

**Independent Competition and Regulatory Commission**

**Draft Report**

**Full Retail Contestability in Electricity  
in the ACT**

**May 2002**

The Independent Competition and Regulatory Commission is established under the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act). The Commission's functions are set out in section 7 of the ICRC Act

The Commission is made up of three Commissioners:

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## Foreword

The Treasurer issued a reference to the Independent Competition and Regulatory Commission on 18 December 2001 to inquire into and provide advice to the Government on the benefits of extending full retail contestability (FRC) for electricity in the ACT.

The Reference directed the Commission to consider a range of matters in arriving at its final advice. The Commission was to have regard to the costs and benefits of implementing FRC. The Commission was to pay particular attention to the impact the decision would have upon the competition payments that the ACT receives from the Commonwealth Government as a continuing participant in the National Competition Policy reforms. Clause 5 of the Competition Principles Agreement implicitly commits the ACT to implementing FRC if it cannot identify substantial benefits in maintaining the level of restriction on competition that currently exists.

The Commission was also to identify the customers using 100 Megawatt hours per annum (MWh pa) or less, identify the costs and benefits to those customers, any means of mitigating the cost of FRC upon the disadvantaged, and whether deemed profiling (pricing based on “typical” usage by a “standard” customer) would be better than moving early to full individual hourly metering. The Commission was also asked to review reform undertaken in other jurisdictions, nationally and internationally.

The Commission was directed to complete its inquiries by the end of March 2002 and report as soon as practicable afterwards.

In the inquiry the Commission has sought the views of all stakeholders. The Commission released an Issues Paper in January 2002, raising broad concerns brought to the Commission’s attention by Government, the media and the community. The comments and the submissions, including those of ActewAGL, ACTCOSS and others, on those issues have been taken into account in this draft report. The Draft Report is the first opportunity the Commission has to present its views and to have those views exposed to critical analysis before the final report is prepared. The Draft Report will have served its purpose if the Commission has substantial data and robust views put to it. The Draft Report is an important part of the process for the Commission to determine its final views before providing advice to the Government, which will then decide on what options to adopt.

The Commission is obliged under section 20 of the *Independent Competition and Regulatory Commission Act 1997* to allow 20 working days for comments to be submitted on the Draft Report. Given the release date of this report the closing date for submissions is the 18<sup>th</sup> of June 2002. Submissions to the inquiry should be in writing and delivered to the Commission’s mail address at PO Box 975 Civic Square ACT 2608 or electronically to [icrc@act.gov.au](mailto:icrc@act.gov.au). For information on the Draft Report or the inquiry please contact Ian Primrose, Chief Executive Officer, on (02) 6205 0799.

Paul Baxter  
Senior Commissioner  
17 May 2002.



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## **Executive Summary**

The Commission received a reference to inquire into and provide advice to the Government on the implementation of Full Retail Contestability (FRC) in the ACT in December 2001. The Commission released its issues paper on the Inquiry in January 2002.

### ***Terms of the Reference***

The reference required the Commission to consider a range of issues including:

- Identifying and describing electricity market participants using 100 MWh pa of electricity or less;
- Identifying the costs and benefits of FRC for ACT consumers using less than 100 MWh pa;
- The means and cost of avoiding or mitigating any adverse impacts on customers, particularly the disadvantaged;
- Whether the ACT should adopt profiling or full metering;
- A comparison with other jurisdictions' experiences with FRC; and
- Any other related matters.

### ***The Commission has considered stakeholder views***

The Commission has considered a number of submissions from community organisations, ActewAGL and government agencies in forming its views on the terms of the reference. The Commission has also had regard to reports prepared for ActewAGL and the Department of Urban Services on the costs and benefits of implementing FRC in the ACT. While some commentators have argued that the comparative information from NSW and Victoria is too insubstantial to make reliable judgements, the Commission is satisfied that a reliable picture of the FRC decision has emerged.

### ***Consideration of experience in other jurisdictions***

The Commission has examined closely the experience of New South Wales and Victoria in implementing FRC. The NSW market surrounds the ACT but both markets are important to the Territory. Consumers in the ACT will naturally compare the ACT with those larger States to gauge whether they are worse or better off. Both NSW and Victoria have recently opened their markets to competition in January this year. Significantly, in both NSW and Victoria the rates of customer transfers and the impact of FRC costs gives the ACT useful guidance on what may occur in the Territory. The modelling in Attachment 1 draws on experience in both those States. Elsewhere reference has been made to the low level of churn, and the correspondingly low level of cost of transfers in the first months of competition.

The experience in the United Kingdom (UK) also provides a useful perspective on the implementation of FRC. The UK experience was different to NSW and Victoria, having a higher rate of churn (transfers) and significantly lower retail prices. However, there were some other problems that are instructive for the implementation process in the ACT if the market is made contestable. California is not a useful model

for the ACT, given that it has been significantly distorted. The Californian market is more an example of what should not be done rather than a model of what might be done.

***The difference between costs and benefits are small***

The Commission has come to the view that, in the short term, there is no quantifiable net benefit arising from FRC for smaller electricity users that would put implementation in the ACT beyond question. The Commission's modelling of both quantifiable and non-quantifiable costs and benefits shows that for the group of consumers using less than 100MWh pa there is a small increased overall cost of about \$2 per month for residential customers, in terms of the likely retail price of electricity in a contestable market. The relative cost impact for consumers increases as the amount of electricity used decreases: smaller consumers will pay relatively more on their total electricity bills than large consumers in a contestable market. For large consumers, who are already contestable, there will be a benefit in terms of price reductions. The Commission has also found that unavoidable FRC costs will be borne by all consumers as both retailers and the network operator seek to recover the cost of providing adequate IT and other systems to cope with a contestable market. Those costs are directly related to FRC, as they would otherwise not have to be met by retailers or the network operator. They include costs arising for systems needed to effect customer transfers, for settlements between retailers and suppliers and for customer billing. In this regard, it should be borne in mind that one-off FRC costs, after they have been recovered, should be eliminated from the electricity price.

In saying that there is no direct price benefit to small customers does not mean that other more generalised benefits may not be available. The benefits that choice of retailer may bring are unquantifiable. The level of competition that is likely to occur in the less than 100 MWh pa segment of the market is equally unclear, although it is expected to be small.

However, it is important to note that some of the increases in future costs that consumers will bear are independent of FRC. For example, the cost of wholesale electricity and the cost of transmission are expected to rise over the short term. ACT consumers have benefited over recent years from wholesale purchase contracts negotiated by ActewAGL at rates that have meant consumers pay up to 20% less for retail electricity than consumers of similar size pay elsewhere. Those arrangements may expire over the short term and the lower energy prices may not be sustained, meaning higher prices for retail electricity may be inevitable. The loss of those benefits will make the prices paid by ACT consumers more comparable with what consumers of similar size pay in other jurisdictions.

***Mitigating impacts on small customers***

While small consumers will pay more for their electricity due to FRC than they are currently paying, the Commission's modelling indicates that on average the costs will be relatively small. However, the Commission would expect that FRC would put some additional pressure on services such as the Essential Services Consumer Council (ESCC), although it is not possible to model the impact with precision.

In considering whether some form of safety net could be provided for disadvantaged customers to lighten the burden that might fall on the ESCC, the Commission has

found no arrangement that would produce greater benefits than a competitive market supported by a body like the ESCC. Protection for a small group of consumers, based on an assessment of disadvantage or deficiencies in competence, would be difficult to target with precision and difficult to provide at a price equal to or lower than the competitive price. With FRC costs to be shared across all customers, to remove some customers from that population would increase the cost of electricity to contestable customers more than it would otherwise be. For larger customers that may mean being cherry picked by other competitors in the market, with consequential additional increases in the cost of electricity to small consumers. The numbers of customers who are unable to cope with a contestable market should be relatively small, and within the scope of the ESCC to provide an avenue of relief.

Having said that, the Commission considers that the way in which fixed costs are allocated could be a means of mitigating the impact on smaller customers. The extent to which that may be effective, or necessary, in reducing a marginal cost increase of \$2 per month will depend on the extent to which allocating more cost to larger customers would increase the risk of losing those customers to other retailers able to offer lower prices for large volume users.

The Commission believes that in the absence of a clear net benefit other indicators need to be considered in making a decision in favour of FRC or not. Concerns about issues such as consumer protection in relation to transparency of contract terms, periods and the provision of standard cooling off periods and controls on marketing behaviour have been met by existing provisions in the Utilities Act and related Codes and Standards which will remain in force subject to oversight by the Commission.

#### ***Impacts of customer churn***

The Commission has not given priority to the risks associated with loss of market share by ActewAGL. Losses of market share would affect the dividend payable by ActewAGL to the Government as a shareholder of Actew Corporation. That is a normal market risk that should not be a sufficient reason in itself for not implementing FRC. In any case ActewAGL's position as the market leader, the incumbent retailer and the network operator give it a strong market presence, brand identification and a large existing customer base.

Further, regarding customer switching (churn), there is no conclusive evidence to suggest that the impact would be sufficient to affect the decision to implement FRC. Experience in Victoria and NSW is that initial rates of churn are insignificant. In both jurisdictions in the first three months of FRC, churn was less than 1%. At a similar rate in the ACT the concerns about loss of market share by ActewAGL would be unfounded and any difficulties in relation to managing demand for transfers would be negligible.

#### ***Providing time for preparation of IT systems***

ActewAGL as the incumbent retailer and network operator has raised the need for adequate time to be provided for its systems to be developed and tested before the market is opened. The Commission has sympathy with that view but some of the required work has already been undertaken. The systems implementation process should not need more than three months, in which case a decision taken by the end of the financial year could be implemented before the end of 2002.

### ***Recognition of competition policy obligations***

The Commission has had to keep in mind the key driving force behind this inquiry. While the immediate costs and benefits appear to support a judgement in either direction on FRC, and might justify declining to implement FRC because there is a net cost to small customers, the ACT Government has made a commitment to National Competition Policy.

In 1995, the Government entered into Agreements such that continued receipt of competition payments from the Commonwealth would depend upon continuing progress against the reform targets in the Agreements. One of the agreed reforms was the establishment of a competitive national market for electricity. It is questionable whether, in the absence of a clear and significant net cost from FRC, the ACT could withdraw from or not honour that obligation by declining to implement FRC. Not to implement reform, without a substantial evident cost argument, would likely incur a reduction in the competition payments to the ACT. The Government will need to weigh any benefits of not proceeding with reform against the loss to the Territory of some part of the competition payments.

### ***The FRC decision is a one-off opportunity***

The Commission is conscious that the present time is a watershed in deregulation and the drive to increase productivity in the economy. Its view is that the opportunity should be taken to make the electricity market for under 100MWh pa consumers contestable rather than close that market to competition for the foreseeable future. The Commission considers that the present opportunity for reform will not recur, or will do so in less favourable circumstances. The value of the opportunity itself should be given some weight in coming to a decision on whether all customers should be able to choose their supplier and level of service.

### ***The Commission's recommendation***

Having considered the costs and benefits of introducing retail contestability to customers using less than 100 MWh pa, the Commission concludes that for the community as a whole the cost of FRC is insubstantial, noting that there is a higher relative cost for smaller consumers than for larger consumers. The Commission observes that in addition to the short-term costs associated with introducing FRC, there is the possibility of longer-term price increases that will affect all customers. The Commission considers that a contestable market would assist in mitigating the scope of those price increases, and may deliver a range of benefits unavailable in a regulated market.

The Commission has given weight to the risks of not introducing FRC, particularly the potential ongoing loss of competition payments from the Commonwealth. The Commission is also convinced that the decision to introduce FRC now is an opportunity that is unlikely to be available in future, without greater cost.

Thus, the Commission recommends that in the absence of strong arguments or evidence to the contrary, that the Government introduce FRC. The commencement date for FRC should take account of the time needed by the incumbent to finalise its systems changes to affect transfers and to provide advice to consumers about their rights and obligations in a contestable market. Consumers will also need to be

informed about the opening and operation of the contestable market, and about the respective rights and obligations of retailers and consumers. Time needs to be allowed for such a public education campaign.



# 1. Introduction

## ***Background to the review***

Together with the other States and Territories, the ACT has been working towards fully contestable markets in electricity and gas since the Council of Australian Governments (COAG) entered into the National Competition Policy Reform (NCP) Agreements in 1995. The pace of progress toward achieving fully contestable markets was subject not only to the milestones set out in the Agreements, and subsequently agreed COAG deadlines, but also to a decision about whether there are net benefits to the community as a whole from fully contestable markets in each jurisdiction. The ACT has made the larger consumers contestable, where the greatest benefits are likely to be concentrated. The Government is asking the Commission for advice about whether there are sufficient benefits for small customers to warrant extending contestability to them, or whether small customers would be better off by remaining subject to regulated prices and conditions of supply.

In progressively opening its electricity market to competition, the ACT has maintained parity with the New South Wales (NSW) and Victorian (VIC) timetables for contestability. However, while NSW and VIC opened their electricity markets to competition for all customers in January 2002, the ACT has delayed its market opening pending the consideration of advice about the costs and benefits of contestability for all customers in the significantly smaller ACT market. Concerns in the ACT Legislative Assembly that full retail contestability would not produce tangible net benefits to the community resulted in an inquiry into contestability that was incomplete when the Assembly rose for the election in October 2001. Early in its term the new Government sought advice from the Commission on the costs and benefits of a fully contestable market for electricity supply in the Territory. The Treasurer issued a reference for the Commission to inquire into and advise upon the benefits of full retail contestability on 18 December 2001, with a final report expected in April 2002.

The Commission produced an Issues Paper for the Inquiry in January 2002, inviting submissions on the matters raised and seeking comments on any other matters that are relevant. The Commission is required by the *Independent Competition and Regulatory Commission Act 1997* to issue a draft report to further stimulate and focus debate. The Draft Report is the first opportunity for the Commission to present its initial views on the inquiry and to have those views tested in the community.

## ***The requirements of the reference***

The reference (Attachment 6) directs the Commission to consider the costs and benefits of the implementation of full retail contestability. The Commission is to take into account the Territory's obligations under the National Competition Policy Agreements, and include options for the ACT to either proceed as soon as management and administrative systems allow or not proceed at this time.

The Commission is also directed to:

- identify and describe the electricity market participants using 100 Megawatt hours per annum (MWh pa) or less;
- identify and quantify the costs and benefits (financial and non-financial) flowing from the extension of full retail competition for electricity in the ACT to customers using 100 MWh pa or less, including the effects of possible changes in prices for different categories of customers, including those who are socially or economically disadvantaged;
- advise on the means and costs of avoiding or mitigating any adverse impacts on consumers, particularly those socially disadvantaged;
- advising on whether or not the ACT should adopt deemed profiling of customer usage and the desirability or otherwise of moving to full metering;
- assess studies and/or experience in other jurisdictions with the implementation of FRC for the different classes of small business and residential users; and
- any other related matters.

The Commission canvassed the views of stakeholders in its Issues Paper in January 2002. Public Notices were published in January to inform stakeholders of the reference and the notices, papers and submissions have been available on the Commission's website. The submissions received have been taken into account in the draft findings in this report. Further submissions on the draft findings are expected as a result of this report being released for consultation.

In addressing the terms of reference, the Commission has endeavoured to focus on the key issues, recognising that the ACT market is surrounded by the NSW market in which full retail contestability has been in place since 1 January 2002. Moreover, the ACT has obligations in its agreements with the Commonwealth, States and Territories that would require the ACT to extend contestability to all consumers in the absence of any substantial costs or other significant reasons for not making the market fully contestable. Thus, the Commission has taken the view that there would have to be significant costs and other disadvantages to the ACT economy for the Commission to recommend that full retail contestability should not apply in the ACT as it does in NSW and elsewhere. The Commission has outlined its findings on the balance of costs and benefits to the ACT in the text following.



## 2. Customer Profile

In the reference, the Commission was asked to identify and describe customers using less than 100 MWh of electricity per year (MWh pa) in the ACT. These are the customers that would become contestable at the introduction of FRC in the ACT.

### ***Who are the customers affected by FRC***

Table 2.1 below shows that out of a total of 136,600 electricity customers in the ACT, 135,000 customers consume less than 100MWh pa. They constitute 99% of ACT electricity customers, although they account for only 53% of electricity consumed in the ACT.

**Table 2.1: ACT Electricity customer profile**

Customer Class		Customer Numbers
>100MWh pa	Business	1,600
≤100MWh pa	Residential	123,500
	Business:	
	metered	11,000
	unmetered	500
		135,000
Total customers		136,600

(Source: ActewAGL Electricity Inquiry Full Retail Contestability, Submission to the ACT Independent Competition and Regulatory Commission, February 2002)

The table shows that the 1% of contestable customers over 100 MWh pa consume 47% of the electricity sold in the Territory<sup>1</sup>. Those consumers are invariably institutions or large businesses or government agencies (for example hospitals, high rise buildings and large government departments). All residential customers are non-contestable customers. Many small businesses are also included in the less than 100 MWh pa group of customers. Residential customers, however, are concentrated in the consumption level of less than 15 MWh pa. While there are some larger residential customers above the 15 MWh pa level, they are few by proportion.

Data on consumer numbers from ActewAGL confirms that the concentration of customers below 40 MWh pa is substantial. Only 2000 customers use between 40 MWh pa and 100 MWh pa of electricity per year. By making those customers contestable and continuing to regulate prices for those consumers using less than 40 MWh pa would only add an additional 5% of load to the contestable total. Under those circumstances 48% of the load would remain franchised<sup>2</sup>.

### ***Non-contestable customers and franchise customers***

Currently, consumers using less than 100 MWh pa are termed franchise customers. Franchise customers do not have a choice about which licensed retailer of electricity

<sup>1</sup> ActewAGL Electricity Inquiry Full Retail Contestability, Submission to the ACT Independent Competition and Regulatory Commission, February 2002, p.12.

<sup>2</sup> ditto p.13

will supply them. Franchise customers are connected to the franchise supplier in the ACT, ActewAGL Retail. The conditions under which they are supplied as franchise customers is spelled out in the terms of the standard customer contract that is provided for in the *Utilities Act 2000* and which is approved by the Commission. All franchise customers are deemed to be parties to a standard customer contract relating to each new connection. The standard customer contract lays out the rights and obligations of the customer and the supplier. The Utilities Act has a number of Codes that prescribe the rights and obligations of the parties, standards of service and customer protection.

Franchise customers also receive regulated prices for the supply of retail electricity and related services. The Commission determines franchise prices under the *Independent Competition and Regulatory Commission Act 1997*. Regulated prices provide customers with relatively efficient prices, but not necessarily the same prices that a competitive market might provide. Moreover a contestable market may provide opportunities for consumers to benefit from packaged product offerings that deliver benefits across a number of possible services not just electricity. Regulated pricing cannot emulate those market arrangements and does not provide incentives for such innovative marketing.

### ***Small customers receiving concessions***

Included in the large group of residential customers in the less than 15 MWh pa group are those residents receiving concessions from government. Concessions include subsidies paid to pensioners, social security recipients and other special cases. The concessions are reductions in prices for electricity consumed. The level of concessions provided to particular consumers is a matter for the Government not the Commission. The Commission neither determines who should receive benefits nor the amount that any concession beneficiary should receive. In providing its advice on the reference the Commission has assumed that the Government's concessions policy will continue unchanged. The Commission has not tried to anticipate what actions the Government may take in response to a decision to implement full retail contestability, although the Commission is aware that a review of concessions and related policy is currently being undertaken.

### 3. The Costs and Benefits of FRC in Electricity

The Commission has considered a range of quantifiable and non-quantifiable costs and benefits of FRC to determine whether there is a clear indication of a net benefit or cost from its introduction. If there is a clear significant net cost the ACT could decide not to proceed with FRC, having satisfied the tests provided in clause 5 of the Competition Principles Agreement for maintaining a restriction on competition.

In order to address the question of the relative costs and benefits of moving to FRC, the Commission has prepared a financial model of the likely cost to consumers of FRC (see Attachment 1). Based upon its analysis using this model, and drawing from other empirical information available to it, the Commission has satisfied itself that costs will increase as a result of implementing FRC and that in relative terms the cost will impact relatively more on smaller consumers, particularly those consuming less than 15 MWh pa. However, the cost involved is considered to be modest. The Commission's modelling has assumed a worst case scenario and has used comparative data from New South Wales and Victoria, where the costs are generally greater than in the ACT. From this modelling, the Commission has determined that the average cost of FRC to residential customers in the ACT would be about \$2 per month.

In assessing the cost and benefits of FRC, the Commission has taken into account both quantitative and non-quantitative costs and benefits. The modelling of quantitative costs has been based on a model which has sought to compare the cost of electricity paid by consumers under a scenario where FRC exists against a scenario where FRC does not exist. In order to do this, the Commission has assembled information to allow the build up of a final price based upon the summation of:

- efficient operating costs and margins;
- costs of purchasing energy; and
- regulated network tariffs.

Based on this approach, the Commission has concluded that the average effect of FRC on prices for residential customers would be an increase in the order of 3% to 5%. The Commission notes that this finding is broadly consistent with the findings of the KPMG Consulting Group report in November 2000, and independent advice provided in 2000 to ActewAGL. The KPMG report also confirms the Commission's view that because smaller customers have a smaller total bill, FRC will have a proportionally bigger impact on them than on larger users.

One of the key assumptions in the model is that most consumers will be using deemed load profiling rather than full metering (deemed load profiling is discussed further in the following chapter). If full metering were assumed to be the standard for a fully contestable market the costs for small customers would escalate considerably, reflecting the additional cost of new metering systems.

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<sup>3</sup> These factors are set out in of the ORG's Special Investigation Electricity Retailer's Proposed Price Increases, Final Report, December 2001;

<sup>4</sup> Special Investigation Electricity Retailer's Proposed Price Increases, Final Report, December 2001.

<sup>5</sup> refer page 71, Volume I Statement of Purpose and Reasons.

Quantifiable benefits are more difficult to measure. Clearly if costs are to increase for some consumers then this will be seen as a 'cost' to these consumers. But from its modelling the Commission has also been able to demonstrate that there will potentially be cost savings for some consumers. These will primarily be the larger consumers who can expect to be offered attractive lower prices by retailers.

Smaller consumers may also be offered cheaper prices than those currently offered by ActewAGL Retail, but as noted below, there is already a considerable favourable relative price situation in the ACT which has meant that all domestic household consumers are paying prices less than those on offer in other states. Thus, in terms of quantifiable benefits, the Commission considers that it is unlikely that prices will come down as a result of competition between retailers, at least in the short term.

In relation to non-quantifiable costs and benefits the Commission has considered costs in the areas of:

- credit risk;
- marketing costs;
- connection/disconnection policy impacts on costs; and
- costs arising from regulatory activity.

The Commission has not been able to quantify these costs, although they are considered to be small.

### ***Credit risk***

For example, credit risk has been identified as a problem experienced in the UK. Credit risk arises from the possibility that customers may accumulate large outstanding debts with one retailer before moving on to another, thereby maintaining access to electricity supply even though they have not met their bills. The problem of credit risk has not been specifically addressed in the ACT's utilities regulation but is recognised as a possibility in the Territory. At this time nothing prevents a customer transferring between retailers even though there may be outstanding debts to a former retailer. The debt is not extinguished by the transfer and aggrieved retailers have recourse to the normal debt recovery avenues to recovery any monies owed.

### ***Marketing costs***

Marketing costs could increase by some degree as a result of the move to FRC. The dollar value of this increase is unknown at this time and depends upon the level of competition in the market. Marketing costs are largely unnecessary for franchise customers although they do exist and to the extent that they are warranted, are currently allowed for in ActewAGL's network prices. In a competitive market however, these costs will be more important especially of retailers. In Victoria and New South Wales the regulators have reviewed marketing costs and concluded that these costs are negligible and, although increasing as competition becomes more general, will remain minor. Unlike other FRC costs that should have a finite life,

marketing costs will become a permanent cost of operating retail businesses, but will be in part driven out of the cost pass-through by competition between retailers.

### **Regulatory costs**

In regard to the regulatory costs, the Commission notes that over the past twelve months during which the *Utilities Act* has been in force, a number of the regulatory requirements that will give rise to regulatory cost have already been met. For example, the Commission has already agreed to Retailer of Last Resort arrangements (which have been tested with the market manager, NEMMCO), developed a Customer Transfer Code, and is reviewing conduct issues (including some codification of marketing conduct). Later in 2002, the *Utilities Act 2000* is due to be reviewed, at which time a number of issues (and associated costs) relating to retail contestability will be considered.

The Commission has also considered non-quantifiable benefits, generally observing that while the costs of FRC are immediate and specific, the benefits are delayed and diffuse.

On balance, the Commission's view is that the non-quantifiable costs and benefits are insubstantial and overall there is not a significant difference between these costs and benefits of FRC to consumers in the ACT. The Commission observes that the increased cost to small consumers of FRC is minor and is not expected to result in substantial increases in the number of people seeking relief through the ESCC. The increased cost to residential customers may also be mitigated by the way in which the costs of FRC are allocated. This issue is discussed in greater detail in the next chapter. Briefly, the modelling assumes that the costs of FRC will be treated as a fixed cost and allocated to customers equally. Thus, the costs will have a relatively larger impact on smaller customers than larger customers. However, if the costs were to be allocated on the basis of the volume of electricity consumed the impact on residential customers would be relatively smaller than the \$2 per month suggested by the model. The allocation methodology is important but may be limited by the extent to which competition for larger volume customers could be affected by the price increases at that end of the market. In a competitive market where there will be considerable interest shown by other retailers in the larger volume customers in the ACT, ActewAGL Retail cannot afford to cross subsidise smaller volume consumers by allocating a greater than equitable share of the FRC costs to the larger volume users.

The Commission also notes ActewAGL's advice that ACT residential consumers pay about 20 percent less for their total electricity bill than residential customers in the other states. In the long term these prices may need to rise reflecting increases in the market for electricity supply from the generators. Thus consumers in the ACT may need to pay more than they are currently paying in order to meet these higher generation costs. Such cost increases are not related to FRC but nevertheless would magnify the impact of FRC on all customers in the short term. They would have a relatively greater impact on the disadvantaged who are often more heavily dependent on electricity as their primary energy source. However, FRC impacts will gradually

reduce as transitional costs are recovered; only additional administrative costs (such as marketing costs) would have a long term impact on prices and even these costs are likely to be tempered by the impact of competition between retailers.

Timing for the introduction of full retail contestability in the ACT is important. The ACT finds itself surrounded by markets which have already moved to full contestability. Furthermore, the current ACT retailer, ActewAGL Retail, is actively involved in retail competition in these other markets. Thus, the Commission considers that the present opportunity to move to full retail contestability is one that should not be lost. The circumstances in which such a decision could be made in future may not recur or not recur in such favourable circumstances. At present FRC establishment costs are relatively minor and potentially can be spread in part across other markets outside the ACT in which ActewAGL is active, thereby lessening the burden on ACT customers. Certainly any new retailer entering the ACT market will have had to incur relevant FRC costs as part of their preparation for FRC elsewhere and will be less inclined to recover these costs in the ACT market as they seek to take customers from ActewAGL. Thus, the Commission has concluded that delaying a decision on moving to FRC is likely to be more difficult and more expensive for the ACT economy.

#### **4. Other cost/benefit issues raised in submissions to the Inquiry**

The analysis above confirms the views expressed in several of the submissions addressing the issues raised by the Commission's Issues Paper, particularly that of ActewAGL which argued that smaller customers would face increasing prices as a result of FRC. The submissions received from the ESCC and ACTCOSS also raised concern that the customers who would face the greatest cost increases from the introduction of a contestable market are those least able to manage the increasing cost burden.

While the model of costs and benefits is a valuable indicator of where the additional costs of FRC might fall most heavily, there are many other issues that have been raised that reflect on costs and benefits that need a response from the Commission in this Draft Report.

##### ***Can residential customers be protected from increasing prices by not extending FRC to all customers?***

The Commission is persuaded that there are pressures evident in the market that will result in increased prices whether there is a decision to make all customers contestable or not. Customers in the ACT have benefited over the past few years from prices that are about 20% lower than other jurisdictions<sup>6</sup>. Should the wholesale price for electricity rise and as ActewAGL renews its wholesale supply contracts, the retail price for electricity will rise. FRC will not impact upon this process and there is no reason to expect that the Commission, in setting a regulated price, would not allow those prices to pass through to consumers. While electricity generation costs will possibly increase, FRC may add slightly to the costs for residential customers over and above those underlying price increases. In the long term however, once adjustment costs have been recovered competition will tend to restrain the pace of price increases more directly and responsively than a regulated price is able to do. Competitive markets are able to respond quickly to change while regulators are less flexible being restricted to periodic reviews and price setting processes.

In future the Commission could not guarantee that in determining prices for a regulated market that it could maintain the relatively low prices that residential customers in particular have enjoyed. The Commission has little power to prevent legitimate price increases occurring upstream of the ACT from impacting on distribution and retail prices. Furthermore, the Commission is directed in its objectives in the *Independent Competition and Regulatory Commission Act 1997* to achieve efficient and competitive prices on behalf of consumers. In doing so the Commission would be unable to justify regulated retail prices that did not reflect costs in the long run. The issue for this inquiry is whether by advising the Government against the introduction of FRC there is a benefit to consumers. In general, the Commission is persuaded that in terms of short-term costs there is no benefit to small customers. However, the costs from which those customers may be protected in the

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<sup>6</sup> ActewAGL February 2002, p.17

short term will eventually occur. The probability is that the difference between the short run and the long run outcome will be in the speed at which the price increases will be experienced. If FRC is introduced there is likely to be a price impact for small residential customers, which could cause some level of economic difficulty for those who are disadvantaged. However, the Commission believes that the impact of this price increase can be lessened in certain circumstances.

### ***How can the impact of FRC be lessened?***

The reference requires the Commission to give attention to ways in which the impact of FRC can be lessened. The Commission has estimated that the price impacts will be relatively more significant for smaller consumers (in percentage terms), which is borne out by virtually all other studies undertaken. However, this impact can be lessened to some extent by using an allocation methodology that avoids simply allocating FRC costs on a fixed constant dollar rate per customer.

#### *Cost allocation by usage*

An allocation of FRC costs simply on the basis of a fixed cost allocation across all customers results in relative cost impacts for small users which translate into significant percentage price increases compared with their present electricity charges. It is important to note that not all relatively small users of electricity are necessarily from a poorer socio-economic group. For example, lifestyle changes have meant that many relatively affluent households now live in inner city apartments, have less areas for lighting and heating (or cooling) and eat out rather than cook at home. Thus, although these households may be smaller users of electricity, they are not necessarily disadvantaged themselves and so will not be unduly disadvantaged by the price increases of the order estimated in this report. It is important to note that the absolute dollar impact of FRC related price changes are of themselves not large. For example, the Commission has estimated that the cost impact for a household could be in the order of an extra \$2 per month.

Nevertheless, it is possible to reduce the impact of those cost flow throughs for smaller consumers. This may be achieved most readily by apportioning some of the cost flow through to consumers on the basis of actual consumption (rather than a fixed constant dollar amount per consumer).

The proportion that is allocated on the basis of consumption can be varied according to the FRC costs directly incurred by retailers, although there are limits to what proportion can be allocated in this way. For example, once contestability is introduced, new retailers are likely, initially, to seek out larger demand customers and target these customers with competitively priced offers (cherry picking). An allocation of retailer FRC costs on a consumption basis will obviously move the recovery of these costs more towards larger customers. However, if a competitive retailer has recovered these costs elsewhere, that would provide an opportunity to offer a price below that offered by the incumbent retailer. Thus, there is a limit to the extent to which this form of cost recovery can be achieved, at least in terms of the retailer's FRC costs.

For the distributor, or network operator, there is less of a competitive restraint on cost allocation using demand levels. Provided the regulator has agreed, theoretically at



least, the network operator could allocate all the relevant FRC costs on a demand basis, although in practice there is more likely to be a combination of a fixed component and a demand related component.

The disadvantage of the demand related approach to allocation of these costs is that it creates potential regulatory difficulties in ensuring that the distributor or retailer is not over-compensated for the costs incurred. This would occur if demand outcomes are higher than projections, the distributor or retailer could find that they are unable to recover all their costs.

#### *Consumer protection*

There are other ways to lessen the impact of FRC on consumers. The transitional issues that are likely to occur should be considered to ensure that as far as possible all precautions are taken to minimise transitional costs. The ACT Council on Social Services (ACTCOSS) referred in its submission to a number of these issues, including:

- where market contracts involve bundling of electricity with other goods and services the various obligations must be separable and apparent to consumers;
- if a retailer has a right to refuse to connect a consumer, written reasons must be given to the consumer for refusing to make a connection;
- there should be a cooling-off period for new contracts and a right for consumers to revert to a standard contract without substantial financial penalty;
- the maximum period and costs for which a consumer is bound in a contract should be set by regulation; and
- there must be specific regulation and oversight of supplier advertising of all kinds to ensure that there is full disclosure of offers in a form which enables offers to be properly compared, and the offers must be accessible to those with disabilities in literacy and numeracy.

The Commission supports the provision of adequate consumer protection regulation to underpin the operation of a competitive market. The Commission notes that there is existing provision to ensure that consumers' interests are protected. The *Utilities Act 2000* already provides for standard contracts and the Consumer Protection Code among other provisions aims at providing a reliable market that is responsive to the needs of consumers. In addition there is existing legislation relating to the sale of goods and trade practices. These should in the first instance be sufficient to ensure that contracts that offer a bundle of services explain the obligations in the contract. The Commission observes that in a contestable market it would retain powers to ensure that licence holders complied with their legislated obligations. Where those obligations are insufficiently spelled out the Commission has the option to develop specific guidelines or codes of practice that would make these requirements apparent to both supplier and consumer.

In relation to a guarantee of connection, maximum contract periods and costs, the Commission is sympathetic to the ACTCOSS view and notes that in a competitive market while no individual retailer can be required to connect a consumer there is a general intention that all consumers will be able to access supply. Where a consumer's credit history is such that they represent a high risk for a retailer that retailer may decline to enter a contract with that person. Alternatively the contract may reflect the consumer's credit history by requiring a security deposit or charging a

premium to reflect the risk. In lieu of all other alternatives, a consumer may have recourse to the local retailer.

### *Capping prices*

The Commission is aware of suggestions that prices for small customers should be capped to provide a measure of protection for consumers. While sympathetic with the desire to protect certain groups of consumers, the Commission is opposed to the proposition that price caps should be applied to prevent prices for small consumers rising above a certain level.

The Commission believes that such intervention is likely to have severe effects upon the market. Without necessarily repeating the Californian experience, where the electricity market virtually collapsed, the market would potentially not have any reliable signals about the operation of the market. The Commission observes that the imposition of price caps in California resulted in unsustainably low prices that benefited customers in the short term but produced substantial long-term unavoidable cost implications.

The potential costs of a price capping arrangement are such that the Commission would not advise reliance on those measures. The Commission notes that in Victoria and NSW the Government has put price control measures in place that will moderate price movements. As measures they are less likely to produce the dire consequences seen in California but can be expected to impose regulatory costs and risks, additional administrative costs and higher levels of regulatory and political intrusion in the market. Intrusion almost inevitably means that risks are increased and the cost of those risks is transferred from industry to regulators and governments at consumers' expense.

The Commission concurs with ActewAGL's submission on this issue, that the imposition of strict price capping or control arrangements is undesirable and costly for consumers. However, the Commission is sympathetic to the view that some form of FRC cost allocation based on usage might be applied, thereby reducing some of the cost impacts on smaller customers discussed previously.

### ***Impact of FRC on the Territory budget***

ActewAGL raised the prospect of FRC reducing the benefit provided to the ACT Government by reducing the annual dividend paid by ActewAGL to its shareholders. The risk identified arises from an anticipated loss in market share as other competing suppliers enter the market and take customers from the incumbent retailer.

There is a risk that ActewAGL will lose market share and the dividend to the Government will be reduced as a result of the introduction of FRC. The Commission has not taken that so-called cost into account because while it is a cost to Government it may entail a corresponding benefit to consumers, providing that the revenue transferred is shared between the alternate supplier and the consumer. To the extent that a competitive market would entail those risks and the Government is aware of them, they should be excluded from consideration. ActewAGL's dominant market position gives them a considerable competitive advantage that should be an adequate protection against either loss of market share or cherry picking of desirable customers.

ActewAGL has been restructured to make it more competitive and efficient over the past ten years and is in a strong position to defend its market share. The Commission agrees with previous statements from ActewAGL to the effect that the smaller end of the consumer spectrum is less desirable to new market entrants than larger customers who are already contestable. Moreover ActewAGL has a presence in other markets outside the ACT, where it is competitive and gaining market share. That also persuades the Commission that while there is a risk of losses of dividend revenue, the risk is low. The relationship between market share and the dividend stream remains one of performance management which is outside the purview of the Inquiry.

### ***Will there be confusion because of customer churn?***

Customer churn, or the degree to which customers switch between one retailer and another, has the potential for disrupting the market and causing costs to retailers and consumers, as retailers seek to minimise that risk. Having considered the evidence available from Victoria and NSW for the first months of FRC in those States, and the experience of the UK market deregulated since 1999, the Commission does not expect that there will be a high risk from churn. In Victoria and NSW the rates of churn were less than 1%. The low level of churn has meant that there is no pressure on prices to mitigate that risk. In the UK, with churn over the first two years of FRC at 38%, there is little evidence that churn is a substantial source of cost or a significant inhibitor to the development of a competitive market that benefits consumers in the long run.

That there is no instability evident in Victoria or NSW from churn itself does not mean that churn has no costs associated with it. The provision of IT systems and administrative processes between and within utility businesses have costs that may legitimately be recovered from consumers. To a large degree those costs have already begun to pass through to consumers as regulators have received applications to redress network and franchise prices for 2002-03. The Commission sees no reason to anticipate a greater risk of churn in a contestable market in the ACT than has been experienced in NSW or Victoria. The more problematic issue for the ACT in relation to the allocation of any FRC costs, whether from churn or any other cause, is the population over which the costs will be spread. In the ACT costs will be larger in effect because there is a relatively small population, compared to NSW for example.

Another reason for the high rate of churn in the UK market is the number of customers transferring between retailers to avoid payment of debts. In the ACT a customer may still transfer despite having an outstanding debt with a retailer. However, a transfer in itself would not extinguish debt and the retailer may still pursue the debt through the normal channels.

### ***Deemed profiling vs full metering***

The reference requested advice on whether the ACT should introduce FRC with full metering or deemed load profiling. In responding to this point the Commission draws attention to the assumptions and its comments made in the section of the report dealing with the modelling of the costs and benefits of FRC. The Commission has assumed, on the basis of all the arguments put to it in submissions and the experience of Victoria and NSW, that profiling is the only feasible option for FRC at this time.

Customers using less than 100MWh pa of electricity are not required to have interval meters, while the contestable customers using more than 1000 MWh pa do need interval meters. Interval meters allow the collection of consumption data for each connection point. The connection point is where the meter is located to measure electricity that passes from the distribution network to a customer's premises. That amount of electricity is the load being consumed by that consumer and the amount of electricity for which the customer is billed. Interval meters read the amount of electricity used in a 30-minute period and then transmit that information to the distributor for billing. The information from all connection points is aggregated to provide an accurate time weighted estimate of the load, which the distributor needs to bid for in the national electricity market to maintain supply. Interval metering requires not only a meter but also communications equipment to transmit the data to the distributor. Profiling allows the older technology meters that do not read and communicate data for short periods to be retained for metering. Older meters accumulate data over a period, meter readings may occur monthly or quarterly in a regular cycle. Data collection is usually carried out manually. With profiling the distributor develops a usage profile for classes of consumers to forecast what load is required at any time of the day, which is bought by bidding for load in the national market. Billing is based on the actual meter reading at each metering point.

Deemed profiling is a solution that is suited to smaller customers with regular patterns of consumption. It is also a simple, inexpensive and reliable process. Although full metering is more accurate, the additional cost of the interval meter and the associated communications equipment outweighs any reduced efficiency in small customers' metering. Despite having been available and having been installed in premises of contestable consumers, the cost of interval meters remains very high. Estimates of the current cost of interval meters range between \$700 and \$1000 per meter, plus the communications equipment cost. Until the cost of interval meters falls substantially the Commission would not advocate their mandatory deployment. Deemed profiling on the other hand is generally supported by both utilities and regulators as a manageable and inexpensive way of metering that does not disadvantage consumers or suppliers and requires no significant additional cost. With few exceptions, franchise customers in the ACT currently connected to the network have accumulation meters and, therefore, can be profiled.

The Commission expects that eventually technology will be available to have a full metering solution that is able to continuously record and transmit data to the network operator. However, achieving that fully metered goal may require a phasing in of the new technology to lower costs to the network operator and customers, and to deal with the scale of the meter deployment task. The questions, when might full metering be introduced and how would its introduction be managed, are not ones for this review but may be the subject of a future advice from the Commission to Government.

### ***Transitional issues need attention***

#### *Is timing an issue?*

ActewAGL has sought the Commission's consideration of timing of FRC in its advice to the Government. The systems for ensuring transfers, settlements and billing for consumers will take some time to complete. The Commission is aware that progress has been made on many aspects of those systems but that some more time may be needed to ensure that the systems are fully operational to support the operation of a competitive market. The Commission has some sympathy with retailers and the network businesses not investing in preparation for FRC if it is not to happen. In its final advice to Government the Commission will raise this issue. At this stage the Commission understands that the systems could be operational by October 2002.

#### *Public information will assist implementation*

In considering how FRC might be introduced most effectively the Commission has given attention to the role of the public information processes in both Victoria and New South Wales. In both those states Government provided substantial financial resources to ensuring that all consumers were informed about the opening and operation of the contestable market, including the responsibilities and obligations of both suppliers and consumers.

Reducing the risk and cost of poor choices among the product offerings that are likely to be available is a significant way of ensuring the most effective implementation. The Commission is not suggesting that the Government provide financial resources for the public information process at an equivalent level to Victoria or New South Wales, but sufficient resources to ensure that all consumer households are contacted and that information is provided in or through a range of media. Also, the Commission considers that informing the public should not be left solely to retailers competing in the market.



## 5. Recent Experience in Other Jurisdictions

The Commission has considered the progress of FRC in Victoria and NSW since January 2002 and the experience of the United Kingdom and California. Several conditions are important to note in relation to these comparisons. Firstly, in Victoria and NSW the experience has only been over six months, which is an insufficient time for long term trends to emerge. Secondly, the UK and Californian examples may also have limited application, California has experience with FRC but the regulatory arrangements in California are such that the lessons that might be drawn from it about FRC are distorted by other policy matters and it is unclear what the benefits of contestability have actually been.

While there seems to be no definitive example of FRC in other jurisdictions that would serve as a basis for predicting the outcome in the ACT, there are observations to be made from those jurisdictions. The Commission in particular notes that:

- in the UK, NSW and Victoria there were initially very low rates of transfers (churn) from the local retailer (the former franchise supplier) to other retailers in the market. This means that the market remained stable and predictable which depresses the likelihood of retail prices rising steeply to address increasing levels of uncertainty and risk;
- prices changed to a marginal extent and disadvantaged smaller rather than larger customers, although the price adjustments were considered efficient in that they reflected market costs allocations and risks more closely than the previously regulated market was able to do;
- other issues not associated with FRC were occurring at the same time that masked the FRC effect, but the general view is that FRC had an insignificant effect on the market as a whole; and
- benefits relating to choice and variety of product offerings made quality differences to the consumer that were unavailable in the previously regulated regimes.

The Commission's inter-jurisdictional comparisons are discussed at greater length in the Attachments at the rear of the Draft Report. However, the general conclusion the Commission draws from those examples is that FRC has not been significantly costly wherever it has been introduced. It has not contributed to instability in the market nor introduced substantial uncertainty. On the contrary FRC has been introduced in an orderly way with little immediate impact on consumers or industry. The contestable markets are not yet mature in NSW and Victoria but there is little sign that prices are increasing to the extent that a number of new entities are seeking market entry. There is therefore no substantial concern that as the market matures it will become more volatile as retailers exit the market. High levels of market entry and exit as the market matures is a healthy sign of competition finding an appropriate balance between supply and demand, but is costly to consumers in terms of reliability, continuity/security and cost of supply. Neither is there evidence of substantial erosion of consumers' ability to meet the additional costs of FRC where they occur.

The attachments to this report outline the experiences in Victoria, NSW, UK and California at greater length. Table 5.1 summarises some of the main points.

**Table 5.1: Overview of FRC experience in Victoria, New South Wales, UK and California**

	Victoria	NSW	UK	California
FRC effective	13 January 2002	1 January 2002	May 1999	1998
Metering requirements (>100MWh pa)	Interval meters and associated communications equipment	Interval meters and associated communications equipment	Interval meters and associated communications equipment	N/A
Metering requirements (<100MWh pa)	As above or accumulation meters and profiling	As above accumulation meters and profiling	Accumulation meters and profiling	
Cost of interval meters	\$700-\$1000	\$700-\$1000	Est \$A615 plus \$A920 pa	
Price impact	+4% regulated rise held for 12 months	No change in franchise prices, subject to a regulated price arrangement	- 2% over two years	Capped prices delivering price reductions not reflecting market costs
Switching rates (churn)	<0.2% in first three months	<0.2% in first three months	38%	Nil change, no market incentives
Net benefits to <160 MWh pa customers	Net cost to small customers. Large customers price benefit	Little change for customers	Net benefits to customers	Market failed.



## **6. The obligations in the National Competition Policy Agreements**

### ***The National Competition Policy Agreements***

There are three agreements that form the NCP, the Conduct Code Agreement, the Competition Principles Agreement and the Agreement to Implement the National Competition Policy and Related Reforms. The Conduct Code Agreement and the Competition Principles Agreement do not have a direct bearing on the achievement of free and open markets in energy. Those pre-existing COAG reform commitments were built into the third Agreement on the Implementation of the Competition and Related COAG reforms<sup>7</sup>. The implementation Agreement combined the previous COAG reform agendas for electricity, gas, water and road transport industries with the conditions for financial transfers from the Commonwealth to the States and the Territories and the reform timetable.

The inclusion of the COAG reforms in the Implementation Agreement was a convenient means of getting progress on difficult reforms by providing financial incentives as part of the NCP package. The combination also gave COAG an instrument for independently ensuring satisfactory progress with the achievement of the commitments and in a reasonable time. The National Competition Council (NCC), established to oversight the implementation of the National Competition Policy also assumed responsibility for ensuring that the parties to the agreements continued to deliver satisfactory progress on the whole reform package. Broadly the parties agreed that there should be a competitive national electricity market. The agreements included obligations to establish a national market with appropriate regulatory infrastructure. The regulatory framework included a new national electricity law, law developed in South Australia and then mirror legislation adopted in other jurisdictions, with a subsidiary regulatory code, the National Electricity Code. The COAG obligations included establishing the National Electricity Market Code Authority (NECA) to regulate the Code as it related to generation and reticulation of electricity throughout the market network. NECA assesses changes to the Code and provides overall coordination of the regulatory framework. The management of the market was to be undertaken by the National Electricity Market Management Company (NEMMCO). The Code provided roles for the local regulators, particularly in establishing prices for regulated distribution and retail activities.

The National Market was formally established in 1997 with the opening of the interim National Electricity Market (NEM1). The original market was made up of New South Wales, Victoria and the ACT. Queensland and South Australia entered the market as full participants with the opening of the NEM proper in December 1998.

### ***Has the ACT met its obligations in the NCP Agreements?***

To date the annual assessments of performance against the obligations in the NCP Agreements carried out by the NCC have indicated that the ACT has maintained satisfactory progress on all its reform obligations including those in relation to electricity. The ACT is a foundation member of the NEM and has maintained a contestability timetable that is comparable to both New South Wales and Victoria, except for the last tranche of small customers. NSW and VIC made the last tranche of customers contestable from 1 January 2002; the ACT has not made that final step pending consideration of the advice provided in the Commission's final report.

The Agreements make provision for the maintenance of restrictions on competition where there is a net public benefit from doing so. The ACT has made the decision on FRC dependent upon the outcome of this assessment of the costs and benefits of FRC for the less than 100 MWh pa customers. The community is understandably concerned that any decision about FRC for this group of customers be subject to a specific assessment because all residential customers, including the elderly, pensioners and the economically disadvantaged lie in this group. Small businesses generally also fall in this group; small businesses may be as economically vulnerable as small residential customers in a contestable market.

### ***Would a decision not to open the market to further competition result in loss of competition payments?***

The competition policy payments made by the Commonwealth to the States and Territories represent a share of the national economic benefits derived from implementing the microeconomic reforms recommended by the Hilmer Committee and the COAG related reforms. Provided that all the parties implemented and sustained those reforms they would be entitled to the share of the additional revenue collected by the Commonwealth. The additional revenue available to be shared as direct competition payments was estimated, at the time the agreements were signed in 1995, to be approximately \$12 billion in 1996 dollars.

Failure to implement reform would obviously damage the process and its capacity to deliver the economic benefits to be shared by the participants. Similarly any restrictions on competitiveness of the national economy that were introduced after reform had occurred would reduce the continued flow of the assessed economic benefits. Only where there was a greater benefit than cost to maintaining a restriction would an exception be made to the view that competition produced better outcomes than restricted markets.

If the ACT did not introduce FRC, would that mean a reduction in the competition policy payments from the Commonwealth? The Commission is not in a position to foreshadow what the NCC might recommend to the Commonwealth Treasurer about any reduction of competition payments. However, it is certain that:

- the ACT has met its obligations to date in full;
- there is no net benefit to introducing FRC for customers less than 100 MWh pa;
- that the balance of the reform program is being, and has been implemented; and
- there is an ongoing commitment to the reform process and maintaining the reforms already delivered.

It is also noteworthy that Queensland has determined not to extend contestability any further than to the largest customers at present, based upon an assessment of the costs and benefits in that State. There does not appear to have been a significant reduction to the competition payments to Queensland. Previously the NCC has recommended reductions in payments to NSW (domestic grain marketing arrangements) and to Queensland (water). Those reductions were partial reductions not withholding of the full amount of the annual available payment. Given that the anti-competitive behaviour of those two States was of a significantly more serious nature than possibly not extending FRC to small customers in the ACT, a less onerous reduction will be expected.

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## **Attachment 1:**

### **Cost and Benefit Analysis**

#### ***What are the costs and benefits of FRC***

In arriving at its final advice to the Minister the Commission will consider a range of issues, some of which were raised in the Issues Paper and other matters raised in submissions to the inquiry. A central consideration for the Commission is to determine whether there is a net benefit that can be delivered by introducing FRC to consumers using less than 100 MWh pa. This was a principle term of the reference and is an essential ingredient in providing comprehensive advice for the Government to make its decision about FRC upon.

Examining the net benefits of FRC that have been achieved by those customers already contestable is not a reliable indicator of the potential costs or benefits to those smaller users who remain outside the competitive market. The nature and market competence of large contestable customers are very different to those of smaller users.

The Commission has found that in the absence of actual information to measure the effects of competition on small customers, it will need to rely on some modelling of expected outcomes. In developing its model the Commission draws attention to a characteristic of many such analyses: that while the costs are short term, evident and quantifiable, the benefits are long term, diffuse and difficult to quantify. The report also assesses whether non-quantifiable costs and benefits of FRC are likely to either counteract or magnify the quantifiable net benefits established by the evaluation in relation to the likely price changes at FRC.

#### ***Quantitative costs and benefits***

The Commission has calculated the quantifiable costs of supplying electricity in the competitive electricity market from the following core components:

- efficient operating costs and margins of electricity retail;
- the costs of purchasing energy; and
- regulated network tariffs.

The calculation of the cost of each of these core components is discussed below.

##### ***(i) Efficient operating costs and margins of electricity retail***

The following estimates of the operating costs of efficient electricity retail functions have been provided in recent regulatory decisions:

- \$40 to \$60 per customer – the estimated cost used by the Independent Pricing and Regulatory Tribunal, NSW (IPART) in its Final Report into Regulated Retail Prices for Electricity to 2004, of December 2000; and
- \$50 to \$80 per customer – the estimated cost used by the Office of the Regulator-General, Victoria (the ORG) in its Special Investigation Electricity Retailer's Proposed Price Increases, Final Report, December 2001.

The Commission has used the upper limit of the ORG's cost estimate (i.e. \$80 per customer) as the benchmark for retail operating costs per customer. The cost range used by the ORG estimates the costs to retailers of providing for customer transfers and for operating a system of deemed load profiles are between \$5 and \$10 per customer.

The publicly available information on retail margins in contestable electricity retail markets seems to indicate that reasonable profit margins on retail sales range between 1.4% and 5%. This range of margins is contained in the following key regulatory decisions:

- 1.4%, as determined by the Commission for ActewAGL in May 1999;
- 1.5% to 2.5%, as determined by IPART in its Final Report into Regulated Retail Prices for Electricity to 2004, December 2000; and
- 2.5% to 5%, as determined by the ORG in its Special Investigation Electricity Retailer's Proposed Price Increases, Final Report, December 2001.

For the purposes of modelling a likely outcome, the Commission has adopted 3% on sales (i.e. approximately \$30 per customer) as the benchmark value for the retail margin for the purposes of this Draft Report. The Commission does not have sufficient information at this stage to conclude whether this mid-point benchmark is more representative of ActewAGL's actual retail margin than the amount previously determined in May 1999.

*(ii) Costs of Purchasing Energy*

The Commission has based the costs of purchasing energy on the following elements:

- peak and off-peak costs of purchasing energy based on average NSW market prices for the respective peak and off-peak periods over the previous 12 months;
- ACT network losses;
- NEMMCO fees and ancillary service payments;
- allowances for renewable energy and other risk factors<sup>14</sup>; and
- hedge mismatch risks.

Hedge mismatch risks may arise where ActewAGL agrees forward contracts for purchasing electricity for its ACT customer base, without knowing the size and composition of its future customer base due to the potential uncertain effects of FRC. In this case, ActewAGL may incur increased costs in purchasing electricity as its long-term forward contracts may not match the actual demand of its customer base. In that case, ActewAGL would need to purchase electricity on the spot market or via shorter-term contracts in order to ensure that electricity supply to its customers matches demand.

As a measure of the hedge mismatch costs, it is proposed to utilise the allowance calculated by the ORG for application in the Victorian market, in the form of a 4% hedge mismatch risk allowance applied to the cost of energy.<sup>15</sup> In the absence of ACT-specific information in relation to this issue, the percentage allowance proposed

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<sup>14</sup> These factors are set out in page 20 of the ORG Special Investigation. Electricity Retailer's Proposed Price Increases, Final Report, December 2001.

<sup>15</sup> page 19. ORG Special Investigation. Electricity Retailer's Proposed Price Increases, Final Report, December 2001.

by the ORG is considered to be an appropriate surrogate for any actual hedge mismatch risk in the ACT.

*(iii) Regulated network tariffs*

The Commission considers that ActewAGL's electricity network tariffs, which are approved by the Commission in accordance with the principles and procedures in the National Electricity Code, represent an appropriate efficient cost of network use of system services.

The Commission has also included an allowance for FRC distribution costs. This allowance has been based on distribution cost calculations made by the ORG in its Electricity Price Determination 2001-05<sup>16</sup> and has been calculated by the Commission on the following basis:

- once-only capital costs as determined by the ORG have been converted into an annual capital charge using a pre-tax nominal rate of return of 10% and a recovery period of 5 years; and
- the annual capital charge, plus the annual operating costs determined by the ORG, have been converted into a cost per customer by dividing the (Victorian) total annual cost amount by the number of Victorian customers.

It should be noted that the values of the factors used by the Commission to convert the once-only capital costs into annual charges (i.e. the 10% rate of return and 5 year recovery period) represent benchmark values only for the purposes of the Commission's analysis in this report and should not be taken as definitive values to be applied to determine costs in the future.

All of the FRC costs determined by the Commission assume that the FRC model adopted is based on standard metering and deemed load profiling. In addition, the following cost allocation principles have been applied:

- FRC costs are assumed to be recovered from all contestable customers as a uniform charge, even though not all customers will switch retailers and thus cause the FRC costs to be incurred; and
- general retail operating costs and margins are similarly assumed to be recovered from all customers as a uniform charge.

The allocation of FRC and retail costs on a per customer basis will have different implications for customers according to their levels of usage. For customers with low value bills, these fixed costs would form a higher percentage of their bills than for customers with high value bills. The effect of allocating these amounts on a fixed basis to customers at different levels of usage is shown in Table A1.1 below. This approach to allocating fixed costs to customers is an important factor behind the effect of FRC established in the following section of this report, to the effect that residential and low usage customers are likely to experience price increases at FRC, relative to the potential price changes likely to be experienced by business and high usage customers.

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<sup>16</sup> page 71, Volume I Statement of Purpose and Reasons. ORG Electricity Distribution Price Determination 2001-05.

**Table A1.1: FRC Cost Components**

Customer Class	Residential Customer		Business Customer		
	KWh pa	7,500	20,000		
<b>Costs, ex GST</b>		<b>\$ pa</b>	<b>% of Total Cost</b>	<b>\$ pa</b>	<b>% of Total Cost</b>
Retail operating costs <i>including retail FRC costs</i>		80	9%	80	3%
Retail margin		30	3%	30	1%
Energy <i>including NEM fee, ancillary services etc</i>		300	34%	800	32%
Network losses		17	2%	44	2%
Network use of system cost		345	40%	1,333	53%
Distribution FRC costs		20	2%	20	1%
<b>GST</b>		79	9%	231	9%
<b>Total Cost, inc GST</b>		871	100%	2,538	100%

The usage levels in Table A1.1 are the approximate average usage levels for respective residential customers and business customers consuming less than 100MWh pa.

It is emphasised that the cost amounts shown in Table A1.1 are broad estimates only based on the assumptions above.

#### *Retail price effects*

This section sets out the Commission's evaluation of the likely price changes at FRC for customers moving off the franchise retail tariffs to contestable market tariffs. The likely contestable market tariffs are based on the benchmark costs of supplying electricity in the competitive electricity market as established in the previous section.

Where prices in the contestable market are likely to be greater than the current franchise retail tariffs, there is assumed to be a net cost. Conversely, where prices are likely to reduce at FRC, there is a net benefit.

The tables below show the estimated effect of FRC on retail prices for particular retail tariff classes, in the case of customers consuming electricity at the following usage levels:

- a low usage customer consuming 3,000KWh pa;
- a customer consuming the average amount for a residential customer, of 7,500KWh pa; and
- a customer consuming the average amount for a business customer, of 20,000KWh pa.

**Table A1.2: Impact of FRC: Peak Usage Customers**

KWh pa	3,000	7,500	20,000
% off-peak	0%	0%	0%



Franchise Retail Tariff Class	% Change in Price at FRC		
Home Plan	11.4%	3.4%	-1.2%
Home Saver Plan	10.1%	4.0%	-0.4%
Home Saver Plus Plan	11.0%	6.2%	1.1%
Business Plan	-1.1%	-6.4%	-9.4%
Community Services Discount <sup>1</sup>	-1.3%	-6.9%	-10.0%

1. Relates to customers currently taking supply on an obsolete retail tariff.

Table A1.2 above shows the likely impact of FRC on customers that consume electricity only in the peak period. It shows that for these customers, residential and low usage customers would be likely to experience price increases relative to business and high usage customers.

The Commission notes that business customers could generally be expected to experience savings given that they currently pay more than residential customers for similar levels of peak usage under the franchise retail tariffs. For example, the Business Plan (Block 1) usage rate is 13.09c/KWh (inc. GST) whereas the Home Plan rate is 9.46/KWh (inc. GST). This price differential is greater than the difference in the costs of supplying the respective customer classes. It means that when business customers move off the Business Plan franchise retail tariff to contestable market tariffs (which reflect the costs of supply), they are likely to experience price reductions.

The difference in the impact of FRC across different usage levels largely reflects the manner in which fixed costs are allocated to customers. This is because FRC costs and retail costs generally, in dollar terms, are generally the same for different customer classes and customers at different usage levels. As discussed in the previous section, such fixed costs will therefore constitute a different proportion of a customer's bill, depending on the size of the bill. For example:

- for a low usage residential customer consuming 3,000KWh pa, fixed FRC costs and retail costs would account for about 30% of their bill (of approximately \$460 pa including GST); whereas
- for a high usage residential customer consuming 20,000KWh pa, fixed FRC costs and retail costs would account for about 6% of their bill (of approximately \$2,000 pa including GST).

Where such fixed costs per customer are passed through to customers in the competitive market, this will tend to limit the ability of low usage customers to realise savings at FRC, relative to high usage customers.

Although the effect of allocating FRC costs and retail costs on a fixed per customer basis has a material effect on the Commission's estimates of the likely price changes at FRC, this broadly reflects the way in which these costs are incurred and, in an efficient competitive retail electricity market, retailers could be expected to allocate these costs to customers on the same basis.

Table A1.3 below shows the estimated percentage price changes at FRC across different usage levels and assuming 50% off-peak usage.

**Table A1.3: Impact of FRC: Customers with 50% Off-Peak**

KWh pa	3,000	7,500	20,000
% off-peak	50%	50%	50%
Franchise Retail Tariff Class	% Change in Price at FRC		
Home Plan	7.2%	-1.8%	-6.9%
Home Plan + Off-Peak Saver Plan	11.0%	1.2%	-4.8%
Home Plan + Off-Peak 1 / 21	14.1%	4.8%	-0.8%
Home Saver Plan	6.2%	-1.5%	-7.1%
Home Saver Plus Plan	8.0%	0.9%	-6.6%
Business Plan	-4.1%	-10.1%	-13.6%
Business Plan + Off-Peak Saver Plan	0.5%	-6.1%	-10.2%
Business Plan + Off-Peak 1 / 21	2.6%	-3.4%	-7.2%
Community Services Discount <sup>1</sup>	-4.4%	-10.7%	-14.3%

1. Relates to customers currently taking supply on an obsolete retail tariff.

As in the case of Table A1.2, which shows the effects of FRC on peak use customers only, Table A1.3 above shows that residential and low usage customers would be likely to experience price increases relative to business and high usage customers. The same effects in Table A1.2, in terms of the fixed cost allocation causing price increases to low usage customers relative to high usage customers, are also shown in Table A1.3.

It should be noted that in assessing the effects of off-peak usage, the Commission has assumed that some customers have both a general usage meter (e.g. to measure usage under the Home Plan retail tariff) and an off-peak meter (e.g. to measure usage under the Off-Peak Saver Plan retail tariff). Further, the Commission has also assumed that even customers which only have a general usage meter are able to benefit from off-peak pricing in the competitive market, as the application of the deemed load profile will enable their peak usage and off-peak usage to be determined. This, in turn, would enable those customers to be charged separately for their peak and off-peak energy consumption at rates reflecting wholesale market costs in relation to the respective peak and off-peak periods.

Overall, a customer's mix of peak and off-peak usage was not found to have an appreciable effect on the estimated pricing outcomes at FRC.

*Concluding comment on assessment of quantifiable costs and benefits*

On the basis of its analysis, the Commission estimates that the average effect of FRC on prices for residential customers is an increase in the order of a 3% to 5%. This outcome broadly reflects the findings of the KPMG Consulting report prepared for the Department of Urban Services in November 2000, KPMG found that residential customers would be worse off under FRC than under a regulated franchise. The KPMG report also confirms the Commission's own estimates that residential customers that consume less than 7,500KWh pa are likely to experience greater increases than larger volume consumers. This increase in prices translates into an increase in the charges estimated to be paid by residential customers, of approximately \$3 million per annum, compared to charges under the franchise retail tariffs.

In the case of business customers, FRC is estimated to result in an average price reduction of around 10%. This equates to a reduction in the charges estimated to be

paid by those customers of approximately \$3 million per annum. The Commission notes other references to the cross subsidy that remains between large business consumers and small residential customers. In a competitive market prices will become more cost reflective and cross subsidies will tend to be removed. The price benefits currently enjoyed by residential consumers would cease. While FRC makes this issue transparent, the removal of cross subsidies to residential consumers could not be confined to FRC alone. To some degree the Commission in setting prices has sought some level of social equity in providing for a cross subsidy from large business consumers to residential consumers, which a competitive market may not allow. In future price determinations, if FRC were not introduced, the Commission may gradually remove such cross subsidies.

These results are sensitive to the assumptions that the Commission has made in relation to how FRC costs, and retail costs generally, are allocated and passed-through to customers in the contestable environment. In addition, the results are highly sensitive to the actual cost levels that have been used. In particular, results will differ where actual costs differ from the assumptions and benchmarks used in relation to peak and off-peak wholesale energy costs, retail costs and margins and FRC costs.

Further, the outcomes would be significantly different if deemed load profiling is not adopted. In that case, given the significantly higher cost of full metering (the alternative form of metering under FRC), the quantifiable costs of FRC would be likely to significantly exceed the benefits for the less than 100MWh pa market.

On the basis of the above assessment of quantifiable costs and benefits, it is not possible to say with certainty that overall, customers that consume less than 100MWh pa are likely to experience a net benefit from FRC. There is however likely to be a quantifiable net benefit to business and high usage customers, relative to residential and low usage customers.

### ***Non-quantitative costs and benefits***

#### ***Costs***

In this section the Commission assesses whether non-quantifiable factors (largely in the form of non-quantifiable benefits) are likely to affect the conclusion arrived at in relation to the balance between the quantifiable costs and benefits.

Below is the Commission's assessment of a range of costs that are commonly associated with FRC, but which are generally not quantifiable based on the information that the Commission has available.

### *Credit risk*

The current practice to address defaulting customers is to disconnect supply. Under FRC a defaulting customer may transfer to another retailer, leaving its initial retailer without a cost-effective means of enforcing the debt. This is an FRC related cost that would not occur if FRC were not introduced. However, it is not possible to quantify the credit risk costs at this stage.<sup>17</sup>

### *Marketing costs*

There may be additional marketing costs as a result of FRC. For example, the costs in signing existing ActewAGL customers to bilateral contracts, where such customers were previously supplied under unilaterally applied tariffs, terms and conditions. While such costs are not quantifiable at this stage, the Commission notes that it was the view of the ORG that costs of this nature would be minor and that not all of such costs would pass through in a competitive market.<sup>18</sup>

### *Connection/Disconnection policy*

In its submission, ActewAGL advice that its current policy is to leave a premises connected to the network for two weeks after it has been vacated. Under this policy, a reconnection effected within two weeks of the previous tenant vacating the premises would not require a service visit. At FRC, the retailer would sever its responsibility for the site so that reconnection would, in all cases, involve a service visit.

In that it is not a feature of ActewAGL's current policy, the additional cost of service visits for premises reconnected within two weeks could be characterised as a cost of FRC. However, because ActewAGL's policy is discretionary (ie the parameters of the policy are not determined by the regulatory framework applying to ActewAGL), any allowance for increased costs from FRC should not compensate ActewAGL for FRC effects relative to its current, discretionary policy.

### *Regulatory costs*

The regulatory framework in the ACT is likely to require a range of amendments in conjunction with the introduction of FRC. Amendments may be required in relation to the following key areas:

- amendment to Retailer of Last Resort arrangements;
- development of a Customer Transfer Code;
- additional conduct code requirements (eg establishment of a marketing code of conduct); and
- revisions to legislation (e.g. to the Utilities Act 2000, which predominantly reflects franchise customer arrangements).

While a number of the above areas of work may be considered to be FRC-related (particularly amendment to the Retailer of Last Resort arrangements and the requirement for a Customer Transfer Code) determining the costs of developing the regulatory framework and separating those costs into general framework development

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<sup>17</sup> It is noted that the retail cost estimate developed by the ORG provides an allowance for this risk. Refer page 30. ORG Special Investigation. Electricity Retailer's Proposed Price Increases, Final Report, December 2001.

<sup>18</sup> pages 27 and 30. ORG Special Investigation. Electricity Retailer's Proposed Price Increases, Final Report, December 2001.

costs and FRC costs is not a straightforward. Those costs are likely to represent a small amount and are currently included in the cost of regulation met from utility licence fees.

On the basis of the above, a range of costs commonly associated with FRC which are not quantifiable based on existing information are either considered not to be FRC-related or are unlikely to have a material effect that would alter the conclusion arrived at above that, based on an assessment of quantifiable costs and benefits, there appears to be no clear overall net cost or net benefit from implementing FRC in the ACT.

### ***Benefits***

As discussed in the introduction to this section 3, in assessing the costs and benefits of FRC, the costs can be more readily determined than the benefits. This is because the benefits of FRC mainly relate to the future effects of competition which will in turn depend on the responses of electricity market participants to the new competitive environment.

The responses of market participants – primarily electricity retailers – to the new competitive environment may include the lowering of costs and prices, improving service quality and developing innovative products and services in order to attain and/or retain market share. Aside from the estimated pricing effects of FRC as discussed above, these benefits are not generally quantifiable. For example competitive benefits are likely to be realised in the following areas:

- service quality improvements resulting from the process of competition. That is, in addition to competition in pricing offers (accompanied by cost reductions), retailers are also likely to offer competing types of services; and
- product and service innovation, in particular, in the bundling of diverse services (e.g. a service combination involving electricity, natural gas and telecommunications) where such innovations are currently precluded by the regulated franchise tariff arrangements.

In addition to potential direct benefits from competition as noted above, there is a range of potential general economic and financial benefits from FRC that cannot be quantified with a reasonable degree of confidence. These benefits comprise:

- full NCP payments from the Commonwealth as a result of proceeding with FRC. The potential benefit from avoiding reduced NCP payments needs to be considered against the cost to the Government arising from a potential reduction in its dividend payment from ACTEW due to a FRC-related reduction in the retail market share of ActewAGL (this issue is discussed further in chapter 6); and
- alignment with the competitive natural gas market in ACT and with competitive electricity markets in Victoria and NSW. These benefits could be evidenced in cost savings, in the form of ActewAGL being able to recover common systems costs, and apply uniform customer procedures, across a broader base of gas and electricity customers;

Greater customer choice and of having competitive markets. In this context, it is the view of the Commission that, in the long term, competitive markets represent a more effective mechanism for achieving efficient outcomes than regulated markets.

***Concluding comment on assessment of costs and benefits***

Overall, in relation to the potential effects within the ACT market, the Commission has found that there are marginal net benefits to some larger consumers and marginal costs to be passed on to a large number of smaller consumers. The average additional cost that the Commission can estimate is in the order of \$2 per month for residential customers and a potential average benefit to business customers in the order of \$20 per month.

The Commission considers that there are broad long-term benefits from introducing FRC in the ACT including increased customer choice, development of a truly competitive electricity market, and no curtailment or reduction in the Commonwealth's NCP payments to the Territory. Based on these potential benefits, which at this stage are not quantifiable, the Commission considers it is likely that the implementation of FRC in the ACT will have a positive net benefit. The form of FRC that is introduced would however need to address concerns that small consumers may be disadvantaged.

## Attachment 2:

### Recent FRC Experience in Victoria

#### ***FRC timetable***

The FRC timetable set by Electricity Industry (Non-franchise Customers) Regulation 1994 provided for a staged introduction of retail competition, with each phase based on customer size class as follows.

**Table A2.1: Victorian FRC timetable**

Date	Threshold condition
December 1994	Customers with loads in excess of 5MW
July 1995	Customers with loads in excess of 1MW
July 1996	Customers with loads in excess of 750MWh pa
July 1998	Customers with loads in excess of 160MWh pa
December 2000	Remaining customers

The date for FRC coincided with the commitment by Victoria to introduce competition reforms in line with the NCP.

At the time the Victorian Government reformed and privatised the state's electricity supply industry it also put in place regulation governing non-franchise customers. Under these arrangements, the elements of the former SECV were disaggregated into separate companies, namely:

- generation companies;
- a company responsible for operating the transmission system and for overseeing the operation of the wholesale energy market;
- a transmission system asset owner; and
- five combined distribution retail companies – each of which was allocated a specific geographic area.

Under the competition reforms, provision of transmission and distribution services (ie the wires businesses) was made subject to economic regulation, on the basis that transmission and distribution are considered to constitute natural monopolies. The service of retail supply, although notionally a competitive service, was made a regulated service in respect of supplies to customers not subject to retail competition. That is, under the arrangements put in place, regulated retail prices applied to a customer so long as the customer was not contestable. On becoming eligible for competitive supply (ie contestable) in accordance with the timetable above, the regulated retail prices were no longer available to the customer.

Thus, the five retailers supplying non-contestable customers could only do so at the regulated tariffs. Their risks of purchasing services to supply those customers were managed by different mechanisms:

- transmission and distribution service prices were subject to regulatory control based on the application of CPI-related average revenue formulas under the Victorian Electricity Supply Industry Tariff Order (the Tariff Order); and
- the cost of purchasing energy, which notionally is determined on a half-hourly basis under competitive conditions through the wholesale power pool, was hedged through Government-developed contracts between the retailers and generators. The key aspect of these contractual arrangements was a two-way hedge that required the retailers to pay the generators the difference between the market price and the hedge strike price when the market price was below the strike price and for generators to pay retailers the difference when the market price was above the strike price. Thus the effective cost of energy was determined directly by the hedge contract strike price.

The contracts protected retailers from price and quantity risks in purchasing energy to sell to non-contestable customers (given that sales to such customers could only be made at price controlled retail tariffs).

The hedge contract coverage was designed to be phased out in step with the introduction of retail contestability. That is, at the contestability of a particular customer class, as the retailer would no longer be required to sell to those customers at regulated (constrained) retail tariffs, the retailers' risks of purchasing energy could be passed on to those customers. Competitive forces in the wholesale power pool, combined with competition between retailers for contestable customers, was considered to provide an appropriate safeguard for those customers.

Due in large part to difficulties in determining the appropriate metering and metrology solution for the last tranches of contestable customers, FRC was delayed from 1 January 2001.

In Victoria the delay was effected through Order in Council made by the Governor in Council. The Order in Council provided a transitional measure to allow 40-160MWh pa customers to switch retailers provided such customers had interval meters installed. It was intended in the longer term, however, that customers consuming less than 160MWh pa would be able to switch on the basis of a deemed load profile. It was envisaged that FRC would be achieved at 1 January 2002.

By subsequent Order in Council, FRC was determined to commence from 13 January 2002.

### ***Form of FRC***

The form of FRC in place at 13 January 2002 provided for customers of different size classes to meet different criteria in order to be able to take supply from a retailer that was not their host retailer.

The switching criteria are as follows:

- customers consuming more than 160MWh pa are required to have full metering; and
- customers consuming less than 160MWh pa are subject to deemed load profiling.



## **FRC effects**

### *(i) Prices*

At the commencement of FRC in Victoria on 13 January 2002, prices for customers using less than 160MWh pa increased on average by approximately 9%. Measures put in place by the Government will result in the effective average increase being in the order of 4%.

The price effect in this case, however, cannot be readily characterised as an outcome of FRC. Rather, this effect has arisen from a combination of factors, which are discussed below in the context of the structural/historical factors that have led to the need for recent retail price increases.

Although the regulated retail price path in the Tariff Order ceased to apply from 31 December 2000 (the Government-established hedge contracts were completely phased out on that date) the Government put in place arrangements in the Electricity Industry Act 2000 which:

- required the franchise retailers to put in place ‘standing offer’ tariffs for all less than 160MWh pa customers that did not elect to switch retailers; and
- provided the Minister for Energy and Resources with powers to give effect to FRC, including powers in relation to regulation of standing offer tariffs.

Customers that switch between retailers, on the other hand, are considered to have taken up a retailer’s ‘market offer’. Market offer tariffs are not potentially the subject of Ministerial controls that may be applied in respect of standing offer tariffs.

Under the above powers, the Minister invited the retailers to publish in the Government Gazette their proposed standing offer tariffs to apply post FRC for the 2002 calendar year.

The retailers’ gazettal of standing offer tariffs made in October 2001 (for application from 1 January 2002) embodied an average price increase of 18% over the tariffs applying in 2001. The average percentage increase embodied in the tariffs proposed by each retailer are shown below:

**Table A2.2: Proposed increases in tariffs**

Retailer	Citipower	TXU	Origin	AGL	Pulse	Average
Proposed increase on 2001 tariffs	16%	19%	21%	15%	17%	18%

On being informed of the gazetted tariff variations, the Minister for Energy and Resources referred the gazettal to the ORG to investigate and report on the retailers’ proposed tariff variations and in doing so to assess the retailers’ costs of supply against relevant cost benchmarks.

Based on the findings of the ORG’s investigation, the Government:

- determined revised permitted average increases for each retailer;
- sought revised proposals from the retailers; and
- requested the ORG to assess the revised proposals for conformance with the Government’s permitted average increases, as specified in table A2.3.

**Table A2.3: Proposed increases in tariffs 2001**

Retailer	Citipower	TXU	Origin	AGL	Pulse	Average
Proposed increase on 2001 tariffs	2.5%	15.5%	13.5%	4.7%	4.0%	9%

The ORG approved each retailer's revised proposals as being in conformance with the permitted average tariff variations.

The tariffs became effective from 13 January 2002 in respect of standing offer customers.

The Government indicated that it anticipated that the gazetted tariffs would apply for 12 months.

Separately, for the 12 month period commencing from 1 April 2002, the Government is to make Special Power Payments (SPPs) to customers in the rural distribution areas (ie TXU's and Origin's former retail franchise areas). The net effect of the permitted retail price variations and the SPPs is that the average increases to standing offer tariffs in the TXU and Origin areas are 4.4% and 4% respectively (in place of the respective approved average variations for those areas of 15.5% and 13.5%) for a State-wide average effect across customers using less than 160MWh pa of c.4%.

The key driver of the above increases is that retailers' costs of purchasing energy have risen to reflect increases in wholesale market prices: in particular, to levels above the forecast market prices used in determining the hedge contract strike price (which, in turn, had been reflected in the previous regulated retail prices).

In respect of market offer customers, that is those customers using less than 160MWh pa that have switched retailer, there is no publicly available information on the prices/average price effects faced by those customers.

*(ii) Customer switching*

Information available on the extent of switching of those customers using less than 60MWh pa is inconsistent:

- the Business Review Weekly<sup>19</sup>, quoting NEMMCO, presents that 1,925 out of the total 2.2M Victorian customers using less than 160MWh pa had switched from their host retailer; and
- It is, however, generally considered that less than 5,000 <160MWh pa customers had switched in the first full month of the FRC in Victoria.

It is feasible that the low rate of churn reflects the fact that the constrained standing offer tariffs provide limited opportunities for developing (comparatively) attractive market offers to encourage customers to switch.

**Net benefits**

Those customers using less than 160MWh pa that have remained with their host retailer (standing offer customers) may be considered to have experienced a detriment

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<sup>19</sup> BRW, 28 February 2002.

at the introduction of FRC. The detriment in this case, however, may stem from the following factors, rather than being the result of FRC:

- structural issues associated with the wholesale market; and
- other issues that were not fully reflected in the pre-existing regulated retail prices.

There is no publicly available information on the extent to which customers using less than 160MWh pa have switched retailer (i.e. market offer customers) have benefited from FRC. It clear, however, that few of such customers have switched.

### ***Implications for the ACT***

The Commission recognises that there are differences between the inter-jurisdictional arrangements in Victoria and NSW and the ACT. In relation to Victoria there has been too little time since the introduction of FRC to have firm trends indicated. However, there are early signs that should provide some level of confidence about FRC in the ACT. Although the introduction of FRC in Victoria was predominantly to small consumers and the Victorian Government invested significant resources in informing the community about FRC there has been a low level of customer transfers. In terms of prices there is a greater benefit to larger customers than smaller, which is what is anticipated in the ACT. In Victoria there has also been little market volatility and systems have proved adequate. The Commission notes the view that on balance there may be more cost than benefit but that the net cost is slight. The Commission considers that the same outcome is probably what the ACT will experience, moderated to the extent that ACT consumers have benefited from comparatively lower prices than experienced elsewhere in the national market and that consequently there will be higher relative prices for small consumers as those lower prices are eroded. The Commission believes that it is a short-term situation which would change over time whether FRC is introduced or not.



## Attachment 3

### Recent FRC Experience in New South Wales

#### ***FRC timetable***

The FRC timetable in NSW provides for staged introduction of retail competition as follows:

**Table A3.1: NSW FRC timetable**

Customer Class	Date	Threshold Condition
Large metropolitan hospital Heavy Manufacturing	1 October 1996	More than 40 GWh pa (Annual bill \$2,000,000+)
Multi-storey office block Food processing plant	1 April 1997	More than 4 GWh pa (\$250,000+)
Supermarket Engineering workshop	29 June 1997	More than 750 MWh pa (\$75,000+)
Fast food restaurant Service station	28 June 1998	More than 160 MWh pa (\$16,000+)
Medium sized businesses with multiple sites	1 July 1999	Aggregation of sites, each with minimum 100 MWh pa (\$10,000 + per site)
Department Stores, Poultry Farms	1 January 2001	100-160 MWh pa (\$10,000-\$16,000)
Restaurants, Medical Centres	1 July 2001	40-100 MWh pa (\$4,000-\$10,000)
Households, Small Businesses	1 January 2002	0-40 MWh pa (\$0-\$4,000)

Similar to the initial FRC arrangements in Victoria, the initial FRC timetable in NSW was determined by regulation and provided for FRC to occur at 1 January 2001 consistent with the CPA requirements. Further, the relevant dates in NSW have been varied by the issue of Contestability Notices by the relevant Minister, similar to the Order in Council process applied in Victoria.

While subject to similar regulatory reform arrangements, the NSW electricity supply industry has not been privatised as in Victoria. There are four NSW franchise retailers and regulated retail prices apply to those retailer's standing offers to customers using less than MWh pa until 2004.

In both the pre-FRC environment, in respect of tariffs for non-contestable customers, and in the post-FRC environment, in respect of standing offer customers, the host retailer may only sell to those customers at the regulated/capped retail rate. The cost recovery risks of the retailers are managed by the following mechanisms:

- transmission and distribution service prices being subject to regulatory control under CPI-related formulas; and
- the cost of purchasing energy, as notionally determined on a half hourly basis under competitive conditions through the wholesale power pool, being hedged through the NSW Government Electricity Tariffs Equalisation Fund (ETEF). Similar to the initial franchise customer arrangements in the Victorian Electricity Supply Industry, the ETEF provides for energy price hedging between franchise retailers and generators. The arrangement requires retailers to pay generators the difference between the market price and the hedge strike price when the market

price is below the strike price, generators pay retailers the difference when the market price is above the strike price.

### ***Form of FRC***

The form of FRC in place from 1 January 2002 provides for customers of different size classes to meet different criteria in order to be able to take supply from a retailer that is not their host retailer.

The switching criteria are the same as those applying in Victoria ie:

- customers consuming more than 160MWh pa are required to have full metering; and
- customers consuming less than 160MWh pa are subject to deemed load profiling.

### ***FRC effects***

#### ***(i) Prices***

Standing offer tariffs for customers using less than 160MWh pa that do not elect to switch retailers are regulated pursuant to determination of IPART in December 2000.

Customers that have switched from their local retailer and have taken up another retailer's market offer are outside the regulated price protections.

While prices in the wholesale power pool have increased over time, franchise retailers' pool price risks, which would otherwise be borne in full by those retailers when selling to standing offer customers under the regulated/capped retail tariffs, are managed by the ETEF arrangements. As such, the effective cost of energy supplied to standing offer customers is the strike price in the ETEF and therefore, unlike supplies to equivalent customers in Victoria, retailers in NSW under current arrangements are not as exposed to market-based energy costs.

Accordingly, prices for customers using less than 160MWh pa that have remained with their host retailer have not changed with the introduction of FRC.

In respect of market offer customers, i.e. those customers using less than 160MWh pa, that have switched retailer, there is no publicly-available information on the prices/average price effects faced by those customers.

#### ***(ii) Customer switching***

Similar to the situation in Victoria, information available on the extent of switching of small customers is inconsistent:

- The Business Review Weekly<sup>20</sup>, quoting NEMMCO, states that 50 out of the total 2.7M customers using less than 160MWh pa have switched from their host retailer to another retailer and are thus on market offer tariffs; and
- It is generally considered that less than 500 customers using less than 160MWh pa had switched in the first full month of the FRC in NSW.

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<sup>20</sup> BRW, 28 February 2002.

As in the Victoria, the low churn rate may reflect the fact that the constrained standing offer tariffs provide limited opportunities for the development of attractive market offers to encourage customers to switch.

### ***Net benefits***

Those customers using less than 160MWh pa that have remained with their host retailer (standing offer customers) have in effect, experienced no change at the introduction of FRC.

This is due primarily to the regulated price arrangements for these customers and to the supporting vesting contract (ETEF) arrangements put in place by NSW Treasury. These arrangements are feasible in this case given that the parties to the contracts are Government-owned.

There is no publicly available information on the extent to which customers using less than 160MWh pa that have switched retailer (market offer customers) have benefited from FRC.

It is clear, however, that few such customers have switched.

### ***Implications for the ACT***

The Commission notes that the comments made in relation to Victoria could well be made in relation to NSW. It is too early to say what the balance of benefits and costs in NSW will ultimately be. However, there is no substantial price benefit to small consumers, even though larger consumers will benefit to a greater degree. Churn in the market is lower than in Victoria and by any measure insubstantial, despite the NSW Government spending substantial amounts on public information. The market in NSW as in Victoria remains orderly, with the ownership arrangements in NSW playing a significant part in that process. The ACT is not in the same position as NSW in relation to generation and therefore is unable to provide the same level of market assurance. However, the security that NSW consumers obtain from the ownership arrangements may not add substantially to the net benefits/costs of FRC in the ACT.





## Attachment 4

### FRC Experience in United Kingdom

#### *FRC timetable*

The FRC timetable in the UK provides for staged introduction of retail competition as follows:

**Tables A4.1: Customer classification**

Customer Class	Date	Threshold Condition
Large business customers	1990	Maximum demand over 1 megawatt.
Medium sized business Customers	1994	Maximum demand over 100 kilowatts.
Small domestic and business customers	Sept 1998 – May 1999	Maximum demand under 100 kilowatts. Three broad phases based on postcode: (1) 10 per cent of domestic and business customers defined by postcode plus all the customers that took supplies through a half-hourly meter. (2) Thirteen weeks later, approximately 30 per cent of domestic customers, plus all remaining business customers. (3) Thirteen weeks later, all remaining customers were added.

(Source: The England and Wales wholesale electricity market, Ofgem, 31 Jan. 2001, [www.ofgem.gov.uk/docs2001/compcomm2.pdf](http://www.ofgem.gov.uk/docs2001/compcomm2.pdf))

The UK wholesale power pool is underpinned by a multilateral contract known as the Pooling and Settlement Agreement which is entered into by generators and purchasers. The Pooling and Settlement Agreement defines the market trading rules and procedures that control a competitive bidding process between generators that sets the price paid for electricity for each half-hour period of the day. It also provides the supporting financial settlement processes that calculate purchasers' bills and ensure payments to generators.

Table A4.2 shows demand-weighted annual average prices on the UK wholesale power pool.

**Table A4.2: Demand weighted prices UK**

Year	SMP	Capacity Payments	PPP	Indexed PPP (99/00 = 100)	PSP
1990/91	23.87 <sup>21</sup>	0.08	23.95	94	25.25
1991/92	25.39	2.09	27.48	108	29.77
1992/93	28.5	0.26	28.76	113	30.57
1993/94	29.95	0.43	30.38	120	33.17
1994/95	25.89	4.65	30.55	120	33.64
1995/96	23.41	6.33	29.74	117	31.99

<sup>21</sup> £/MWh, September 2000 prices

1996/97	24	4.48	28.48	112	30.83
1997/98	27.76	1.19	28.95	114	29.45
1998/99	26.1	1.31	27.41	108	27.81
1999/00	21.81	3.57	25.38	100	26.25

Source: Ofgem.

Table A4.2 shows that the real cost of purchasing energy on the UK wholesale power pool rose by approximately 6% in the period 1990/01 to 1999/00. This represents a more moderate increase to that experienced on the NEM.

### **Form of FRC**

As in Victoria and NSW, a small customer<sup>22</sup>, may switch retailers where they either have interval meters and associated communications equipment, or where load is to be measured by standard meters in conjunction with deemed load profile.

The cost of installing an interval meter and the associated communication interface is approximately £100-200. There is also an annual charge of £299. This cost is considered likely to fall significantly with large production runs to around £40-50.

### **FRC effects**

#### *(i) Prices*

In the period from April 1998 to April 2000 the average annual domestic electricity bill fell by 11% per cent in real terms<sup>23</sup>. This is the equivalent of almost \$A2 billion per annum.

**Table A4.3: Average annual domestic electricity bill**

	Nominal	Real
April 1998	252	268
April 2000	238	238
Reduction	14	30

(Source: OFGEM, Annual Report 2000-01, Chapter 4 "Competition in Gas and Electricity Supply")

Further, electricity customers attracted a range of competitive offers compared to the tariffs offered by their local suppliers, with reductions of up to 17% for direct debit, up to 14% on other credit tariffs and up to 7% on prepayment.

#### *(ii) Customer switching*

In percentage terms, 38% of all domestic customers with a maximum demand of less than 100 KW had switched suppliers as at August/September 2001 since full contestability began in 1998. As at August/September 2001 there had been approximately 11 million gross transfers in total. The rate of transfers continued at a steady rate over time of about 5 million transfers per year, or about 100,000 per week to September 2001.

<sup>22</sup> In the UK a small consumer is defined as using less than 100MW

<sup>23</sup> based on an average consumption of 3,300 KWh standard credit customer

The following table shows the proportion of UK customers in special groups that have switched supplier, at August/September 2001, compared with the previous year:

**Table A4.4: Percentage of customers that have switched**

Customer Group	Proportion that have switched (%)	
All domestic electricity users	19	38
Very low income earners	13	43
Disabled customers	21	44
Single parent families	19	43
Pensioners	20	30
Geographic area		
Urban	20	41
Rural	17	32

(Source: Review of Domestic Gas and Electricity Competition and Supply Price Regulation, Ofgem, November 2001, p.25-28)

Thus it can be seen that switching rates have increased over time. However, pensioners and rural electricity customers continue to have a lower than average switching rate.

### ***Net benefit***

“The introduction of competition has just been completed. Over the past eight months significant changes have been experienced by both customers and suppliers alike. Nonetheless, both appear to have adapted to these changes. The prospects, therefore, for competition appear good. They could be further enhanced by suppliers making customers more aware of the offers available in a manner that does not confuse customers.”<sup>24</sup>

“Overall, the findings from the review of domestic competition indicate that competition is now well established, effectively protecting consumers’ interests, and continuing to develop well... Customers are able to obtain significant savings by switching. Switching rates are much more evenly distributed across customer groups than in previous years.”<sup>25</sup>

<sup>24</sup> Source: OFFER, A Review of the development of competition in the Designated Electricity Market, June 1999, p.71.

<sup>25</sup> Source: Review of Domestic Gas and Electricity Competition and Supply Price Regulation, Ofgem, November 2001, p.2.



## **Attachment 5**

### **FRC Experience in California**

#### ***FRC timetable***

At 31 March 1998, customers in most existing electricity utility service areas were free to choose their electricity retailer/generator (in California, referred to as direct access).

From 17 January 2001, retail choice has been suspended in California. Any existing contracts are permitted to continue until they expire.

#### ***Form of FRC***

While under the Californian model customers were free to choose their electricity retailer, uniform capped prices were applied for delivered energy.

Customers did not require interval metering in order to switch from their host retailer.

#### ***FRC effects***

##### *(i) Prices*

The following price arrangements were adopted in California, becoming law at 23 September 1996:

Regulated investor owned utility rates for agricultural, residential, industrial and large commercial customers were frozen at June 1996 levels until the utilities recovered their generation related uneconomic costs through a transition charge or until 31 March 2002, whichever is the earlier.

Commencing from 1 January 1998, rates for residential and small commercial customers (defined as 20 KW or less peak demand) were reduced 10% and were to remain fixed thereafter until the utilities recovered their generation-related uneconomic costs through a transition charge or until 31 March 2002, whichever is the earlier.

These regulatory arrangements have had significant impacts as follows:

- the price freeze and reduction resulted in significant falls in California's average retail prices;
- the regulatory structure (ie lack of demand signals in retail prices) led to large price spikes in the wholesale power pool. By mid-2000 one of the major investor-owned utilities, SDG&E, had completed the competitive transition change and was therefore able to charge its customers unregulated prices thus pass through wholesale costs to its customers; and
- in addition to price spikes, wholesale electricity prices were generally increasing (eg from June 1999 to June 2000, by 270%). For SDG&E, this meant retail prices for delivered energy increased from c.11c KWh to c.16c KWh.

At that point, legislation was introduced to prevent the retail price increases by capping the energy component of electric bills for residential, small commercial and lighting customers of SDG&E at 6.5 cents per KWh. This resulted in large financial losses for SDG&E.

The general price freeze applied to other utilities meant that they were also incurring significant losses.

These financial losses, combined with the lack of regulatory price certainty are held to be the factors that have led to California’s shortage of new generation facilities and consequent power shortages.

Also contributing to power shortages is the fact that demand has increased by 29 per cent in the past five years. Because consumers were paying far below market prices during this period there was little incentive to reduce demand.

On 17 January 2001, the Californian Governor declared a state of emergency and in response the legislature suspended retail choice in California.

**Table A5.1: Weighted average electricity rates**

1990-2000				
Weighted Average Electricity Rates				
Nominal Cents per kilowatt-hour (¢/KWh)				
Year	Residential	Commercial	Industrial	System Average
1990	10.40	9.69	7.29	9.36
1991	11.06	10.07	7.48	9.80
1992	11.51	10.44	7.60	10.17
1993	11.64	10.29	7.30	10.08
1994	11.79	10.47	7.33	10.22
1995	11.60	10.06	7.03	9.90
1996	11.66	9.71	6.69	9.71
1997	11.66	9.68	6.68	9.69
1998	10.94	9.62	7.45	9.57
1999	10.94	9.54	7.45	9.54
2000	11.19	9.75	7.68	9.76

Note: These averages only include rates for PG&E, Edison, SDG&E, LADWP and SMUD. Systemwide rates only include residential, commercial and industrial customer classes. 2000 rates are estimated.

(Source: California Energy Commission, Electricity rates, <http://www.energy.ca.gov/electricity/index.html#numbers>)

*(ii) Customer switching*

“Observers note that an unforeseen consequence of the rate cut may have been that it reduced the potential for profits to the point where would-be competitors could not offer most consumers power at prices that were sufficiently below regulated rates to prompt large numbers of consumers to switch. Hence, most customers continued to use their distribution utility as their ‘default’ power purchaser”. (Source: Learning from California: Power Shortages and Unique Market Rules Lead to Price Spikes, Edison Electric Institute)

## **Attachment 6:**

### **Reference**

Australian Capital Territory

#### **INDUSTRY REFERENCE FOR INVESTIGATION INTO FULL RETAIL CONTESTABILITY FOR ELECTRICITY**

##### **Disallowable instrument DI2001-346**

made under the **INDEPENDENT COMPETITION AND REGULATORY  
COMMISSION ACT 1997, 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 matter of an investigation into the public benefit of the extension of full retail contestability for electricity in the ACT.

#### *Specified Requirements in Relation to Investigation Under Section 16*

Pursuant to subsection 16(1) of the Act, I specify the following requirements in relation to the conduct of the investigation:

The Commission is to have regard to the following in its investigation:

1. The costs and benefits of the implementation of full retail contestability for electricity for the ACT, taking into account the Territory’s obligations under the Council of Australian Governments (COAG) and National Competition Agreements. The review should include options for the ACT in relation to:
  - (a) proceeding as soon as management and administrative systems allow; and
  - (b) not proceeding at this time.
  
1. Identifying and describing the electricity market participants using 100 Megawatt/hours per annum (MWh pa) or less;
2. Identifying and quantifying the costs and benefits (financial and non-financial) flowing from the extension of full retail competition for electricity in the ACT to customers using 100 MWh pa or less. This should include the effect of possible changes in electricity prices for different categories of customers, including those who may be socially disadvantaged;
3. The means and costs of avoiding or mitigating any adverse impacts on consumers, particularly those socially disadvantaged;

4. Whether or not the ACT should adopt deemed profiling of customer usage and the desirability or otherwise of moving to full metering;
5. An assessment of studies and/or experience in other jurisdictions with the
6. implementation of FRC for the different classes of small business and residential users; and
7. any other related matters.

In undertaking the investigation, the Commission is to:

- (i) canvass the views of key stakeholders including, consumer groups, small business representatives, social welfare groups and electricity suppliers and retailers; and
- (ii) conclude the investigation by 31 March 2002 and report as soon as practicable thereafter.

Dated this 18<sup>th</sup> day of December 2001

TED QUINLAN  
TREASURER