final decision: Benchmark Retail Cost Index for electricity: 2006–07 and 2007–08*, June 2007.

‘energy purchase’ cost element designed to reflect the retailers’ load shape, the volatility of spot prices and the correlation between spot prices and load.

The generation cost estimate for Queensland is calculated using methods that derive the LRMC of energy based on a combination of generation technologies during a single year. The LRMC of energy in Queensland was projected to increase from \$43.30/MWh in 2006–07 to \$44.00/MWh in 2007–08. These costs are before taking into account various other costs, such as Queensland’s 13% Gas Scheme, MRET and NEM fees, and the ‘energy purchase’ costs.

The QCA released a final report on its Benchmark Retail Cost Index for 2008–09 in May 2008.²² In its report, and to meet the requirements of the Queensland legislation, the QCA has had to consider not only the long-run marginal cost (LRMC) of electricity generation in that state, but also ‘the cost of purchasing energy to supply the NEM load of Queensland’. The QCA continued to rely on analysis undertaken by CRA but also factored in market data from d-cyphaTrade. In its final decision, the QCA revised its estimate of the cost of energy for 2007–08 to \$48.86/MWh and for 2008–09 to \$52.91/MWh²³, showing an 8.3% increase in the cost of energy over the year (including the ‘energy purchase’ cost element designed to reflect the retailers’ load shape, the volatility of spot prices and the correlation between spot prices and load).

2.4.3 ESCOSA

In its final determination of November 2007²⁴, ESCOSA used two different approaches to estimate the LRMC of energy for each quarter of the regulatory period from 1 January 2008 to 30 December 2010. ESCOSA adopted a range of energy prices of between \$76.66/MWh and \$87.70/MWh for 2008 and \$78.77/MWh and \$88.60/MWh for 2009 (all in March 2008 dollars). This equates to between a 1.0% and 2.8% real increase respectively, or between 3.3% and 5.1% respectively in nominal terms using the Commission’s inflation assumption.

2.4.4 OTTER

The approach to regulation of regulated franchise tariffs in Tasmania differs from other jurisdictions. OTTER concentrates regulation on the terms and conditions of the fall-back contract, and the allowed retail margin and retail service costs.²⁵ Otherwise, Aurora Energy is free to articulate its tariff strategy through a public consultation process.²⁶ These reports from Aurora do not provide details of average energy purchase cost allowances, which are effectively a pass-through to retail customers. It is not possible to identify, therefore, the energy generation costs used in the Tasmanian calculations.

²² QCA, *Final decision: Benchmark Retail Cost Index for electricity: 2008–09*, May 2008.

²³ QCA, May 2008, Table 2.2, p. 25.

²⁴ ESCOSA, *2007 review of retail electricity price path, final inquiry report & price determination*, November 2007, Table 7.6, p. A-51.

²⁵ OTTER, *Final decision: Approval of pro-forma fallback contract, retail margin and retail service costs proposed by Aurora Energy Pty Ltd*, December 2006.

²⁶ Aurora Energy, *Retail tariff strategy, 2008–09 and 2009–10*, 15 May 2008.

2.4.5 Summary of energy cost outcomes

For reasons described more fully in Section 6.2.1 of this report, the Commission has adopted a higher energy purchase cost in its analysis than that identified in the jurisdictional reports cited above. In part, this reflects the requirement that the Commission consider section 20 of the ICRC Act, and the single-year, one-off nature of the price determination that the Commission is to provide. The Commission cannot ignore the evidence that appears to support a rise in electricity prices at the current time, although it is not possible to determine the full extent of this rise or the likelihood of any price reduction in the near future to levels more consistent with the market outcomes before January 2007. The Commission has therefore adopted an energy purchase cost of \$68.9/MWh, which is a 7.9% increase in wholesale energy price for the year. This excludes an energy contracting/management cost of \$0.70/MWh, which has been added separately to the cost base.

The energy cost outcomes in the Commission's current decision are higher than those in the IPART and QCA final determinations for 2008–09, but below the values adopted by the ESCOSA final determination for 2008–09. Unlike other regulators that have been able to smooth out the high spike in prices that occurred in 2007, the ACT Government's approach has effectively required the Commission to pass through annually the efficient costs of sourcing electricity from the generators.

3 Summary of draft decision

This section summarises the Commission’s draft decision.²⁷

3.1 Summary of benchmark retail costs from draft decision

Based on the benchmark cost analysis in its draft decision report, the Commission proposed the cost breakdown provided in Table 3.1 as the reasonable cost base for development of the weighted average price cap to be applied to the TFT for the 2008–09 year.

The Commission believed that these costs were reasonable for an efficient incumbent retailer providing services to the TFT customer base in the ACT. As efficient costs, these met the objectives of s. 20(2)(c) and allowed the correct price signals to be seen by end-users of the TFT. This aligned with the objective of s. 20(2)(h) to provide robust demand-side management pricing signals while protecting TFT consumers from excessive price increases, which would not support the objective of s. 20(2)(a) to limit the exploitation of monopoly power.

The cost breakdown for the draft decision was based on the available benchmark costs for each cost category. For the draft decision, the cost category associated with wholesale energy purchase costs used updated data from the Sydney Futures Exchange (SFE) relating to swap prices for base and peak delivery.

In the previous final decision for 2007–08, the Commission relied more heavily on the historical settlement data, and pegged the value for June 2007 forward to June 2008 to estimate for the forward wholesale energy price. This was a reasonable approach given the apparent continuing rise in the electricity pool price and concern over the liquidity of the futures contracts; hence, whether the SFE data was representative of future contract prices. The use of SFE data in the Commission’s draft decision reflected the stronger liquidity in these contracts resulting from the significant increase in pool price volatility during the second half of 2007, and the indication that this improved liquidity allows the forward futures price curves to be a reasonable representation of likely contract prices between generators and retailers in the wholesale electricity market. This data appears reliable out to contracts for delivery in 2010 and to contracts for 2011 being written at the time of this decision’s preparation. The Commission notes that the futures data set available at

Table 3.1 Composition of TFT retail price

	2008–09
Energy purchase costs (\$/MWh)	
Electricity purchase cost (\$/MWh)	71.69
Energy contracting cost (\$/MWh)	0.72
Green costs (\$/MWh)	4.95
NEM fees (\$/MWh)	0.72
Energy losses	4.86%
Total energy purchase cost (\$/MWh)	81.87
Retail operating costs (\$/MWh)	9.94
Customer acquisition costs (\$/MWh)	0.00
Total retail costs (\$/MWh)	9.94
Network costs (\$/MWh)	54.27
Total retail costs (\$/MWh)	146.08
Retail margin (EBITDA % of Sales)	5.00%
Total retail price (\$/MWh)	153.38
Assumed CPI change, 2007–08 to 2008–09	2.33%
X factor in CPI+X on MAR in \$/MWh	7.86%

²⁷ ICRC, *Draft report: Retail prices for non-contestable electricity customers*, Report 2 of 2008, April 2008.

the time of the draft decision was more limited than is now available for this final decision, and this has had an impact on the wholesale electricity costs, which is discussed further in Section 6.2.1.

The Commission also separately benchmarked the combined retail operating costs and customer acquisition and retention costs against other jurisdictions in its draft decision, but concluded that there was not enough clear evidence that an additional amount needed to be added for customer acquisition and retention costs within the ACT. The Commission had concerns that its reference from the government, which was focused on the s. 20(2) criteria, did not specifically require the cost build-up to that of a new entrant into the ACT retail electricity market. This is discussed further in relation to this final decision, in Section 6.2.7.

In all other respects, the draft decision followed the approach used by the Commission in its previous decisions on regulated retail tariffs. The cost analysis for the final decision is outlined in more detail in Chapter 6.

3.2 Weighted average price cap in draft decision

In its draft decision, the Commission determined that ActewAGL Retail's franchise tariff revenue should increase by up to the CPI plus 7.86%. The Commission determined in its draft decision that the appropriate value of the CPI was 2.33%. In making this determination for one year, the Commission has not changed the form of regulation faced by ActewAGL Retail, continuing the regulated retail arrangements initiated in its 2003 report.

3.3 Primary issues for review in the final decision

During its analysis of benchmark and market-based costs for the draft decision, the Commission became aware of a number of issues that would affect its development of a final decision. The primary issues identified were:

- evidence of a moderation of the wholesale electricity pool price following recent high pool prices during the period from June 2007 to December 2007
- evidence that the futures market and bilateral contract prices were reflecting these changes in pool prices
- the possibility that a further increase in the benchmark costs for TFT customers could impose a further strain on ACT consumers, following the increases in the current financial year
- recent regulatory outcomes in other jurisdictions that had reviewed and/or adjusted their regulated retail tariffs.

The Commission continues to have less detailed information than ActewAGL Retail on the level of ActewAGL Retail costs for TFT customers, in part due to the commercially sensitive nature of the contestable electricity retail sector.

The Commission has considered these issues and, particularly where submissions raised concerns about them, sought ways to ameliorate their effects, subject to the guidance of s. 20(2) of the ICRC Act.

4 Developments in other states

All jurisdictions associated with the NEM retain some form of residual retail price regulation on retail customer tariffs to cater for customers who have access to contestable retail tariffs but choose to remain on a regulated tariff with their original incumbent retail supplier. In the ACT, these customers are termed ‘franchise’ customers.

Between late 2006 and mid 2008, the end of a regulatory period approached in a number of jurisdictions, requiring regulators to reassess the regulatory settings for residual regulated retail tariffs. Of prime interest to the Commission are the retail price reviews by IPART in New South Wales, the QCA in Queensland, ESCOSA in South Australia and OTTER in Tasmania. IPART, QCA, ESCOSA and OTTER have all published their final determinations and have undertaken the tariff reviews required for the 2008–09 year. For the Victorian Department of Primary Industry, the deadline for updating regulated retail arrangements is 1 July 2008.

The Commission considered what had occurred in other jurisdictions up to mid June 2008 in preparing the final price direction. The Commission had to rely principally on the benchmark information provided in the draft determinations of IPART and the QCA and on the information available on the electricity pool and contract markets. The following three sections briefly describe the IPART, QCA and ESCOSA final determinations for 2008–09 and, in particular, the make-up of the final retail prices.

4.1 Final outcomes from New South Wales

IPART undertook a regulatory review of the retail price control arrangements for franchise customers, and developed a final determination for the period 2007–08 to 2009–10. Its final determination, dated June 2007, required an annual review of the wholesale electricity price modelling to determine whether a $\pm 10\%$ price path reopening trigger had been met. IPART’s analysis, published in May 2008, indicated that as the trigger had not been met for 2008–09, the existing predetermined price control arrangements would not be changed.

One of the prime principles imposed on IPART by its terms of reference was that the benchmark costs it uses to establish the regulatory framework should be based on hypothetical ‘new entrant’ prices. Table 4.1 summarises the IPART final determination using the cost categories adopted by the Commission in its analysis of ActewAGL Retail’s benchmark costs.

The Commission notes that the IPART approach to regulating the tariffs for franchise customers is based on a weighted average price cap. However, instead of leaving the structure and level of the regulated tariff to the discretion of the incumbent retailer, as is done in the ACT, IPART imposes prescriptive price caps on a *tariff-by-tariff basis* which it has calculated to meet the forecast price cap for each of three years of the regulatory period from 2007–08 to 2009–10. Table 4.1 presents the results only for the 2008–09 financial year (in 2006–07 dollars), as extracted from the June 2007 IPART report.

Table 4.1 Composition of IPART's final determination on retail price control

Incumbent retailer (expressed in 2006–07 dollars)	Country Energy	Energy Australia	Integral Energy
	2008–09	2008–09	2008–09
Energy purchase costs per customer (\$/MWh)			
Electricity purchase cost (\$/MWh)	48.4	55.5	57.8
Energy contracting cost (\$/MWh)	–	–	–
Green costs (\$/MWh)	5.1	4.7	4.9
NEM fees (\$/MWh)	0.68	0.68	0.68
Energy losses	12.3%	6.8%	9.1%
Total energy purchase cost (\$/MWh)	60.7	64.8	69.2
Retail operating costs (\$/customer/year)	75	75	75
Customer acquisition costs (\$/customer/year)	35	35	35
Adjustment for double-counting	(5)	(5)	(5)
Total retail operating costs (\$/customer/year)	105	105	105
Network costs (\$/MWh)	n.a.	n.a.	n.a.-
Total supply costs (\$/MWh)	n.a.	n.a.	n.a.
Retail margin (EBITDA % of sales)	5.0%	5.0%	5.0%
Total average retail price (\$/MWh)	n.a.	n.a.	n.a.
Assumed CPI change, 2007–08 to 2008–09	3.1%	3.1%	3.1%
X factor in CPI+X on MAR in \$/MWh (Source: Tables 9.1 to 9.3, June 2007)	6.0%	7.5%	8.1%

4.2 Final outcomes from Queensland

The QCA process commenced with a reference from the Queensland Minister for Mines and Energy in March 2007. In particular, the QCA was delegated the responsibility of calculating the Benchmark Retail Cost Index (BRCI) for 2007–08, subject to certain conditions. Following submissions from stakeholders and reviews of reports from various independent consultants, the QCA published its draft decision in May 2007, and then its final decision in June 2007. The Minister gazetted the final prices soon afterwards. Subsequently, the QCA issued its draft decision for 2008–09 in February 2008 and its final decision for 2008–09 in May 2008. Again the Minister gazetted the final prices soon afterwards.

One of the prime principles imposed on the QCA by the reference from its Minister was that the electricity purchase costs should be based on long-run marginal cost to make prices more stable in the long run. Table 4.2 summarises the QCA final determination for 2008–09 using the cost categories preferred by the Commission in its analysis of ActewAGL Retail's benchmark costs.

The Commission notes that the QCA approach to regulating tariffs for franchise customers is based on examining the potential percentage changes in each cost category from 2006–07 to 2007–08 to build up the allowed overall BRCI.

The QCA draws a distinction between a gross margin on total sales (the gross amount remaining after network and energy cost components are removed from total sales), and a net margin (the net amount remaining after retail, network and energy cost components are removed from total sales). The 5% margin is determined on total sales to define the net retail margin in the QCA decision. In this sense, the QCA approach is similar to the approach used by the Commission.

The QCA indicates that the BRCI is separate from the retail margin, which should remain stable over time. The BRCI can thus be interpreted to be the sum of the underlying changes in the network, energy and retail cost components of the incumbent retailer and includes inflation (as it is determined from nominal numbers) and the effects of growth in customer numbers and energy consumption. Table 4.2 presents the results for the 2008–09 financial year, quoted in 2008–09 dollars.

Table 4.2 Composition of the QCA’s final determination on retail price control

	2008–09
Energy purchase costs per customer (\$/MWh)	
Electricity purchase cost (\$/MWh)	48.2
Energy contracting cost (\$/MWh)	–
Green costs (\$/MWh)	3.65
NEM fees (\$/MWh)	0.33
Energy losses	n.a.
Total energy purchase cost (\$/MWh)	52.2
Retail operating costs (\$/customer/year)	80.6
Customer acquisition costs (\$/customer/year)	18.0
Total retail costs (\$/customer/year)	98.6
Network costs (\$/MWh)	57.5
Total retail costs (\$/MWh)	121.3
Retail margin (EBITDA % of sales)	5.0%
Total retail price (\$/MWh)	127.4
Assumed CPI change, 2007–08 to 2008–09	n.a.
X factor in CPI+X on MAR in \$/MWh	n.a.
BRCI (% from 2007–08 to 2008–09)	5.38%

The Commission notes that the retail margin used by the QCA is applied to the total retail supply costs, including network energy and retail costs, in generating the overall picture of how overall revenues might move between two successive financial years. As the CPI assumed by the QCA to occur between 2007–08 and 2008–09 is not defined, the Commission cannot estimate an implied X factor from the QCA’s final decision.

4.3 Final outcomes from South Australia

The ‘standing contract’ in South Australia is an electricity contract made available by AGL South Australia Pty Ltd (AGL SA) to small customers with electricity consumption less than 160 MWh/year as the ‘declared retailer’. The ESCOSA process commenced with a submission by AGL SA regarding the retail price control mechanism to be used to regulate the tariffs for this customer segment.

The regulatory period in South Australia is from 1 January 2008 to 31 December 2010. The approach adopted by ESCOSA is to develop a retail cost base for the wholesale electricity cost (WEC) and for the retail operating cost (ROC) and to apply a margin to these values over the price control period. The network costs are considered as a pass-through cost. A CPI-X approach to smooth the price changes is applied, following an initial revenue adjustment at 1 January 2008 (a Po adjustment).

While the detail of the analysis has not been published, Table 4.3 provides those numbers, which are approximately equivalent to the approach adopted by the Commission. The Commission has had to interpret the ESCOSA results to provide this summary.

ESCOSA has assumed that there is little distinction between a retail margin on total sales (the margin remaining after network, energy and retail cost components are removed from total sales) which it has set at 5%, and a margin on the controllable retail costs or WEC plus ROC (the costs excluding network costs) which it has set at 10%. The 5% margin is determined on total sales, which is similar to the approach used by the Commission. Table 4.3 presents the results of the ESCOSA final determination for the mid point of the 2008–09 financial year, quoted in March 2008 dollars.

The Commission notes that the wholesale electricity costs assumed by ESCOSA are somewhat higher than the costs used by IPART and QCA and that this is likely to reflect the fact that the ESCOSA decision occurred towards the end of 2007, when the wholesale electricity prices were yet to show a significant reduction towards previous historical levels.

The Commission also notes that the retail operating costs per customer are similar to those used by the Commission and that, on balance, the overall outcome is somewhat lower than seen in other jurisdictions.

Table 4.3 Composition of the ESCOSA's final determination on retail price control

	2008–09
Energy purchase costs per customer (\$/MWh)	
Electricity purchase cost (\$/MWh)	n.a.
Energy contracting cost (\$/MWh)	n.a.
Green costs (\$/MWh)	n.a.
NEM fees (\$/MWh)	n.a.
Energy losses	–
Total energy purchase cost (\$/MWh)	88.2
Retail operating costs (\$/customer/year)	n.a.
Customer acquisition costs (\$/customer/year)	n.a.
Total retail costs (\$/customer/year)	94.3
Network costs (\$/MWh)	n.a.
Total retail costs (\$/MWh)	n.a.
Retail margin (EBITDA % of Sales)	5.0%
Total retail price (\$/MWh)	106.96
Assumed CPI change, 2008 to 2010 (%pa)	3.0%
Po in MAR at 1 Jan 2008 in \$/MWh	12.34%
X factor in CPI+X on MAR in \$/MWh	0.0%

4.4 Approaches in other states

The form of regulation used for franchise customers in other jurisdictions varies widely, both in the form of price control and in its implementation in regulated retail tariffs. As these functions are unlikely to be standardised between jurisdictions or relinquished to the Australian Energy Regulator by the states, there is a need to ensure that benchmark cost studies use information from each jurisdiction on a like-for-like basis.

In its analysis for the final price direction in this report, the Commission has been mindful of potential differences in interpretation of benchmark costs from other jurisdictions.

5 Submissions to the Commission

In its draft price direction released on 23 April 2008, the Commission sought submissions from interested parties on any aspects of the price direction to be imposed on ActewAGL Retail for the year from 1 July 2008 to 30 June 2009. Given that the Commission was required to operate to an extremely short deadline for the development of this price direction, the Commission called for submissions by 23 May 2008.

The Commission received five submissions. The submissions were from:

- the Essential Services Consumer Council (ESCC)
- the Department of Disability, Housing and Community Services (DHCS)
- ActewAGL Retail
- TRUenergy Australia
- AGL Energy Limited.

The following sections summarise the submissions and highlight each organisation's primary areas of concern about the draft price direction.

5.1 Essential Services Consumer Council

In its submission of 17 May 2008, the ESCC was concerned that in making its decision the Commission appeared to rely on rebates and concessions, community service obligations and the services that the ESCC, CARE Incorporated and other support agencies provide in order to satisfy its obligations under 20(2)(g) of the ICRC Act to have regard to 'the social impacts of the decision'.²⁸ Further, the ESCC stated:

[that] ActewAGL Retail has been adequately compensated for its costs in previous price increases. Therefore Council strongly recommends that the price for electricity only be increased by CPI, rather than by the amount proposed.

The ESCC has also expressed the following concerns in regard to the price determination for non-contestable electricity customers:

- inappropriate compensation to ActewAGL Retail for the short-lived surge in electricity wholesale prices
- price-setting for electricity at levels higher than a 'fair price' in order to encourage the competition.

These comments and concerns expressed by the ESCC are discussed further in the following sections.

²⁸ See ICRC, *Draft report: Retail prices for non-contestable electricity customers*, Report 2 of 2008, April 2008, section 4.1 (Safety net provisions).

5.1.1 Social impacts

The ESCC is uncomfortable that the Commission relies only on current rebates and concessions and considers them adequate to protect vulnerable consumers from the price rise. The ESCC considers that it is inappropriate for the Commission to rely on the ESCC to discharge debt where the price of reasonable consumption is out of reach of the householder when no special circumstances apply.

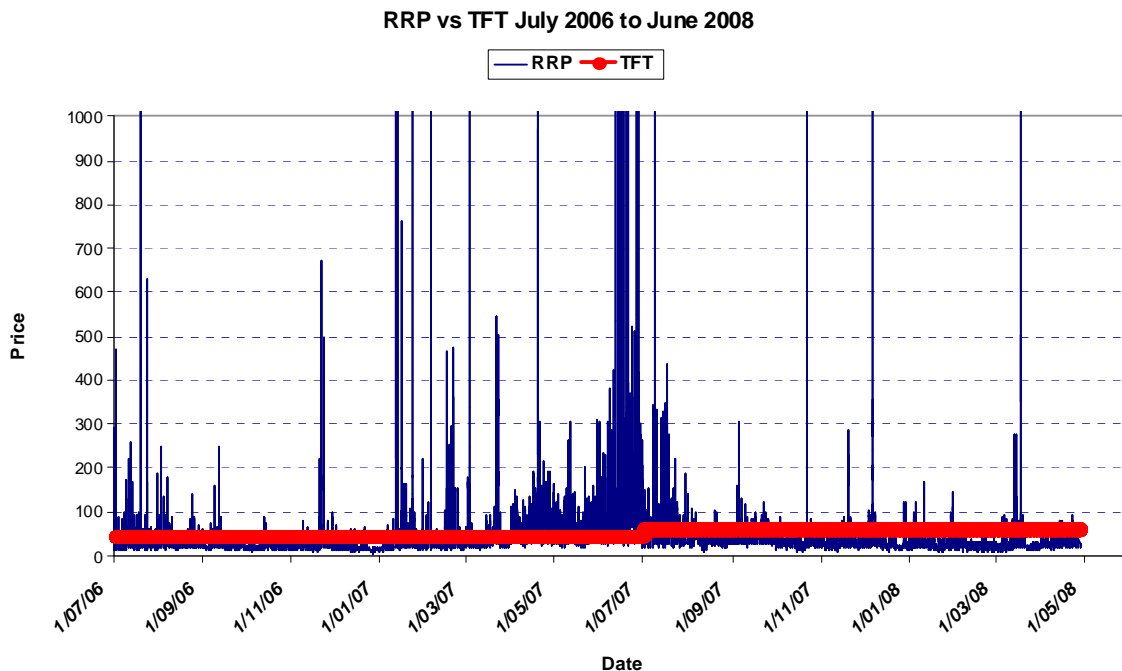
In its submission, the ESCC also made the following observations:

- Electricity prices have increased well in excess of CPI over the past five years.
- Concessions and rebates have not kept pace with rising electricity prices and other costs of living.
- While the inclusion of Health Care Card holders in the electricity rebate scheme helps more households, it does not assist those already eligible for the rebate.
- Since July 2007, increasing numbers of ESCC clients with no exceptional life circumstances are unable to afford their reasonable electricity consumption.

Commission's response: The Commission has regard to and gives weight to s. 20(2)(g) of the Act. The difference between the pool price over the period of concern, mid 2007 to the end of the first quarter 2008, and the allowed wholesale price (with hedging assumptions) is a clear indication that the Commission balances the requirements of s. 20(2)(g) (relating to social impacts) with those of s. 20(2)(d) (relating to return) and s. 20(2)(e) (relating to cost).

Figure 5.1 below shows the regional reference prices (on the NSW node) versus the regulated electricity tariff between 1 July 2006 and 31 May 2008. Clearly, the assumptions around reasonable hedging which the Commission believes a prudent retailer should employ reduce the excessive electricity pool prices which have been seen over the past few years during which the TFT arrangements have been in place.

Figure 5.1 Electricity pool price compared to TFT hedged wholesale electricity price (\$/MWh)



Source: NEMMCO, regional reference price for NSW, <http://www.nemmco.com.au>, Commission analysis.
 Note that the figure does not show the most extreme price events.

The capping of the wholesale electricity prices through the hedging assumptions used by the Commission for a retailer providing services to TFT customers is very clear in the period around mid 2007. This was the period during which the Commission had to make its previous final decision for 2007–08.

5.1.2 Appropriateness of compensation for ActewAGL

The ESCC expressed a view that ActewAGL Retail had already been appropriately compensated by the Commission in last year’s price determination. Drought conditions and subsequent water restrictions on electricity generators had led to the wholesale electricity price significantly increasing in a very short time.

Commission’s response: The Commission agrees that the further increase is undesirable, but is clearly supported by the cost analysis undertaken by it and the regulators in other jurisdictions. Further price rises are necessary under s. 20(2)(d) and (e), as evidenced by the drop in churn and the submissions from TRUenergy Australia and AGL Energy. The ICRC has had regard to the social impact provisions of s. 20(2)(g). Indeed, the submissions from TRUenergy Australia and AGL Energy suggest that the Commission has given too much weight to those provisions. Competition is also an important objective for the Commission, under the provisions of s. 7(1), and the Commission must strike a balance between social impact considerations and competition considerations. By avoiding a one-on-one correlation between the TFT price and movements in electricity wholesale market prices, it has sought to achieve that balance.

5.1.3 Setting a 'fair price' for electricity

The ESCC is concerned that setting higher than a 'fair price' for electricity to encourage competition and thus lower the prices for those customers who shop around may adversely affect small non-commercial consumers who would not bundle their utilities needs. The ESCC further commented that the majority of its clients, as well as low-income consumers, do not lead a 'bundle-able' lifestyle.

Commission's response: The Commission understands that the discounts for moving off the TFT are not marketed exclusively with a bundle or other services. For example, electricity discounts below the TFT are available from TRUenergy (www.truenergy.com.au) without a bundle—offering a 3% discount below most government-regulated tariffs. The Commission believes the prices it has set in the past are 'fair prices' notwithstanding this is not a specific criterion imposed by either the Act or the reference provided by the government. Ultimately the Commission is not able to control the behaviour of the wholesale electricity market. The Commission also notes that it has not approved the inclusion of a customer acquisition cost in the TFT even though this cost has been allowed in other jurisdictions. The Commission further notes that the TFT price in the ACT is still less than the price in areas surrounding the ACT, and that the price increase approved for 2008–09 is less than the price increase allowed in NSW.

5.2 Department of Disability, Housing and Community Services

In its submission of 22 May 2008, the Department of Disability, Housing and Community Services (DHCS) acknowledged that in the ACT consumers had enjoyed relatively low electricity prices that had only risen at rates commensurate with the general inflation rate when averaged over a longer time period.

In its submission, DHCS supported the draft decision, but noted that the extension of the current concession rebate arrangements to Health Care Card holders extended only to the water supply charge. Electricity was already covered.

Commission's response: The Commission does not set the concession rebate arrangements for Health Care Card holders. The government has the prerogative to define the concession rebate arrangements to suit its budget constraints and social policies. The Commission notes that the government recently tabled a report in the Legislative Assembly on concession arrangements and an interdepartmental committee has been appointed to examine what further action might be taken in response to this report.

The Commission is mindful of the need for due process in the consideration of any amendment to government policy relating to the coverage and size of concessions that are granted. However, the Commission notes that for a number of years it has highlighted the need for further consideration to be given to the suite of available concessions to address the rising cost of utility services in the ACT, and with the recent more significant rises in water and electricity prices, and potentially in gas prices, there is a need for a mechanism that allows the government to respond in a more timely manner to the changing price paradigm that faces consumers, particularly those who are in financial difficulty.

5.3 ActewAGL Retail

In its submission of 23 May 2008, ActewAGL Retail argued that successive price directions by the Commission continue to expose it to regulatory risk and do not provide the level of certainty required for ActewAGL to conduct its retail business in an increasingly volatile and uncertain electricity market. The main issues raised by ActewAGL Retail in its submission on the draft price direction include the following:

- the Commission's approach
- calculation of electricity purchase costs
- inclusion of customer acquisition and retention costs in retail operating costs
- retail margin
- network costs
- average franchise price
- cost pass-through mechanism.

The following sections further present the details of ActewAGL Retail's main concerns and contentions.

5.3.1 Commission's approach

In its submission, ActewAGL Retail encourages the Commission to apply benchmark information and to incorporate some of the costs of a new entrant so as to reduce customer reliance on regulated prices at levels lower than those of a new entrant (that is, to set regulated tariffs at a level that would allow new entrants, with efficient new entrant retail operating costs and margins, to compete).

Commission's response: The Commission notes that the terms of reference issued by the government for this review did not specify that the Commission should set a TFT commensurate with a new entrant price. Rather the terms of reference referred to the requirements under s. 20(2) of the ICRC Act, and it is these requirements that the Commission has addressed in making its determination.

The Commission has included in the TFT a slightly higher retail margin than in previous determinations to reflect what it believes are efficient margin rates. At the same time, the Commission has decided to exclude the costs associated with the attraction of new customers, although inclusion of these costs has been the approach adopted elsewhere. A decision to include these costs would be inconsistent with the terms of reference issued in the ACT. In making this decision the Commission believes it has fully factored in the provisions of s. 20(2)(d) and s. 20(2)(e).

5.3.2 Electricity purchase costs

In its submission, ActewAGL Retail expressed concerns about the methods and assumptions presented by the Commission. Specifically, ActewAGL noted:

- the implications of trying to hypothesise and apply a generic hedging strategy given the assumptions about the timing of purchases and the forecast load covered by hedged products at points in time which are unlikely to reflect the commercial nature of managing purchase risk and load volatility in a market environment, where existing retailers or new market entrants will adopt differing strategies and approaches to managing risk across competing suppliers
- that basing the energy purchase cost allowance on a set of assumptions about hedging behaviour highlighted the regulatory risk facing ActewAGL Retail, given that it would have been prudent for ActewAGL Retail to continue to expect that any future regulated electricity tariff would continue to reflect wholesale market-based costs, and to develop and implement its purchasing policy accordingly.

Commission's response: The Commission has relied on a set of proxy costs because ActewAGL Retail, for reasons including the confidential nature of the costs in a competitive market, did not submit its actual costs for the purposes of the public consultation on costs. The Commission developed an approach based on 1) jurisdictional benchmarks 2) wholesale energy hedging arrangements and 3) escalations of previously available cost numbers, where these were available. The Commission reviewed the hedging assumptions with ActewAGL Retail and also examined a wide range of wholesale market data gathered by the Commission and provided in confidence by ActewAGL.

As a result of this further examination of the data, the Commission revised its analysis, principally by updating some of the wholesale market prices. The revised energy cost estimate that the Commission used is below the estimate presented in the draft decision. The Commission believes this reflects a realistic hedging strategy that an efficient retailer would use.

The difficulty that the Commission faces is that requirements for the preparation of one-year TFT directions may encourage retailers to wait to see what the Commission does before making firm decisions about their electricity purchases for the year ahead. While retailers cannot leave themselves completely unhedged for the year, retailers may try to minimise their risk to the regulator's decision by leaving some of their hedging until the last minute. This is not an efficient approach, but reflects the conflict that exists between the requirement to set a one-year TFT and the requirements of s. 20(2) of the ICRC Act. The Commission believes that the approach that it has adopted, together with the use of updated information on trends in the wholesale electricity market, balances the requirements of s. 20(2)(d) and s. 20(2)(e) (relating to cost recovery and reasonable return) with those of s. 20(2)(g) (relating to the social impact of its decisions).

ActewAGL Retail noted that it agrees with the Commission that the impacts of the recent period of volatility on the price of wholesale electricity will not be reflected as a one-off price spike, but will continue to affect retail prices for some time based on the range of factors contributing to market uncertainty.

5.3.3 Retail operating costs

ActewAGL Retail stated that it ‘believes that escalating the retail operating costs in line with CPI does not adequately reflect recent and expected trends in retail operating costs’. It has ‘identified that in 2007 labour costs had increased at rates in excess of CPI and were expected to continue to do so’.

Further, ActewAGL Retail believes that the retail operating costs for 2008–09 should include customer acquisition and retention costs, as they were included in New South Wales. ActewAGL Retail proposes that customer acquisition and retention costs of \$20.85 per customer be included as part of the retail operating costs.

Commission’s response: The Commission has considered the arguments by TRUenergy, AGL Energy and ActewAGL Retail that acquisition costs should be included in the cost build-up. The Commission, in its cost modelling, has a retail operating cost of \$97.12 per customer without a specific allowance for customer acquisition and retention costs. The final decision from IPART²⁹ includes an amount of \$79.36 per customer in nominal terms for 2008–09 for the equivalent costs.

If the Commission includes the amount proposed by ActewAGL for the customer acquisition and retention costs, the total retail operating costs are \$117.97 per customer, which is higher than the IPART comparable cost for 2008–09, which is \$111.10 per customer. The Commission does not believe that further cost increases relating to customer acquisition and retention costs for ActewAGL Retail are necessary, as the costs for its current migration strategy appear to be already covered in the \$97.12 per customer amount allowed. While TRUenergy has argued for a new entrant cost of \$35.00 per customer, the Commission believes that based on the criteria in s. 20(2), these increases in the cost base are not acceptable.

Without a specific requirement in s. 20(2) or in the government reference to replicate the costs of a new entrant retail business, the Commission will not include \$20.85 or \$35.00 per customer as a customer retention and acquisition component of the retail operating cost. The Commission must balance the requirements of s. 20(2)(g) (relating to social impacts) against those of s. 20(2)(d) (relating to return) and s. 20(2)(e) (relating to cost).

5.3.4 Retail margin

ActewAGL Retail supports the Commission’s decision to adopt a retail margin of 5% in its calculations for the TFT in the ACT. This represents the same value as the average value used by IPART in its most recent final determination of June 2007, and is now in line with the most recent

²⁹ IPART, *Promoting retail competition and investment in the NSW electricity industry: Regulated electricity retail tariffs and charges for small customers 2007–2010 (Final report and final determination)* June 2007, Table 6.1, p. 75, adjusted for the Commission’s inflation assumptions.

regulatory decisions in Queensland, South Australia and Tasmania. The Commission retail margin is applied to total retail sales (including network costs) as it is in NSW, Queensland and Tasmania.

Commission's response: The Commission has retained the 5% retail margin in the final determination. This balances the requirements of s. 20(2)(g) (relating to social impacts) against those of s. 20(2)(d) (relating to return) and s. 20(2)(e) (relating to cost).

5.3.5 Network costs

ActewAGL Retail noted that the Commission has estimated the network cost for 2008–09 to be \$54.27. However, ActewAGL Distribution has now published the approved network tariffs for 2008–09 and the network cost will be \$56.05/MWh for the forecast volumes for TFT customers.

Commission's response: The Commission accepts the more accurate estimate now available for ActewAGL Retail by consideration of s. 20(2)(e).

5.3.6 Average franchise price

In its submission, ActewAGL Retail stated:

[that] the Commission's draft determination applies CPI plus X-factor to the average franchise price in 2007–08 assuming 2007–08 prices are applied to the actual quantities sold in the 12 months to March 2008. The average franchise price in 2007–08, using the load profile for the 12 months to March 2008 is \$142.00 per MWh excluding GST.

Commission's response: The draft decision used the load profile assumed for 2007–08. The comments made by ActewAGL Retail go to the issue of the actual load profile for the year to March 2008 being slightly different from that used in the projected loads. This has the effect of altering the average 2007–08 price, which is used as the base from which the CPI+X formula for setting the new tariffs is calculated. The Commission acknowledges the need to make this change and has accordingly adjusted its modelling for purposes of calculating the CPI+X formula for setting individual tariff rates. This is required by consideration of s. 20(2)(e).

5.3.7 Cost pass-through mechanism

In its submission, ActewAGL Retail drew attention to the possibility of the introduction of a feed-in tariff scheme in the ACT. ActewAGL Retail noted that it can only support feed-in tariffs if it is no worse off financially as a consequence of the policy. If, as is likely, such a scheme were implemented via network charges, ActewAGL Retail would need to pass through the additional costs. These costs would include not only the feed-in tariff, but also the costs associated with implementing, managing, administering, reporting, publicising and advertising the scheme.

Commission's response: The Commission acknowledges that the government will introduce a feed-in tariff arrangement for the generation of electricity by individual residential households. While details of the feed-in tariff scheme have yet to be formalised, the scheme may not come into effect until 2009–10. It is unclear at this time whether the direct costs will be incurred by the retailers (with the distributor to reimburse the retailer) or by the electricity distributor directly.

Whatever arrangement is decided, costs are likely to be passed through to retailers, possibly by way of a change in the distribution charges. A decision on this matter could be made by the Australian Energy Regulator, depending on when the new arrangement takes effect. However, ActewAGL Retail's concern is that, if there is any mandated increase in distribution or other costs that it will need to recover from its retail sales, the TFT should have some form of trigger device under which ActewAGL Retail can seek to have the TFT adjusted to reflect this additional unavoidable cost. The Commission will incorporate a trigger mechanism in the final decision on the TFT. The pass-through arrangements are discussed in detail in section 7.3.

In addition, ActewAGL Retail seeks assurance from the Commission that ActewAGL Retail would be able to recover in its prices any additional costs associated with managing carbon emissions if any such policies are implemented during the regulatory period.

Commission's response: The Commission believes this issue is unlikely to arise in the period to 30 June 2009, which is the period of this decision on the TFT. However, the Commission will incorporate a trigger mechanism which will allow the matter to be considered should it arise and the implications for the TFT can be assessed. The pass-through arrangements are discussed in detail in section 7.3.

5.4 TRUenergy Australia

In its submission of 22 May 2008, TRUenergy Australia was concerned that the regulated retail tariffs in the ACT have been held below market-based levels while the development of competition has fallen short of that achieved in other Australian jurisdictions.

Commission's response: The Commission accepts that the low churn during the last quarter of 2007 and the first quarter of 2008 could have been as a result of the TFT outcome for 2007–08 being close to the possible market-based levels. The low churn could also signal a more risk-averse approach by new entrant retailers because of uncertainty resulting from the increase in volatility of the wholesale electricity price during this same period. The Commission has had to balance the requirement for a cost-based outcome (s. 20(2)(e)) against the requirement to protect consumers from excessive prices (s. 20(2)(a)). The Commission had to achieve this balance on a forecast basis, which has been extremely difficult. As discussed in section 2.1, the short reference period makes this analysis even more difficult.

TRUenergy Australia supports the Commission's decision to increase the retail margin to 5%. The company also recommends that the cost of competing in the market should be included in the

retailer's operating costs as a separate item (to the retail margin). This could be done through the allowance for acquisition and retention or through a loss of scale allowance.

Commission's response: The Commission does not accept that an extra level of acquisition and retention costs needs to be included in the cost base, based on the need to balance the requirement for a cost-based outcome (s. 20(2)(e)) with the requirement to have regard to the social impacts of the decision (20(2)(g)). Refer to the discussion at section 5.3.3.

TRUenergy Australia is concerned that if a low level of churn is assumed in the calculation of customer acquisition costs, the cost allowance will be low, thus providing limited scope for competition. TRUenergy Australia recommends the Commission adopt CRA's cost of competing assumptions (including a cost-to-acquire) of \$177.69 provided in its report to the QCA. This effectively provides a cost-to-acquire allowance of \$35.00 per customer.

Commission's response: The Commission's analysis does not require an assumption on the target level of churn. The Commission's reliance is on s. 20(2)(e) for cost-based outcome on a per customer basis, and the outcome on the level of churn follows from the retailer view of the attractiveness of the ACT retail electricity market following the regulatory decision on the TFT.

The Commission is also not required to consider the cost of a new entrant into the market under its terms of reference, and thus has not factored in any costs associated with new entrant activity. The Commission notes that ActewAGL Retail suggests \$20.85 per customer new entrant cost and TRUenergy Australia suggests \$35.00 per customer new entrant cost. The Commission does not have data on whether incumbent churn is lower than new entrant churn, and suggests this might be the better measure of whether, in any particular market circumstance, the new entrant is able to compete with the incumbent for customers on the TFT.

The Commission believes that the balance between s. 20(2)(e) for cost-based outcome and s. 20(2)(a) for not excessive prices means that the higher \$35.00 per customer new entrant cost cannot be included in the TFT cost base. Refer to the discussion at section 5.3.3.

5.5 AGL Energy Limited

In its submission of 23 May 2008, AGL Energy expressed concern about the allowance for efficient retail costs. In particular, AGL Energy believes that the retail operating costs should be set at a level that incorporates the following:

- costs associated with attaining, retaining and servicing customers
- costs associated with customer retention and acquisition.

Commission's response: The Commission has rejected the proposals to include the customer acquisition and retention costs as discussed at section 5.3.3.

AGL Energy recommends that the Commission perform benchmarking activities with other jurisdictions to assist it in deriving an appropriate level of customer retention and acquisition costs to be included in the total retail cost per customer.

Commission's response: The Commission has already looked at the benchmarks in other jurisdictions to check the reasonableness of the costs it has included in its build-up. In consideration of the s. 20(2) criteria it must apply and in the absence of a specific reference to accommodate the full costs of a new entrant, the Commission has decided not to include a specific allowance for customer acquisition and retention costs. Refer to the discussion at section 5.3.3.

AGL Energy is pleased that the Commission recognises that the transitional franchise tariff is not intended to be a 'safety net' used for social or targeted support to small customers.

6 Analysis of efficient costs

In developing its price direction for 2008–09, the Commission must ensure that it has regard to the provisions of section 20 of the ICRC Act, as required by the Act and by the reference provided by the Attorney-General. The Commission believes that these provisions provide a list of issues (sometimes considered as objectives) that it needs to address in determining the weighted average price cap under which the TFT levels for 2008–09 will be developed.

One of the objectives of the Commission’s analysis is to ensure that the retail services are delivered in a reasonably efficient manner (s. 20(2)(c)) to reduce the costs paid by consumers, without the exploitation of monopoly power (s. 20(2)(a)), which might otherwise raise costs for consumers. The costs it considers for ActewAGL Retail (s. 20(2)(e)), however, must also allow for an appropriate rate of return (s. 20(2)(d)) and a financially viable outcome for the service provider (s. 20(2)(i)). There is tension between these objectives. In part, the Commission balances these objectives by considering actual cost information provided by ActewAGL Retail and by building a cost base from benchmark data derived from public sources or from market data. In practice, the Commission relies heavily on the latter information to address the information asymmetry that can arise between the incumbent and the regulator.

This section of the report describes the build-up of the estimates of the various cost components of retail electricity supply in the ACT. The Commission currently considers that the cost base for an incumbent retailer servicing TFT customers should be the cost base used in this price direction. The Commission is not required to estimate the costs of a new entrant retailer, but it does consider the costs that competitive players might experience in the marketplace. The Commission reiterates that its reference from the government is not the same as IPART’s, which among other things requires IPART to consider the cost of a new entrant, or the QCA’s, which requires the QCA to consider energy purchase costs derived from an LRMC analysis.

The Commission notes that, in a period of increasing energy prices, a new entrant may be less inclined to enter a new market as a retail electricity supplier. Given that the terms of reference for this review have specified a 12-month TFT, the Commission is not able to transition price changes over a number of years, as is possible under the IPART determination. The Commission is not constrained, however, in having to use an estimate of the LRMC for electricity generation, as has been required of the QCA; rather, it must address the market risk that is managed primarily by incumbent retailers which are competing in the ACT market and, in the case of ActewAGL Retail, providing services to franchise customers.

6.1 Section 20 criteria

Section 20(2) of the ICRC Act states:

- 20 (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
 - (b) standards of quality, reliability and safety of the regulated services
 - (c) the need for greater efficiency in the provision of regulated services to reduce costs to consumers and taxpayers

- (d) an appropriate rate of return on any investment in the regulated industry
 - (e) the cost of providing the regulated services
 - (f) the principles of ecologically sustainable development mentioned in subsection (5)
 - (g) the social impacts of the decision
 - (h) considerations of demand management and least cost planning
 - (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
 - (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.
- (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.

In this final decision, the Commission does not believe there is a need to place specific emphasis on the issues raised by s. 20(2)(b), which relate to service quality, and s. 20(2)(f) and s. 20(5), which relate to ecologically sustainable development. Neither of those objectives or issues is central to the question of the reasonable pricing of retail electricity to TFT customers.

The Commission recognises, however, that the green costs factored into the retail cost base, such as those associated with mandatory renewable energy targets (MRET) and with the Greenhouse Gas Abatement Scheme (GGAS), have begun to address increasingly widespread concerns that the consumption of fossil fuels comes at an environmental cost in air quality, increased carbon emissions to the atmosphere and, potentially, increased global warming. To the extent that the MRET and GGAS costs are included in the price, there is a potential to dampen the demand for electricity and thereby contribute to ecologically sustainable development.

The Commission also recognises that demand-side management (s. 20(2)(h)) is better served when the price of the electricity consumed is based on the best estimate of the costs to provide electricity. This is especially so if the cost of energy in the wholesale pool rises in accordance with demand and supply conditions. Indeed, when the electricity price is kept artificially low, the price signals to encourage reduced consumption are muted. Excess consumption has a negative emissions impact, as well as an adverse impact on the economically efficient delivery of retail electricity services.

A detailed statement of the Commission's regard for each issue identified in s. 20 is set out in Appendix 3.

6.2 The electricity retail cost elements

The costs of retail electricity supply can be grouped into the following categories:

- energy costs:
 - energy purchase costs
 - energy hedging, contract and management costs
 - green costs (MRET and GGAS fees)
 - energy losses
- retail costs:
 - retail operating costs
 - customer acquisition and retention costs
- network costs:
 - distribution network costs
 - transmission network costs.

The Commission has considered the submissions received from stakeholders in this price direction and has examined external benchmarks and market information in the context of the guidance provided by section 20(2) of the ICRC Act. Following consideration of these issues, the Commission has arrived at the cost values which it believes should be used for each of these retail costs and which will be recovered under a weighted average price cap from the regulated TFT customers.

The following subsections of the report are divided into two parts: the first responds to the comments by interested parties about the particular cost categories under discussion; the second outlines the Commission's findings on its preferred approach to balance the objectives of its reference from government and the objectives of section 20(2) of the ICRC Act.

6.2.1 Electricity purchase costs

Response to comments on energy purchase cost methodology

For its final decision on the price direction, the Commission has continued to use current market data and a number of assumptions about an ideal electricity retail hedging strategy to understand the reasonable electricity purchase costs that might be faced by an incumbent retailer in the ACT during 2008–09.

In its submission, ActewAGL Retail argued for a \$72.06/MWh energy purchase cost. The Commission has discussed with ActewAGL Retail technical matters to do with the hedging model used by the Commission to clarify how the model operates, and to help ActewAGL Retail better understand the methodology used in the previous year. ActewAGL Retail continued to express concern, however, about the generator price derived from the model, noting:

While ActewAGL is satisfied that the Commission has maintained a consistent methodology for this calculation, ActewAGL would like to determine why its estimate of energy purchase costs that

it derived using the Commission’s model does not correlate exactly with the Commission’s estimate.

Table 6.1 provides the input data used by the Commission, as sourced from d-cyphaTrade, which relates to the average futures prices seen in the SFE. The Commission notes that ActewAGL Retail uses a different data source. It derives its data from ICAP, and that data includes information from the SFE and from over-the-counter (OTC) trading.

Table 6.1 Contract energy price assumptions (\$/MWh)

	Dec-04	Jun-05	Dec-05	Jun-06	Dec-06	Jun-07	Dec-07	Jun-08	Dec-08	Jun-09
Peak time (\$/MWh)	59.4	59.4	59.4	60.3	62.2	117.7	94.8	89.1	89.1	89.1
Shoulder time (\$/MWh)	59.4	59.4	59.4	60.3	62.2	117.7	94.8	89.1	89.1	89.1
Off-peak time (\$/MWh)	24.3	24.3	24.3	24.8	24.9	50.4	39.1	30.5	30.5	30.5

When compared to the ActewAGL Retail data³⁰, it is noted that the Commission used slightly higher average contract prices for peak and shoulder periods, but lower average contract prices for off-peak periods. These differences, in combination with the time-of-day profile identified in Table 6.3, explain the difference between the average energy cost of \$72.06 requested in ActewAGL Retail’s submission and the final outcome of \$68.90 used by the Commission in this final decision. The final generator price derived by the Commission is lower than the Commission’s draft decision of \$71.69, primarily due to the estimate of the off-peak average prices for the forward forecast period, which the Commission reduced following further detailed analysis of the average contract-market base and peak prices.

The Commission believes these input assumptions and the simplified methodology it is using to estimate electricity purchase costs are reasonable in the absence of other direct information on ActewAGL’s actual hedging strategy and resultant costs. Further, the assumption and the methodology support a balance between ensuring that efficient costs are allowed to be recovered (s. 20(2)(d), (e) and (i)), that any immediate rises to current contract prices that are likely to include a windfall gain above existing hedging arrangements are excluded from the final generator cost and that, as a consequence, the cost included in the price build-up by the Commission lessens concern about the social impacts on consumers (s. 20(2)(g)). At the same time, the pricing signals resulting from inflation in the costs of electricity generation are eventually fed through to consumers (s. 20(2)(j)) to allow higher prices to dampen demand (s. 20(2)(h)).

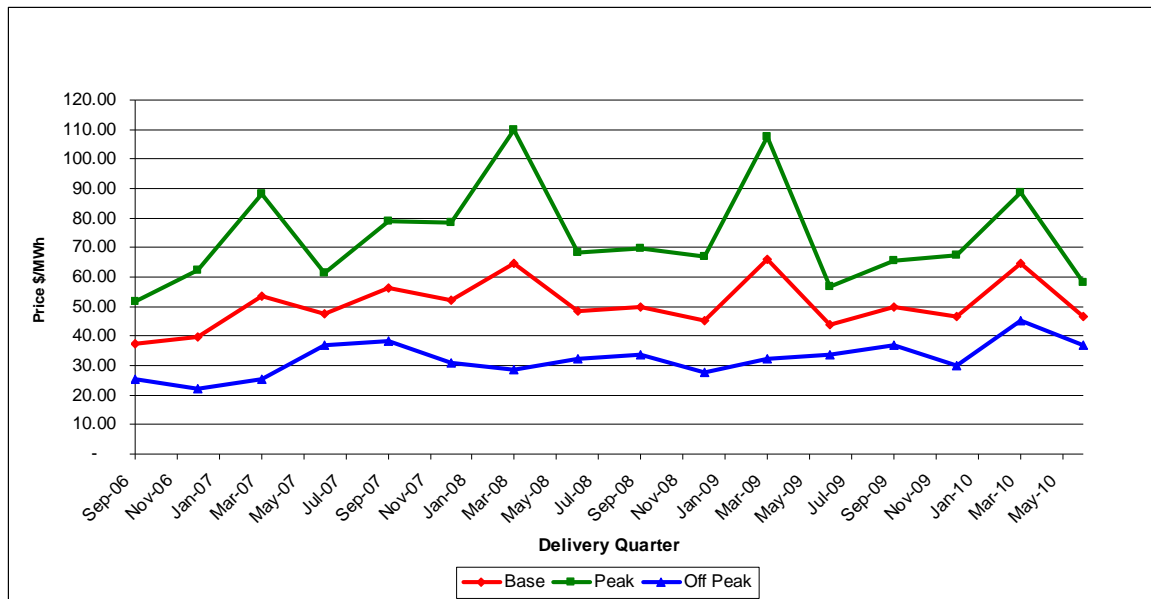
Information to assist with transparency

For its final decision on the average energy costs to allow for 2008–09, the Commission has improved its analysis of the off-peak average contract prices derived from the base and peak average swap contract prices. The additional analysis of the base and peak swap contract prices was performed on data over the period from 1 October 2005 to 31 March 2008 for delivery of energy between 1 July 2006 and 30 June 2010. This data is provided in one view in Figure 2.2 in Section 2, and in a second view as the average of swap costs for delivery on a quarterly basis in Figure 6.1. When the swap prices in Figure 6.1 are compared to the futures prices in Figure 6.2, there is a better correspondence between the outcomes of these two analyses, so the Commission is

³⁰ ActewAGL Retail, Submission, May 2008, p. 10.

more comfortable with the data it is using for its final decision when compared to its draft decision.

Figure 6.1 Average swap prices by delivery date, \$/MWh



In reaching a decision on contract energy prices, the Commission must decide whether it should rely on the futures prices or the swap prices in the hedging model used in its analysis. In developing its hedging portfolio, an electricity retailer is likely to use a mix of swaps, caps, futures and other hedging instruments. One problem with using a more complex approach to model a retailer’s hedge portfolio is that the ‘reasonableness’ of such a necessarily complex model can be questioned when compared with the incumbent retailer’s hedging strategy. While retaining a simpler approach to hedging strategy, and given the feedback provided by ActewAGL Retail, the Commission continues to use futures prices in its analysis of the historical period and has used swap prices for the forecast period in this final decision on TFT price control. The Commission believes this approach provides a reasonable cost analysis which supports s. 20(2)(c), (d) and (e) of the ICRC Act.

The approach adopted for the final decision

After considering the submissions received, the Commission continued with the following assumptions to complete its modelling of reasonable electricity purchase costs for the final price direction. The hedging assumptions used are summarised as follows:

- a The retailer seeks to have more than 100% of its forecast load from the TFT customer base hedged at least six months before delivery (specifically, hedge to 105% of the forecast load).
- b The retailer begins to build its hedge portfolio a minimum of 24 months before delivery. The proportion of the forecast load which is hedged for each six-month period of future delivery is shown in Table 6.2. The outcome is that the Commission is assuming the retailer has achieved the target of 105% hedging for the TFT customer energy requirement by 30 June 2008, for delivery during the following six months ending 31 December 2008. Likewise, the Commission is assuming the retailer has achieved the target of 105% hedging for the TFT

customer energy requirement by 31 December 2008, for delivery during the following six months ending 30 June 2009.

Table 6.2 Assumptions about hedged contracts

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%

- c For its final decision, the Commission has continued using the load profile shape used in its final decision for 2007–08 and the draft decision as requested by ActewAGL and as supported by load profile for TFT customers served by ActewAGL Retail. Table 6.3 provides the assumed block profile of energy purchase requirements for the TFT customer group.

Table 6.3 Block profile of energy purchase requirements

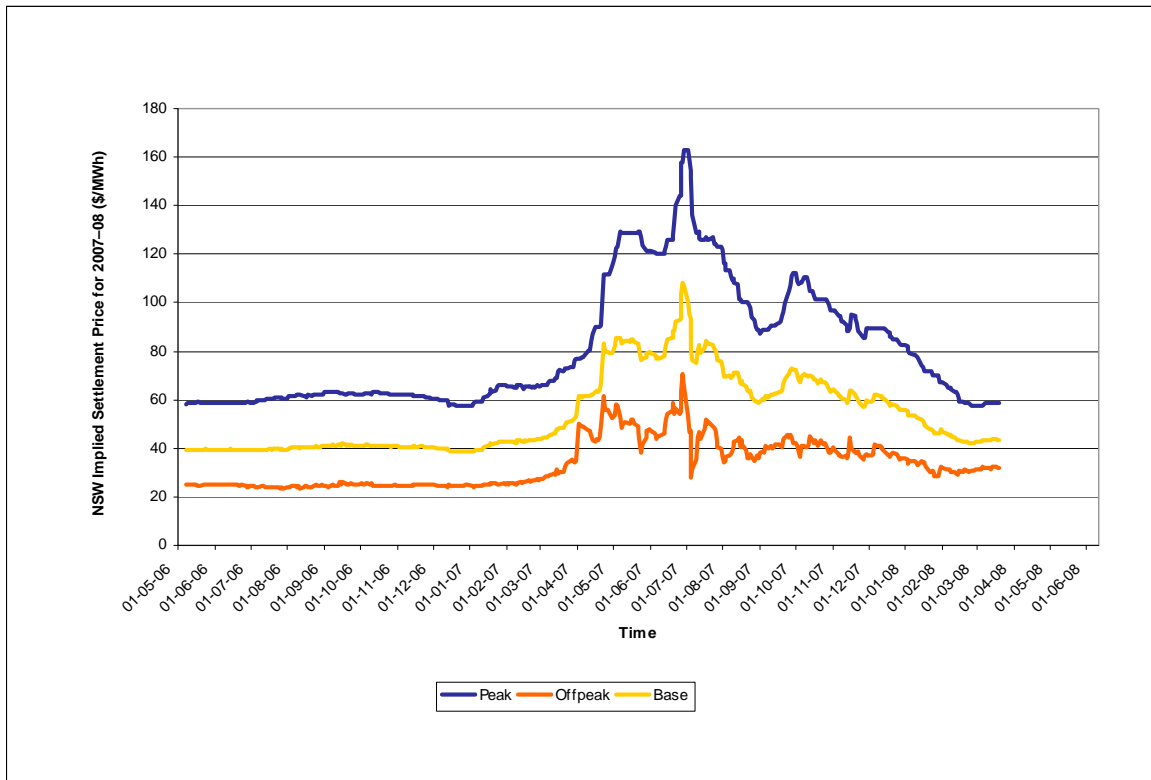
Approximate pricing profile	Hours/day ^a	Time (%) ^a
Peak	4.5	18.6%
Shoulder	7.6	31.6%
Off-peak time	11.9	49.8%
Total	24.0	100.0%

a Output rounded to one significant figure.

- d The cost of bilateral contracts is typically arrived at during confidential negotiations between retailers and generators. The Commission has reviewed the publicly available data on the price of electricity futures for New South Wales and on base and peak swap contracts for delivery over the period from June 2006 to March 2008.

While the futures contracts are financial instruments, they should reflect the confidential marketplace for bilateral, swaps, collars, caps and other electricity hedging contracts, albeit adjusted for differences in the risks borne in each contract. If this were not the case, there would be arbitrage opportunities and any differences between the two markets would soon be traded away. The Commission believes it is reasonable for its final decision to assume that the futures prices observed in the marketplace serve as a reasonable benchmark for developing the energy purchase costs for TFT customers. Figure 6.2 shows the implied futures settlement prices for base-load delivery, and the breakdown of this into peak and off-peak load delivery.

Figure 6.2 New South Wales implied futures settlement price for June 2006 to March 2008 (\$/MWh)



e The prices for the proportions of the hedge book shown in Table 6.2 for the historical period up to 31 December 2007 are then taken from the graph of the futures pricing data (Figure 6.2), and for the future period up to 30 June 2009 from the graph of the swap pricing data (Figure 6.1). In its draft and final decisions the Commission has made the assumption that the ‘peak’ futures price is the price available for delivery during shoulder periods of the load profile, as used in its final decision for 2007–08, as suggested by ActewAGL Retail. Table 6.4 shows the dates between which the futures prices are averaged to develop the price for that block of load to be delivered to TFT customers in the future.

Table 6.4 Assumed periods for futures price averaging

Six-month delivery period (ending date)	30 June 2007 (Historical)	31 December 2007 (Historical)	31 December 2008 (Future delivery)	30 June 2009 (Future delivery)
Dates for averaging price data	1 April to 29 June 2007	1 October to 31 December 2007	1 July 2006 to 31 March 2008	1 July 2006 to 31 March 2008

Based on these assumptions and this analysis, the Commission has calculated the weighted average hedge portfolio cost resulting from the average prices being weighted by time-of-day profile and delivery period and proportion of the hedged forecast load. This has provided an average cost for delivery in each of the four six-month periods leading up to 30 June 2010. The average of the costs for the six-month periods ending 31 December 2008 and 30 June 2009 was used as the estimate of the 2008–09 electricity purchase costs. The Commission found that its estimate of the electricity purchase costs was \$68.90/MWh for 2008–09. The Commission notes that, using the same methodology, the electricity purchase costs for 2009–10 are estimated to be \$63.78/MWh. While this latter estimate is not central to its analysis for the 2008–09 year, the Commission observes that

based on these numbers it appears that the electricity marketplace does not believe that the mid 2007 increases in the energy pool price are to continue in the long term, and all else being equal lower energy prices may be available in the pool during the 2009–10 financial year.

In undertaking this analysis using independent market data and a simplified model to hedge the risks of purchasing wholesale energy from a competitive market pool, the Commission has drawn the primary balance between the social imperatives of the provision of reliable electricity to TFT customers (s. 20(2)(b),(g)), the reduction of market power through the setting of the lowest efficient prices in an open market pool (s. 20(2)(a), (c), (h), (i) and (k)), and the need for the financially sustainable continuation of the TFT offer by the incumbent retailer in the ACT (s. 20(2)(d), (e), (i) and (j)). It has also used a stepped contract purchase timing profile to ensure that the energy price rises in mid 2007 were smoothed by energy price hedging arrangements, as the implied windfall gain from using direct pool prices in the analysis would be counter to its requirement to consider the social impacts of its decisions under s. 20(2)(g).

The Commission reminds stakeholders in retail electricity service delivery that the TFT is not intended to be a ‘safety net’ to be used for social or targeted support to smaller consumers. Other mechanisms mandated and funded through government and community programs are in place to fulfil that need (see Section 7.1). Under the requirements of section 20 of the ICRC Act, the Commission cannot allow the imposition of cross-subsidies between contestable and non-contestable customer groups, particularly in the costs associated with the purchase of electricity, which constitute a large proportion of the retail costs of electricity. The allowance of significant cross-subsidies associated with underpricing the costs of TFT would severely impede the offering of alternative tariffs by competing retailers, increase the barriers to entry of new-entrant retailers, accelerate the rate of electricity cost increases in the medium term, and potentially limit the equitable flow of benefits of reform in the electricity sector to consumers in the ACT.

6.2.2 Energy risk management costs

Comments on risk management costs

The Commission did not receive any comments on the estimate of a \$0.72/MWh risk management cost it included in the draft decision.

The approach adopted for the final price direction

For its final price direction analysis, the Commission will continue to add an energy risk management cost.

In its previous decisions on the TFT, the Commission factored the costs of managing an energy trading desk and the other costs of hedging the retailer’s forecast load into the electricity purchase cost. Given that the estimates of the electricity purchase cost in this report are based on market measures of cost which do not factor in those costs, the Commission has added a separate estimate of energy-purchase risk-management costs. It is reasonable that the retailer recover such costs, as this is the prime risk reduction function that the retailer carries out on behalf of its aggregate customer base. While the costs of undertaking this function are small, its value underpins the retail margin that the retailer expects because of complexity of the function. The Commission has escalated the energy risk management cost used in its previous decision for 2007–08 by the assumed CPI factor and has adopted \$0.72/MWh as the reasonable cost base for this activity for

2008–09. The recovery of these costs meets the economic efficiency objective in s. 20(2)(c), as well as the cost recovery provisions of s. 20(2)(e).

6.2.3 Green costs

Comments on green costs

For its draft decision, the Commission did not have access to the detailed data required to verify green costs for 2008–09. Following the publication of the Commission’s draft decision, ActewAGL Retail provided feedback that \$4.95/MWh was somewhat high and that the calculation of MRET (mandatory renewable energy target) and GGAS (Greenhouse Gas Abatement Scheme) costs under the relevant legislation for 2008–09 should follow the IPART estimates for 2007–08 as more representative of the costs.

The approach adopted for the final price direction

ActewAGL Retail is required to calculate costs of its MRET and GGAS obligations for the coming year using the methodology prescribed by Commonwealth law.³¹ This information was not available to the Commission for its final decision. Based on feedback from ActewAGL, the Commission has based its decision on the outcomes for Integral Energy from the IPART report for 2007–08 and allows \$4.87/MWh (excluding the New South Wales renewable energy target (NRET) costs which do not apply in the ACT, but inflated to nominal numbers using the Commission’s CPI assumption).

The MRET has been estimated at \$1.27/MWh and the GGAS has been estimated at \$3.60/MWh. Table 6.5 shows the estimated outcomes for 2008–09, along with the IPART and QCA outcomes provided in those regulators’ recent final determinations.³²

The Commission believes that the estimates are reasonable for the 2008–09 year and that, being cost-based and not unduly overstated, they balance the requirements of s. 20(2)(i) on cost recovery and s. 20(2)(a) on avoidance of misuse of monopoly power.

Table 6.5 Green costs (\$/MWh)

	ICRC 2008–09	IPART 2008–09	QCA 2008–09
NRET	n.a.	0.42	n.a.
MRET	1.27	1.27	1.35
GGAS	3.60	3.60	2.29 ^a
Total green costs	4.87	5.29	3.64

^a Queensland 13% gas scheme

6.2.4 NEM fees

Comments on NEM fees

The Commission did not receive any comments on the estimate of a \$0.72/MWh for NEM fees that it included in the draft decision; nor did it receive any additional information from ActewAGL Retail on estimates of those costs.

³¹ *Renewable Energy (Electricity) Act 2001* (Cwth).

³² Based on IPART, *Promoting retail competition and investment in the NSW electricity industry: Regulated electricity retail tariffs and charges for small customers 2007–2010 (Final report and final determination)*, June 2007, Table 6.1, p. 75, and QCA, *Final decision: Benchmark Retail Cost Index for electricity: 2008–09*, May 2008, p. 26.

The approach adopted for the final price direction

The Commission did not receive a submission from ActewAGL Retail providing its estimates of the NEM general participation fees, full retail contestability fees and the costs of ancillary services likely to be applicable in 2008–09. The Commission has adopted for its final price direction the values used by IPART in that regulator’s final determination for 2008–09 escalated to nominal values using the Commission’s CPI assumption.³³ The values used are shown in Table 6.6.

Table 6.6 NEM fees (\$/MWh)

	ICRC 2008–09	IPART 2008–09
Market fees		
Participant	0.35	0.35
Full retail contestability	0.06	0.06
Ancillary services	0.31	0.31
Total NEM fees	0.72	0.72

The Commission recognises that the recovery of NEM fees meets the objective of s. 20(2)(d), (e) and (i). The payment of ancillary services fees assists NEMMCO in providing for safe and reliable delivery of electricity to all consumers, which supports the objectives of s. 20(2)(b).

6.2.5 Energy losses

Comments on energy losses

The Commission did not receive any comments on the estimate of 4.86% for the low-voltage loss percentage that it included in the draft decision.

The approach adopted for the final price direction

Before the beginning of each financial year, NEMMCO publishes its report of distribution loss factors so that distribution and retail businesses can factor the impacts of distribution losses into the tariff structures that they apply to various customer segments. The loss factors are used in the estimate of the electricity purchase costs to allow the retailer to recover the costs of energy losses as the energy is delivered across the distribution network to its customers. Ultimately, the customer pays for the energy lost in delivery to their take-off point. The Commission has adopted the value of 4.86% for the low-voltage loss percentage to apply in its analysis for the final price direction. Table 6.7 shows the loss factors used by the Commission in previous decisions.

The Commission has extracted the distribution loss factors for the ACT provided in the NEMMCO reports to assist with its estimate of the weighted average price cap which applies to the TFT. It also uses the values to estimate the total network costs in 2007–08 and the likely energy demand requirements for TFT customers for 2008–09.

Table 6.7 Energy loss factors

	ICRC 2005–06	ICRC 2006–07	ICRC 2007–08	ICRC 2008–09
Energy losses	5.19%	5.06%	4.97%	4.86%

The Commission notes that the recovery of these energy losses meets the objectives of s. 20(2)(d), (e), (h) and (i) by ultimately requiring customers to pay for the energy they consume. As this approach to energy losses in the distribution system is mandated in the NEM framework, it also meets the objectives of s. 20(2)(k).

³³ IPART, *Promoting retail competition and investment in the NSW electricity industry: Regulated electricity retail tariffs and charges for small customers 2007–2010 (Final report and final determination)*, June 2007, Table 6.8, p. 90.

6.2.6 Retail operating costs

Response to comments on low retail operating cost estimates

In their submissions, both ActewAGL Retail and TRUenergy argued that the Commission’s estimate of retail operating cost of \$97.12 per customer in 2008–09 was insufficient and did not align with the costs allowed in other jurisdictions, which were based on a number of independent studies which purported to show that costs for this sector had risen faster than costs in the general economy. For further details refer to section 5.3.3.

The approach adopted for the final price direction

In the past, the Commission has preferred to rely on industry benchmarks and regulatory precedent to guide the estimate of retail operating costs. Following ActewAGL’s comments on the draft decision, the Commission again reviewed the final determinations by the QCA relating to Energex et al. and IPART relating to EnergyAustralia et al.

The use of a CPI inflation adjustment to the previous \$85.00 per customer from the Commission’s 2003–04 final decision provides an estimate which, at \$97.12 per customer per year (or \$9.94/MWh) for the 2008–09 financial year, compares reasonably with the regulatory outcomes in other jurisdictions (Table 6.8). The Commission accepted that the impact of the recovery of similar fixed costs across a larger customer base could account for some of the difference seen in other jurisdictions.

	QCA (Energex) 2008–09	IPART (EA) 2008–09	ICRC 2008–09
Retail operating cost	\$74.58	\$79.36	\$97.12

After considering the comments provided in the submissions, the Commission came to the view that a retail operating cost allowance of \$97.12 per customer is reasonable for the 2008–09 financial year. The Commission believes such an outcome is a reasonable balance between the need to allow cost recovery (s. 20(2)(e)) but also to require the incumbent to operate efficiently (s. 20(2)(c)) and to acknowledge the need to consider the social impacts of its decisions (s. 20(2)(g)) by requiring ActewAGL Retail to manage its controllable costs to within the general price inflation seen over this five-year period. This is relevant where external and uncontrollable costs (such as generation costs) have risen at rates well above the general inflation rate in the economy. The Commission prefers to use \$97.12 per customer per year (or \$9.94/MWh) for the 2008–09 financial year for its final decision.

6.2.7 Customer acquisition and retention costs

Response to comments on exclusion of customer acquisition costs

In its submission, ActewAGL Retail argued that the Commission should make an allowance for customer acquisition costs, and that a value of \$20.85 per customer was more reasonable, as it was closer to the cost which a new entrant would be likely to experience (refer to section 5.3.3). In its submission, TRUenergy suggested the Commission adopt the QCA value of \$35.00 per customer (refer to section 5.4).

The approach adopted for the final price direction

While its original decision in 2003 did not separately identify costs associated with the ‘new entrant’ activity of acquiring new customers, the Commission has included the possibility of inclusion of the customer acquisition and retention costs into the TFT base recognising that

potentially the development of competition would likely be fostered by allowing those costs into the cost recovery for the TFT customer base. This would support the objective of s. 20(2)(c) by reducing the barrier to entry for competing electricity retailers, which would allow competing price discounts to be offered to the TFT customer base.

In its draft decision, the Commission did not accept that ActewAGL Retail pays additional costs when it takes previous non-TFT customers back onto the TFT, particularly when it has paid no advertising costs to encourage such customers to return. Furthermore, under the terms of reference for this review, the Commission does not believe it is bound by the new entrant cost principle to the exclusion of the other objectives of s. 20(2) of the ICRC Act.

Table 6.9 Customer acquisition costs, final decisions

	QCA (Energen) 2008–09	IPART (EA) 2008–09	ICRC 2008–09
Customer acquisition cost	\$18.00	\$37.03	\$0.00

The Commission notes the comments by the ESCC and DHCS on the possibility of including a new customer cost, and although the Commission notes that other regulators have made allowance for this cost (for example, QCA and IPART), the Commission is not convinced that an allowance for this cost is appropriate under the terms of reference issued to the Commission. Should any future terms of reference issued by the government to the Commission make a requirement for the Commission to consider the ‘new entrant costs’, as has been the practice in NSW and Queensland, the Commission would need to consider what is an appropriate additional cost to include. The Commission notes that TRUenergy’s proposal of \$35.00 per customer is significantly higher than the proposal from ActewAGL Retail. The inclusion of the proposal made by ActewAGL Retail would add around \$2.15/MWh to the price of electricity at the retail level. For its final price direction, therefore, the Commission believes that it has met the requirements of the terms of reference and the social impacts of its decisions (s. 20(2)(g)) by not including a new customer acquisition cost in the price determination for the TFT for 2008–09.

6.2.8 Network tariffs

Response to comments on network tariff estimates

The submissions received by the Commission from ActewAGL Retail provided the estimate of \$56.06/MWh for the network costs for 2008–09 based on the outcome of the Commission’s previous decisions on network price control and estimates of the TFT customer base consumption levels for tariff setting purposes.

The approach adopted for the final price direction

The Commission has used the outcomes of its March 2004 price direction relating to ActewAGL Distribution’s network tariffs³⁴ and the forecast prices in a confidential submission on the annual network pricing report³⁵ to verify the network cost proposed by ActewAGL Retail for 2008–09. The Commission’s analysis confirms that the average network cost to franchise customers of \$56.06/MWh appears reasonable for 2008–09. The Commission believes this approach supports

³⁴ ICRC, *Final decision: Investigation into prices for electricity distribution services in the ACT*, March 2004.

³⁵ ActewAGL Distribution, *Annual pricing report 2007–08, Electricity distribution services*, 4 May 2007.

the objectives of s. 20(2)(a) through arm’s length confirmation of cost data otherwise delivered by a regulated entity, while at the same time accepting that the recovery of network cost pass-throughs is a legitimate activity for the retailer, which meets the objectives of s. 20(2)(c), (d), (e), (i) and (k).

6.2.9 Retail margin

Response to comments on allowed retail margin

In their submissions, both ActewAGL Retail and TRUenergy supported the Commission’s draft decision to apply a retail margin of 5%. It was felt this level of retail margin was better supported by the final determinations in other jurisdictions

The approach adopted for the final price direction

In its previous price direction for 2003–04 to 2005–06, the Commission adopted a retail margin of 3% of the retail sales value. For its final decision for 2007–08 the Commission adopted a retail margin of 4% of the retail sales value. Following consideration of the submissions it has received, and benchmarking its previous decision outcomes against recent regulatory final determinations, the Commission believes that the retail margin of 5% that it contemplated in its draft decision is reasonable. The Commission confirms its view that a 5% value for the retail margin on total sales is sufficient for the TFT customer segment in the context of the Commission’s decisions on electricity purchase costs, and when compared to other jurisdictions on a like-for-like basis.

Table 6.10 summarises the recent benchmark final determinations from other jurisdictions.

In its final decision³⁶, ESCOSA adopted a 10% retail margin on wholesale electricity cost (WEC) plus retail operating cost (ROC). It equated this to being approximately the same as in other jurisdictions of 5% of sales revenue, where sales revenue is

Table 6.10 Retail margin benchmarks

	ESCOSA 2008–09	IPART 2008–09	QCA 2008–09	OTTER 2008–09	ICRC 2008–09
Cost basis	WEC+ROC	EBITDA	EBITDA	Gross margin	EBITDA
Retail margin	10%	5%	5%	12%	5%

considered to be earnings before interest, tax, depreciation and amortisation (EBITDA). In this sense the ESCOSA approach does not consider the average network costs for the TFT customers (referred to as ‘standing contract’ customers in South Australia). This approach has been retained by ESCOSA over the period of the three-year price path from 1 January 2008 to 31 December 2010. In effect, the ESCOSA decision was similar in quantum terms to the decisions taken by IPART and QCA.

In its final decision³⁷, IPART adopted a 5% retail margin on EBITDA (percentage of sales). This was adopted over the period of the three-year price path from 1 July 2007 to 30 June 2010.

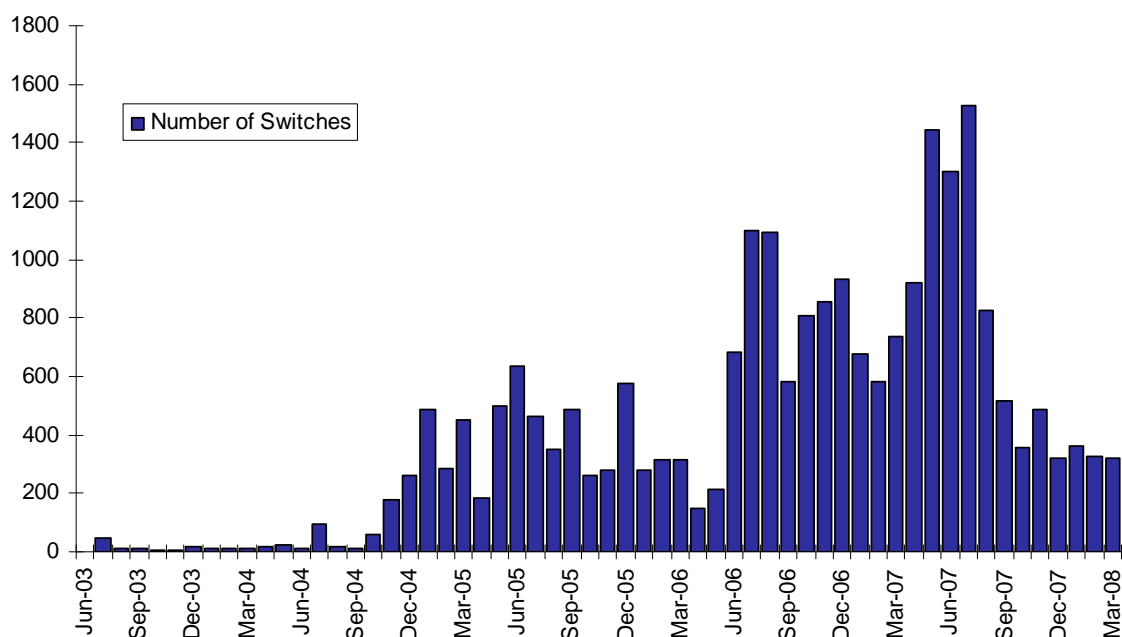
³⁶ ESCOSA, *2007 Review of retail electricity price path: final inquiry report & price determination*, November 2007, p. A-67.

³⁷ IPART, *Promoting retail competition and investment in the NSW electricity industry: Regulated electricity retail tariffs and charges for small customers 2007–2010 (Final report and final determination)*, June 2007, p. 94.

The QCA is constrained to use a Benchmark Retail Cost Index (BRCI) approach to its regulation of TFT customers (in Queensland referred to as ‘notified price’ customers). In its 2007 decision³⁸, the QCA adopted a 5% retail margin on EBITDA (percentage of sales).³⁹ QCA recently confirmed its use of a 5% margin for both 2007–08 and 2008–09.⁴⁰

The Commission sought the most recent data on customer churn in the ACT to determine whether its previous allowance of a 4% retail margin was sufficient to cover the efficient retail costs for TFT customers and to encourage continued entry by competing retailers. Figure 6.3 shows that the customer churn has reduced markedly in the past 12 months.

Figure 6.3 Customer churn or switching in ACT (NEMMCO data)



While the reduction in churn is evident, the identification of the specific causes is difficult. While contributing factors to this fall are likely to include the dramatic increase in pool price and price volatility during mid to late 2007, as well as a retail margin that has been lower than other jurisdictions, there may be other contributing factors which are retailer specific.

The Commission notes that the total number of customers on contestable tariffs rose from around 26,000 in 2006 to around 35,000 in 2007, but that the share of contestable customers held by ActewAGL Retail (the incumbent) is currently around 70% as compared to other competing electricity suppliers. While there are still competing offers available for household consumers in

³⁸ QCA, *Final decision: Benchmark Retail Cost Index for electricity: 2006–07 and 2007–08*, June 2007, Table 3, p. 6.

³⁹ QCA, *Final decision: Benchmark Retail Cost Index for electricity: 2008–09*, May 2008, Table 4.1, p. 24.

⁴⁰ QCA, *Draft decision: Benchmark Retail Cost Index for electricity: 2008–09*, February 2008, p. 29.

the electricity market, the level of contestability in the market is not as strong currently as has been evident in previous years.

There are two possible explanations for this easing of contestable activity (and the continuing strong position that ActewAGL Retail holds in the contestable market). First, consideration needs to be given to the size of the retail margin. The retail margin itself provides a return to the regulated retail entity, among other things to compensate it for the risks it bears in aggregating an uncertain retail load and purchasing this load in a wholesale electricity pool (albeit using hedging strategies to mitigate such risks to the greatest extent possible).

The Commission believes that the recent electricity market price outcomes display a change in price volatility which has also been seen in the contracts market. The contracts market has shown a step change in the outlook for future prices which is related to apparent externalities affecting the balance in supply and demand for electricity, resulting in an increase in the average price in the electricity pool. While there has been a reduction in the average pool prices seen in the electricity market, there remain concerns that a further deepening of the drought conditions and a further increase in peak demand, combined with continuing increases in the price of crude oil (and hence diesel and coal prices) may see a return to higher pool prices with increased volatility in the short to mid term. This would justify a re-rating of the risks for retailers and, hence, provide an argument for an increase in the retail margin allowed.

Second, in setting a TFT, the Commission has to make a decision on the forward purchase model that it uses to determine the generator prices that will flow into the TFT. The Commission considers that the hedging model adopted ensures that its estimate of the average contract costs for electricity to service TFT customers is not artificially constrained, and that it reasonably reflects both the existing market prices and a reasonable hedging strategy for an incumbent retailer in the ACT.

The Commission, however, also recognises that a new entrant which does not have an existing strong base in the ACT may have to seek contracts to meet any contestable customer supply requirements that it generates from its marketing activity in the ACT. Such a new entrant may conclude that the generator price determined by the Commission is at a level that is difficult to match at the margin. Unless such a supplier has adopted an approach which ensures that it has excess supply capacity at a balanced hedged buy-in price, the potential new entrant may be less inclined to seek customers in the ACT market. In the context of larger market opportunities emerging in Queensland and existing markets in New South Wales and Victoria, where the TFT-equivalent price has been set on the basis of a new entrant price, this can mean that the ACT market becomes less attractive.

Thus, the Commission believes that the decline in churn in the ACT may be explained by a number of factors, some of which reflect the decisions made in setting the TFT, and some reflecting external factors outside the control of the Commission. A decision to increase the retail margin from 4% to 5% will not of itself deepen the extent of contestability in the ACT market, although the Commission notes that the mere absence at this time of a large number of active retailers in the market does not necessarily mean that there is not the possibility of retailers returning at some future time (and thus the efforts by ActewAGL Retail to continue to offer discounts on bundled services, thereby shoring up its customer base for the future).

Based on the precedent being set across other jurisdictions which indicates that on a benchmarking basis some adjustment is required, but without accepting the view that an increase in the margin is required solely to provide head room for new market entrants, the Commission believes a 5% retail

margin on total sales is reasonable compensation for the risks for the incumbent in the ACT, and has incorporated this value into the average revenue cap for 2008–09.

The Commission believes this approach meets the objectives of s. 20(2)(d) and (i), and that overall the social impacts of its decisions on the total cost bundle to be included in ActewAGL Retail’s cost bundle are ameliorated because of consumers’ access to competing contestable tariffs. Where the Commission’s decision on the allowed weighted average price cap for 2008–09 has factored in costs which might in future appear high against the actual outcomes in 2008–09, consumers can choose tariffs of a lower cost where they are offered by competing retailers. The Commission believes this property of the contestable market serves the interests of consumers on the TFT under s. 20(2)(g) of the ICRC Act.

6.3 Summary of cost elements

Based on the benchmark cost analysis in Section 6.2, the Commission believes the cost breakdown in Table 6.11 provides the reasonable cost base for development of the weighted average price cap to be applied to the TFT for the 2008–09 year.

The Commission believes that these costs are reasonable for an efficient incumbent retailer providing services to the TFT customer base in the ACT. As efficient costs, these costs meet the objectives of s. 20(2)(c) and allow the correct price signals to be seen by end-users of the TFT, which meets the objective of s. 20(2)(h) while protecting TFT consumers from excessive price increases, which would not support the objective of s. 20(2)(a).

Table 6.11 Composition of TFT retail price

	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
CPI change, 2006–07 to 2007–08	2.33%
X factor in CPI+X on MAR in \$/MWh	4.67%

6.4 Weighted average price cap outcome

The Commission has reviewed the average weighted TFT price cap for 2007–08 and compared this to the build-up of cost estimates for 2008–09 to generate the required X factor in the weighted average price cap to be imposed on ActewAGL Retail for its TFT customers. As shown in Table 6.10, the X factor preferred by the Commission for its final price direction is 4.67%.⁴¹

⁴¹ Note that this number is derived by use of the formula $(1+\text{delta}\%) / (1+\text{CPI}) - 1$ which is the same as the previous year. This formula has been used so that the second order terms in the price control are effective. This is required because the cost changes reflected in the delta% have been large, and the second order terms thus become important in a calculation using a polynomial.

Based on the regulatory CPI estimate of 2.33% for 2008–09, the Commission proposes that, in order for ActewAGL Retail to recover its efficient costs and to meet the objectives of s. 20 of the ICRC Act, the weighted average price cap for 2008–09 must allow average price increases of 7.11% for TFT customers.

7 Other aspects of the transitional franchise tariff

7.1 Safety net provisions

The Commission has carefully considered the submission by the ESCC as it relates to the impacts of continuing and multiple price rises on less well-off ACT consumers. To the extent that it can under the powers given to it by legislation and by government reference, the Commission has considered and, where appropriate, adopted the recommendations brought forward by the ESCC. However, the Commission recognises its limited mandate in areas associated with social welfare and the more financially vulnerable consumers in the ACT community. The Commission reiterates its comments from its draft decision, as follows.

In its previous reports⁴², the Commission has stated that the TFT was never intended to be a safety net measure for more vulnerable customers. The Commission is still of this view. In other industries and for other goods and services, a competitive retail market is usually considered to offer the best guarantee against price gouging or exploitation of consumers. 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 seek to minimise the churn of customers that can occur when prices change rapidly and regularly.

In setting the TFT for 2008–09, the Commission has sought to set a price which does not reflect the volatile prices and occasional price spikes which can be seen in the short-term marginal cost (although this might be the price that a new retail entrant might charge if they had not hedged in advance of the current price increases). Refer to Figure 5.1 above.

In these circumstances, the TFT provides a degree of certainty and stability for consumers' likely electricity costs over the next 12 months. To ensure security of supply and to avoid any potential for events such as those in California, where retail prices were set below generation costs, forcing retailers to leave the market and suppliers to fail, the Commission has recognised the need for further price increases to take effect from 1 July 2008. This, in itself, represents a form of 'safety net' for security of supply to consumers. At the same time, it comes at a cost, which is reflected in the higher charges that will apply in 2008–09.

The Commission notes that a competitive market already exists for electricity supply in the ACT. Also that electricity prices appear to have begun to ease off their very high levels during mid 2007. Should generation costs decline further during 2008–09, competition between suppliers for the growing number of households that have converted to a non-franchise competitive supplier will force the early pass-through of those price reductions.

⁴² 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.

The Commission also notes that it has had regard to the comments from the ESCC on the non-inclusion of new entrant costs in the TFT. The Commission has not included these costs despite requests from the industry for their inclusion, and the inclusion of these costs in the equivalent TFT tariffs that apply in other jurisdictions. This raises competition issues in the ACT market, but the Commission believes that in the context of its terms of reference and requirements under section 20(2) the appropriate balance of interests requires it to exclude these costs from the TFT.

The price increases that will be experienced in the ACT for electricity as a result of the Commission's determination will in fact be at a lower rate than that applying in NSW and will mean that prices for electricity in the ACT are still cheaper than those applying in surrounding areas to the Territory. These points cannot be overlooked in any consideration of the social implications of the Commission's determination for the 2008–09 TFT, and represent what the Commission believes is a correct and well balanced weighting of all the arguments and issues that must be considered in making a decision of this type.

7.2 Support for vulnerable customers

The Commission continues to support the implementation of appropriate support arrangements for more vulnerable customers, including the targeted use of community service obligations; rebates and concession arrangements for welfare benefit and pension recipients; and the consumer advocacy and support services provided by the Essential Services Consumer Council, Care Financial Counselling Service (Care ACT), the ACT Council of Social Service and other support agencies. It is not possible to adopt a policy which forces the TFT price down below its cost to provide on the basis that this will provide assistance to those in need. Effectively, any assistance for more vulnerable customers should be composed of a range of measures that address particular needs and particular situations. The issue for government is whether the balance of support services that it provides is appropriate and correctly targeted.

The Commission has noted that on 1 April 2008, the Minister for Disability, Housing and Community Services, Katy Gallagher, tabled in the Legislative Assembly the report *Review of ACT Government Concessions* together with the government's response to the report. An interdepartmental committee is currently addressing matters arising out of this report, including programs to assist low-income households and individuals.

The ACT Government provides concessions to a range of individuals and groups. Table 7.1 lists current concessions. A recent announcement by the Chief Minister of the extension of these concession arrangements to Health Care Card holders has been significant in terms of its expansion of the concession arrangements.⁴³

⁴³Media release, Jon Stanhope, Chief Minister, ACT, 11 April 2008

Table 7.1 Concession programs

Energy
General Rates (Pensioner rebate of General Rates and Fire and Emergency Services Levy)
Life Support
Low Vision Aids Scheme
Motor Vehicle Registration and Drivers Licences
Public Transport
Secondary Bursary Scheme
ACT Senior Spectacles
ACT Spectacles Subsidy
Student Transport
Taxi Subsidy Scheme
Water and Sewerage

In terms of the concessions that apply to electricity costs, the concession arrangements provide a maximum annual rebate of \$189 on the electricity bills. If eligible, this concession can be as much as \$238 per year when combined with the concession on water charges.

Notwithstanding these concession payments, the Commission notes that there has been an accumulation of higher utility charges in 2008–09 as a result of higher than historical averages in increases in generation costs for electricity and the recent decision for higher water charges. These additional costs will have an impact on those in the community who are less well off, and appropriate funding of support programs by the government is required to address this issue.

These higher utility charges also come at a time when there is concern about the rising cost of housing in the ACT, higher petrol and transport costs, and concern that the costs of household necessities such as food are rising at a greater rate than the general rate of inflation and the growth in incomes or income support arrangements.

The interdepartmental committee that is currently working on the appropriate policy and program response to the Review of ACT Government Concessions report needs to consider carefully the implications for less fortunate households of the continual increase in utility charges. It is for government ultimately to implement and fund policies and programs that can address the specific needs of individual groups within our society that require help. But there is a tendency for the administrative arrangements to lag behind the realities of rising costs that these less fortunate households face. The establishment of the TFT and the Commission's observations on the underlying factors impacting on the cost of electricity and the price that consumers ultimately will need to pay should provide a strong indication of the existing and likely growing need for targeted assistance in the period ahead. The Commission can only fully support the endeavours of the ESCC and other organisations who are seeking to encourage the government to reconsider carefully its ability to fund these programs now and into the immediate future.

7.3 Pass-through arrangements

The Commission's determination is for a 12-month period. ActewAGL Retail has made submissions that should certain trigger events occur then ActewAGL Retail should be allowed to come back to the Commission and seek to have the TFT adjusted to compensate for any additional costs that ActewAGL Retail incurs.

The request is not unusual in the sense that the Commission and other regulators usually have some form of trigger arrangement to allow a reopening of a determination. However, these arrangements usually apply to price paths that extend for a period of more than 12 months whereas the TFT determination is for a 12-month period. In these circumstances, rather than wait for the end of a regulatory price path which may be up to five years in length, the regulator usually provides some comfort to the regulated entity that it will allow for consideration of a possible adjustment if certain events occur that are outside the ability of the regulated entity to control.

In terms of the TFT, ActewAGL has requested that there be a trigger mechanism that might apply should either carbon tax arrangements be introduced (or an emissions trading scheme, ETS, as is currently being explored by the Climate Change Review⁴⁴), or the feed-in tariff proposed for the ACT be implemented in the next 12 months. Each of these initiatives have the potential to increase the costs that are ultimately incurred by the electricity industry at some level, and therefore are likely to be passed through to the retailer who would normally seek to recover the costs from consumers.

The precise arrangements whereby any future emissions trading scheme or feed-in tariff arrangements might work are not known at this time. Thus it is difficult to have a view as to what might be the extent of any impact of these policy initiatives on ActewAGL Retail in its role as the incumbent supplier of electricity in the ACT. However, it is generally recognised that there will be costs associated with these proposals, and that these costs will need to be ultimately recovered from consumers.

The Commission's examination of these two possible programs suggests that they are unlikely to become operational prior to 1 July 2009, although it is still uncertain just what the timing may be. Thus the likelihood that ActewAGL Retail will need to activate a trigger is extremely small. Nevertheless, the possibility does exist that the relevant authorities which include the Federal Government as well as the ACT Government, may take decisions that will have an impact on the costs that ActewAGL Retail faces over the next 12 months.

Thus, the Commission is inclined to make a provision in the determination for the reopening of the TFT tariff during the 12 months from 1 July 2008 should one or both of these programs be introduced and there be an actual flow-on of additional costs to ActewAGL Retail in its role as the supplier of electricity to franchise customers in the ACT.

The Commission notes that under the trigger it will apply the following conditions:

- There must be actual financial costs being incurred by ActewAGL Retail and these costs must be non-trivial (any cost likely to amount to less than \$250,000 on an annual basis would be regarded as trivial).
- ActewAGL Retail must be able to show evidence and convince the Commission of the magnitude of the cost involved.
- Any adjustment must be on the basis of the allocation of the cost across both franchise and non-franchise customers such that there be no cross-subsidy between the TFT price for

⁴⁴ Ross Garnaut, *Climate Change Review*, refer www.garnautreview.org.au.

franchise customers and the competitive market prices offered by ActewAGL Retail to non-franchise customers.

- The Commission reserves the right to initiate action to amend the TFT determination if, as a result of any actions taken to introduce an emissions trading scheme or the feed-in tariff, there is a reduction in costs currently incurred by ActewAGL Retail.

While the last condition is highly unlikely, there is a need for symmetry in the trigger arrangements, and the Commission would require a similar symmetrical arrangement for any other trigger device that it approved under another determination. It should also be noted, lest there be any doubt, that the trigger mechanism only arises from a decision that relates to the introduction of an emissions trading scheme or the feed-in tariff.

8 Conclusion on the final price direction

In this final decision on the price direction for 2008–09, the Commission has considered the build-up of efficient costs for the provision of retail electricity services by ActewAGL Retail to customers on the regulated retail tariff, or TFT. In coming to its decision, the Commission has considered ActewAGL’s likely costs for 2008–09, especially taking into account the increases in electricity pool prices during mid 2007 and subsequent slow easing of these pool prices, and the effect on contract or hedging prices as seen in the futures market outcomes over the period to June 2008. The Commission has been mindful of the requirements of section 20 of the ICRC Act, and its obligation to balance the requirement for prices that reflect the costs of supply against the social implications of price increases.

The Commission has determined that ActewAGL Retail’s franchise tariff revenue may increase by up to the amount of 7.11%, which incorporates both a CPI factor and an X factor of 4.67%. The Commission has determined that the appropriate value of the CPI is 2.33%. In making this determination for one year, the Commission has not changed the form of regulation faced by ActewAGL Retail and has used the same cost build-up methodology as used in the previous year.

The Commission has incorporated into its decision a trigger mechanism to apply should certain decisions be taken in relation to the feed-in tariff or an emissions trading scheme and should these decisions have a non-trivial impact on ActewAGL Retail in the provision of the TFT.

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 1)

Disallowable instrument DI2008–13

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 2008 to 30 June 2009.

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

7 February 2008

Appendix 2 Final price direction

This appendix contains the Commission's price direction in respect of the transition franchise tariff (TFT) for the period from 1 July 2008 to 30 June 2009.

1 Period of the direction

The provisions below will apply to the period from 1 July 2008 to 30 June 2009.

2 Variation to price of retail electricity services

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

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

Where:

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

P_{ij}^{t-1} is the actual 2008–09 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

CPI = 2.33%

X = 4.67%

3 Trigger arrangements

ActewAGL Retail can seek to have the determination of the TFT reviewed in the event that there has been government action to introduce and implement either an emissions trading scheme or a Feed-in Tariff arrangement. For these trigger arrangements to apply, the following conditions will need to be met:

- There must be actual financial costs being incurred by ActewAGL Retail and these costs must be non-trivial (any cost likely to amount to less than \$250,000 on an annual basis would be regarded as trivial).
- ActewAGL Retail must be able to show evidence and convince the Commission of the magnitude of the cost involved.
- Any adjustment must be on the basis of the allocation of the cost across both franchise and non-franchise customers such that there be no cross-subsidy between the TFT price for

franchise customers and the competitive market prices offered by ActewAGL Retail to non-franchise customers

- The Commission reserves the right to initiate action to amend the TFT determination if as a result of any actions taken to introduce an emissions trading scheme or the feed-in tariff there is a reduction in costs currently incurred by ActewAGL Retail.

Appendix 3 Commission's regard for section 20 of the ICRC Act

When making any direction about prices in a regulated industry, the Commission is required to take into account a number of issues identified in section 20 (Directions about prices) of the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act).

The Commission's conclusions on each of these matters, considered in regard to its decision on the TFT for electricity, are summarised in the following table:

ICRC Act s. 20 issues	Commission conclusions
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 [s. 20(2)(a)]	The Commission considers that competition, both current and imminent, from existing and new entrants will ensure appropriate efficient pricing of electricity and the provision of service options that will best meet the needs of consumers. It is proposed that the government will retain the ability to refer retail pricing of electricity to the Commission should there be evidence of market failure or abuse of market power at any time in the future.
Standards of quality, reliability and safety of the regulated services [s. 20(2)(b)]	Competitive market conditions will ensure that service standards are met. Exercise of choice by consumers will ensure that competing retailers are required to maintain and improve service standards while operating in a competitive environment. The existing technical regulations relating to safety and quality of electricity provided will remain unchanged.
The need for greater efficiency in the provision of regulated services to reduce costs to consumers and taxpayers [s. 20(2)(c)]	Competition is acknowledged as the optimal method for ensuring efficient provision of services, and the Commission has concluded that existing and potential imminent competition will ensure the efficiency of the provision of electricity services to small consumers.
An appropriate rate of return on any investment in the regulated industry [s. 20(2)(d)]	The Commission's analysis of the retail margins currently included in the TFT applying in the ACT confirms that they are consistent with the margins included in regulated and contestable retail price offerings in other states.
The cost of providing the regulated services [s. 20(2)(e)]	The margin analysis undertaken by the Commission incorporates the full flow-on of network and generation costs, albeit using a general hedging strategy which the Commission believes all reasonable and financially viable retailers use to mitigate their exposure to the electricity pool. The margin analysis also demonstrates that retailers are able to recover their retailing costs in the current TFT tariffs, and decisions by retailers to discount below the TFT price indicate a further margin within which retailers are able to compete and remain viable in this market. The Commission has confirmed that customer churn off the TFT is continuing in March 2008 in the face of higher wholesale electricity costs. Withdrawal of the TFT in a competitive market will still allow retailers to recover their costs.
The principles of ecologically sustainable development mentioned in s. 20(5) of the Act [s. 20(2)(f)]	Pricing of electricity to reflect its actual cost, including charges such as greenhouse gas emission costs, provides a clear signal to consumers of environmental and ecological sustainability issues and encourages best use of energy resources. The decision will not alter the pass-through of these costs as is at present included in electricity prices.
The social impacts of the decision [s. 20(2)(g)]	The Commission has examined the social implications of the decision, and has highlighted the continuing need for funding of targeted assistance (including for the operation of the Essential Services Consumer Council) for vulnerable households. The Commission has retained a set weighted average price cap for the 2008–09 financial year, without access to additional cost pass-throughs, as a balance between the social impacts of its decision and the imperative to allow the incumbent franchise retailer to recover its efficient costs. The access to choice of alternative retail supplier provides a safeguard should the set TFT become more costly than available contestable tariff offerings.
Considerations of demand management and least cost planning [s. 20(2)(h)]	Greater opportunities for competition in the ACT market are expected to bring new service and pricing offers, including time-of-use tariffs, which will have a positive impact on better demand management.
The borrowing, capital and cash flow requirements of persons providing regulated services and the need to renew or increase relevant assets in the regulated industry [s. 20(2)(i)]	The Commission's margin analysis has confirmed that the margins allowed in the TFT are adequate to meet the financing needs of the electricity retailers, and the margins applying on discounted electricity offerings observed in the marketplace are consistent with margins offered by competitive retailers in other jurisdictions.
The effect on general price inflation over the medium term [s. 20(2)(j)]	There is not expected to be any significant impact on price inflation from this decision as retailers compete to maintain or expand their customer bases. It should be noted that the general price inflation in the near to mid-term may change where the electricity pool price and the contract prices being offered to manage this pool price risk increase due to external market supply and demand imbalances. The control or influence of such externalities is outside the mandate of the Commission.
Any arrangements that a person providing regulated services has entered into for the exercise of its functions by some other person [s. 20(2)(k)]	Not applicable, as an incumbent retail supplier has not brought forward for consideration any third-party contracts that cannot otherwise be serviced under the proposed weighted average price cap.

Glossary and abbreviations

ACT	Australian Capital Territory
ActewAGL	ActewAGL Retail
BRCI	Benchmark Retail Cost Index
Commission	Independent Competition and Regulatory Commission (ACT)
CPI	Consumer Price Index
DHCS	Department of Disability, Housing and Community Services (ACT)
EBITDA	earnings before interest, tax, depreciation and amortisation
ETS	emissions trading scheme
ESCC	Essential Services Consumer Council (ACT)
ESCOSA	Essential Services Commission of South Australia
FRC	full retail contestability
GGAS	Greenhouse Gas Abatement Scheme (ACT) Greenhouse Gas Reduction Scheme (NSW)
ICRC Act	<i>Independent Competition and Regulatory Commission Act 1997</i> (ACT)
IPART	Independent Pricing and Regulatory Tribunal (NSW)
LRMC	long-run marginal cost
MAR	maximum allowable revenue
MRET	mandatory renewable energy target
MWh	megawatt hours
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company
NRET	New South Wales renewable energy target
OTTER	Office of the Tasmanian Energy Regulator
OTC	over-the-counter (trading)
QCA	Queensland Competition Authority
ROC	retail operating cost

RRP	regional reference price
SFE	Sydney Futures Exchange
TFT	transitional franchise tariff
Utilities Act	<i>Utilities Act 2000 (ACT)</i>
WEC	wholesale electricity cost