

# Retail Prices for Non-Contestable Electricity Customers

ActewAGL Response to ICRC Draft Decision

June 2007



## Contents

1.	<i>Overview of ActewAGL's response to the draft decision</i>	3
2.	<i>Context for the draft decision</i>	5
3.	<i>Responses to the draft decision</i>	6
3.1	The Commission's approach	6
3.2	Energy purchase costs	7
3.3	Retail operating costs	11
3.4	Retail margin	12
3.5	Green costs	12
	<i>References</i>	14



## 1. Overview of ActewAGL's response to the draft decision

ActewAGL Retail (ActewAGL) appreciates the opportunity to respond to the Commission's draft decision. At the outset, ActewAGL acknowledges the very difficult circumstances involved in setting a regulated price in a market that is not only open to competition but is becoming increasingly dynamic with prices changing daily. ActewAGL firmly believes that there should be no price regulation in the competitive ACT retail market. However, given that the Commission is required to set a new regulated tariff, it is critical that the regulated electricity retail price not disadvantage ActewAGL relative to its competitors in the ACT marketplace.

ActewAGL has reviewed the Commission's draft decision and finds that the cost estimates adopted in the draft decision (i) do not adequately reflect the market reality of sharply rising wholesale electricity prices, (ii) are out of step with other recent regulatory decisions, and (iii) do not adequately take account of the costs that new entrants will face and the implications this may have for the ongoing development of competition in the ACT electricity market.

### Energy purchase costs

- The energy purchase cost allowance of \$58/MWh is significantly below current spot and forward market prices (around \$80/MWh). Wholesale electricity prices have increased sharply in recent months, reflecting underlying generating capacity shortages. The Commission acknowledges that the recent wholesale price increases are driven by 'underlying fundamentals', not one-off shocks<sup>1</sup>. It is essential that retail prices adequately reflect these market changes now, giving consumers, retailers and investors an opportunity to respond.
- The Commission has previously recognised the importance of allowing consumers to respond to price signals, both in its recommendation to remove retail price regulation and its decision requiring the phased installation of interval meters, yet it effectively shields consumers from crucial market signals by basing its energy cost estimate on a set of 'simplified (but hopefully robust)'<sup>2</sup> assumptions.
- The model and assumptions used by the Commission to establish its energy purchase cost estimate need to be reviewed. The model uses NSW system demand, not the load profile for the ACT, as the load reference. The NSW system has smaller temperature variation and large flat load customers, resulting in a better load profile than the ACT and lower costs. In addition, the assumptions about hedging and purchasing policies cannot properly reflect the commercial nature of managing purchase risk and load volatility in a competitive and dynamic market environment. ActewAGL notes the difficulty and implications of trying to hypothesise and apply a generic hedging strategy instead of

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<sup>1</sup> ICRC 2007, p. 6

<sup>2</sup> ICRC 2007, p. 15

basing the energy cost allowance on forward market prices. The Commission's draft decision to base the energy purchase cost allowance on a set of assumptions about hedging behaviour, without warning or precedent, highlights the regulatory risk facing ActewAGL. The draft decision places ActewAGL in the position of having its TFT based on a new and unexpected hypothetical hedged price that is well below market prices.

- As a regulated retailer in a competitive market, ActewAGL is placed in the difficult position of being locked-in to supplying franchise customers at a regulated price. If energy costs rise during the regulatory period then ActewAGL must continue to supply at the regulated price, which may not even cover costs. If costs fall during the period, ActewAGL will lose customers to competitors. The risks are exacerbated when the TFT is based on a new and unexpected hypothetical model, which results in the energy cost allowance being below current and expected market values.
- The Commission proposes a possible mid-term pass-through to address changes in energy costs, although it does not explain how this would work (for example, what energy cost would be the benchmark and what size change would trigger a pass-through). The mid-term pass-through approach does not address the financial risks that ActewAGL faces in the first half of the period, when its regulated tariff is based on energy costs below market values. ActewAGL's preferred approach is that the initial energy cost allowance be increased to more accurately reflect current market expectations. This should reduce the likelihood that an uncertain mid-year adjustment to the TFT will be necessary.

### Retail operating costs

- In the draft decision, allowed retail operating costs have been increased in line with the CPI, despite confirmation that wages, the major component of retail operating costs, have grown at rates well above the CPI and are likely to continue to do so due to the very tight labour market.
- The Commission does make some allowance for 'new entrant' costs, recognising that 'the development of competition would likely be fostered by allowing these costs into the cost recovery for the TFT customer base'<sup>3</sup>. However, the allowance needs to be re-assessed. Instead of adding estimated customer acquisition costs that new entrants would face (as IPART did in its draft decision), the Commission adds an estimate of ActewAGL's likely additional unit costs associated with loss and churn of TFT customers. The Commission notes that this cost is not as high as the costs for a new entrant retailer. This approach therefore appears inconsistent with the intention to foster competition by reflecting new entrant costs in the TFT.

### Retail margin

- The Commission's proposed retail margin of 4% is below the 5% allowed in the two most recent regulatory decisions (by IPART and the Queensland Competition Authority), and at the bottom of the range of recent decisions, with no clear justification. IPART has allowed

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<sup>3</sup> ICRC 2007, p. 18

an increase in NSW from a 2% margin in the current period to 5% for each of the next 3 years. The Commission's argument that IPART's proposed 5% is transitional over 3 years is not supported by IPART's draft report. Indeed, given the significant risks involved in retailing electricity, 5% is not an adequate return.

The Commission has recognised the importance of competition, and explicitly 'encourages all consumers using TFTs to exercise their choice of retailer and to seek lower prices of electricity supply where they are available'<sup>4</sup>. However, the draft decision to set the TFT significantly below market rates will undermine competition in the ACT market.

A new entrant would need to set its prices based on current wholesale market prices (around \$80). A new entrant retailer's price would also need to reflect a retail margin above 5%, as well as retail operating costs well above the amount allowed by the Commission. This higher energy cost component (with a retail margin of 5%) would represent an increase of around CPI+34%, compared with the CPI+10.85% in the draft decision.

Clearly new entrants would not be able to compete with the regulated TFT. ActewAGL notes that customers are already facing a regulated rate that is well below market rates.

Under the draft decision to set the TFT well below the market rate, not only will customers currently on the TFT have no incentive to switch to a market-based contract with competing suppliers, but those already on market-based contracts will have an incentive to switch back to the TFT (at least for the one year duration of the price direction). This would have serious financial implications for ActewAGL, as it would be forced into a situation of having to supply significantly increased loads at prices well below market rates. The outcome of customers switching away from market-based contracts to the regulated TFT, set well below market rates, would also be out of step with the intention of COAG to facilitate competition and provide better price signals to consumers.

## **2. Context for the draft decision**

On 16 April 2007 the ACT Government issued terms of reference requiring the Independent Competition and Regulatory Commission (the Commission) to provide a price direction for the supply of electricity to franchise customers for the period from 1 July 2007 to 30 June 2008.

The current price direction expires on 30 June 2007. Under the current direction the transitional franchise tariff (TFT) was set by the Commission for one year, as an interim measure pending a Government decision on the Commission's recommendation that the TFT be removed from 1 July 2007.

ActewAGL fully supports the Commission's recommendation that the TFT should be removed. This will allow competition to fully develop in the ACT, delivering to all customers the benefits of greater choice, lower prices and new and innovative products and services.

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<sup>4</sup> ICRC 2007, p. 7

However, the Commission has now been asked to provide a further one-year price direction. The direction is made against a backdrop of:

- Strong and growing competition in the ACT electricity market;
- Widespread recognition of the potential costs of ongoing retail price regulation;
- Commitments by governments, through COAG, to gradually remove retail price regulation;
- COAG's commitment to 'improve price signals for consumers and investors' and to progressively roll out smart meters from 2007<sup>5</sup>;
- The Commission's decision to require that interval meters be installed on a new and replacement basis and when requested by a customer;
- Recognition by IPART and the Commission that, in the transition to removal of price regulation, light-handed regulation which encourages further development of competition is appropriate;
- Explicit recognition that it is appropriate to set regulated prices 'in a way that reduces customers' reliance on regulated prices'<sup>6</sup>; and,
- Sharply rising and volatile wholesale electricity purchase prices, which highlight the risks faced by regulated retailers who are locked into supplying franchise customers at a regulated price.

Against this backdrop, ActewAGL notes that the price direction should encourage, not stifle, further strong growth in competition, adequately reflect developments and trends in wholesale and retail energy markets, and facilitate a smooth transition to a market free of regulatory distortions and constraints.

### **3. Responses to the draft decision**

#### **3.1 The Commission's approach**

In the overview to the draft decision the Commission explains that its:

'approach to the determination of retail electricity prices for ActewAGL Retail customers who choose to stay on the TFT has been to draw on benchmark cost information available in the marketplace or in other regulatory decisions within the electricity retail sector in Australia. This benchmark information has been used to arrive at a reasonable estimate of

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<sup>5</sup> COAG 2007, p. 2

<sup>6</sup> IPART 2007, p. 1



the economically efficient cost base of an incumbent electricity retailer providing retail electricity supply services to a regulated customer segment'.<sup>7</sup>

ActewAGL has concerns about the broad approach taken, and also the approach to estimating each of the cost components.

The broad approach of building up an estimate of the efficient cost base of the incumbent supplier is the approach taken by the Commission and most other regulators in recent determinations. However, the context for retail price regulation decisions has changed in recent times (as outlined in section 2 above), and this has implications for the appropriate approach to regulation.

IPART's approach to its current review of regulated retail electricity tariffs in NSW represents a shift in paradigm to one that is more forward-looking and aimed at facilitating ongoing development of competition. IPART explicitly includes the costs that new entrants may face and sets regulated tariffs 'in a way that reduces customers' reliance on regulated prices and facilitates retail competition'<sup>8</sup>. ActewAGL supports this approach.

Our main concerns with the Commission's approach to estimating values for each cost component are discussed in detail below.

## 3.2 Energy purchase costs

For the Commission's 2003 price direction, ActewAGL proposed that the TFT should be based on market-based wholesale energy costs. These comprise the expected forward cost of purchasing energy at pool prices in the NEM and through contracts with generators, plus trading and hedge management costs and an allowance for other risks including the effect of customer churn in the ACT market<sup>9</sup>. The Commission found that this 'broad approach for arriving at energy purchase costs is reasonable'<sup>10</sup>.

In the draft decision, the Commission has introduced a new way of estimating energy purchase costs. This involves 'a number of assumptions about an ideal electricity retail hedging strategy'<sup>11</sup>.

ActewAGL has several concerns with this approach.

### 3.2.1 Changing the approach to setting energy purchase costs

The Commission has proposed to introduce a new model for estimating energy purchase costs. This approach is without warning or precedent in any past Commission decisions concerning the regulated retail electricity price. It highlights the regulatory risk facing ActewAGL as it is not consistent with the Commission's past approach. It would have been

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<sup>7</sup> ICRC 2007 p. 3

<sup>8</sup> IPART 2007, p. 1

<sup>9</sup> ICRC 2003, p. 24

<sup>10</sup> ICRC 2003, p. 24

<sup>11</sup> ICRC 2007, p. 13

prudent for ActewAGL to expect that the TFT would continue to reflect wholesale market-based costs, and to develop its purchasing policy accordingly. However, under the Commission's newly proposed approach ActewAGL would be locked into supplying franchise customers at a price based on a hypothetical cost tied to a hypothetical risk management strategy.

The uncertainty facing ActewAGL is exacerbated by the short-term nature of the price direction and the possibility of a mid-term adjustment to reflect movements in market prices. That is, the TFT would initially be based on an assumed and hypothetical hedged cost, but there may be a switch to market determined costs during the period. The Commission does not outline how the pass-through would work. Under the draft decision, the allowance (\$58/MWh) is already well below market prices (around \$80/MWh), and the Commission does not explain what would trigger a mid-term pass-through. For example, how would a fall in market prices to below \$80/MWh, but still above \$58/MWh, be treated? How would a rise above \$80/MWh be treated in the Commission's proposed pass-through? The proposal therefore involves unreasonable uncertainty and risk for ActewAGL in a market which is clearly signalling that purchase prices will remain well above the \$58/MWh allowed by the Commission (as discussed further below).

### 3.2.2 Hedging model is based on unreasonable assumptions

The Commission describes its approach to setting the energy purchase cost as 'simplified (but hopefully robust)<sup>12</sup>. ActewAGL cannot support this assertion. The Commission assumes that 'the load profile shape and pool price for TFT customers served by ActewAGL Retail is the same as the annual average of the load profile and the pool price profile for the NSW region for the 2006 calendar year<sup>13</sup>. However, the ACT load profile is quite different from that of the NSW region. Compared with NSW, the ACT has greater variances in temperature and fewer large flat load customers. NSW therefore has a better load factor, which should result in lower purchase costs. As noted by IPART, referring to a report prepared for it by Frontier Economics, 'a less peaky load is cheaper to supply since less peaking plant is required to meet load, which means that the stock of plant is utilised more throughout the year, thereby reducing average costs<sup>14</sup>.

The assumptions about the timing of purchases and the percentage of the forecast load covered by hedged contracts at each point in time are also unreasonable. They are unlikely to reflect the purchasing policy of existing retailers or new market entrants because of the differing strategies and approaches to managing risk across competing suppliers.

ActewAGL is also concerned about the lack of transparency in the Commission's approach. For example, the Commission 'has assumed that the futures prices observed in the marketplace are likely to be slightly higher than those in the negotiated market<sup>15</sup>. However, it

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<sup>12</sup> ICRC 2007, p. 15

<sup>13</sup> ICRC 2007, p. 13

<sup>14</sup> IPART 2007, p. 52

<sup>15</sup> ICRC 2007, p. 14

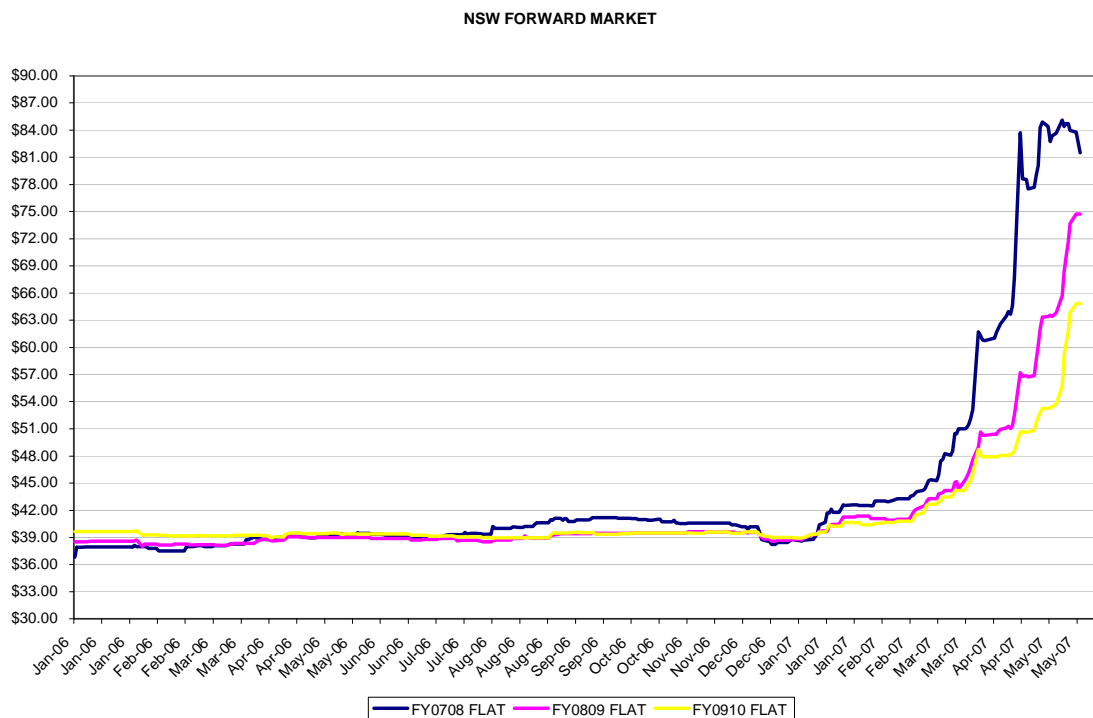
does not make clear what assumptions it has made about the difference between negotiated prices and futures prices.

### 3.2.3 Failing to adequately reflect market information

The Commission says in the draft decision that it ‘cannot ignore the evidence that appears to support a rise in electricity prices at the current time, although it is not possible to determine the full extent of this rise or the likelihood of any price reduction in the near future’<sup>16</sup>.

ActewAGL believes that the Commission has not adequately taken into account the observed market signals about the extent of the current price rise and the likelihood that prices will remain high. The Commission notes that NEMMCO’s Regional Reference Price for April 2007, which is \$78.20/MWh, is significantly higher than the allowed \$58.04/MWh. The allowed cost is even further below forward market prices, as shown in chart 1. During May 2007, the price for 2007/08 contracts has remained above \$81/MWh. Contract prices for delivery in 2008/09 and 2009/10 continue to rise, and are well above the allowed \$58.04/MWh.

Chart 1: NSW forward contract market



The Commission says that its energy cost allowance is broadly consistent with the energy cost estimates in IPART’s draft decision. However, wholesale prices have risen sharply since IPART’s decision. Incumbent retailers’ submissions to IPART’s review have highlighted this

<sup>16</sup> ICRC 2007, p. 9

and argued that IPART's energy cost modelling needs to be reviewed<sup>17</sup>. It should also be noted that IPART concludes that 'it is better to err on the side of overestimating rather than underestimating electricity purchase costs'<sup>18</sup>. The Commission has done the opposite.

The Commission acknowledges that the increase in the pool price is driven by a change in underlying fundamentals and not generated by large one-off shocks to the market<sup>19</sup>. Even by its own estimates (based on the simplified model), the purchase cost will be a further 36% higher in 2008/09 (\$79.10/MWh compared with the assumed \$58.04/MWh for 2007/08)<sup>20</sup>.

While consumers may benefit in the short-term (ie over the coming year) from a decision to set purchase costs significantly below current market value, this is not a situation that can be sustained. Prices will eventually have to rise significantly. If wholesale prices drop, this will be reflected in a drop in competitive retail market prices. If the TFT is then above market rates, then customers can choose to switch to market-based contracts. As the Commission notes in its discussion of safety net provisions, a competitive market is usually considered to offer the best guarantee against price gouging or exploitation of consumers<sup>21</sup>.

However, during the coming year, the dynamics of the development of the competitive market in the ACT would be seriously undermined if the draft decision were implemented. Customers currently on the TFT would have no incentive to switch to a market-based contract with competing suppliers. Furthermore, those customers already on market-based contracts would have an incentive to switch back to the TFT (at least for the one year duration of the price direction). This could include business customers switching from market-based contracts back onto the TFT. The switching would have serious financial implications for ActewAGL, as it would be forced into a situation of having to supply significantly increased loads at prices well below market rates.

These outcomes would also be inconsistent with the clear intention of COAG to facilitate competition and provide better price signals to consumers, and indeed with the Commission's own intention that consumers should be given the opportunity to respond to price signals via the removal of regulated prices and the phased introduction of interval meters.

ActewAGL believes that the energy purchase cost allowance in the draft decision should be increased significantly, to reflect the real price signals in the wholesale market. The recent and expected increases should be fully reflected in the Commission's final decision, and not left to be addressed via an uncertain 'pass-through' process mid-way through the year.

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<sup>17</sup> For eg, Energy Australia 2007, p. 2 and Integral Energy 2007, p. 6.

<sup>18</sup> IPART 2007, p. 55

<sup>19</sup> ICRC 2007, p. 6

<sup>20</sup> ICRC 2007, p. 15

<sup>21</sup> ICRC 2007, p. 21. ActewAGL also notes that the Commission's comments in relation to safety net provisions are relevant to the comments made by the ESCC in its response to the draft decision. ActewAGL believes that it is not appropriate for the TFT to be kept below market levels to protect consumers from price rises.

### 3.3 Retail operating costs

The Commission has taken its estimate of retail operating costs from its previous price direction report and escalated it by the CPI to arrive at an estimate for 2007/08.

ActewAGL believes that escalating in line with CPI does not adequately reflect recent and expected trends in retail operating costs. Labour costs, by far the biggest component of retail operating costs, have increased at rates well in excess of the CPI in recent years and are expected to continue to do so. According to the ABS, wages and salaries per person employed in the electricity supply industry increased by 11% in 2004/05<sup>22</sup>, which is well above the CPI. The Essential Services Commission (ESC) consultants' recently noted that 'combined with the entry of new players, particularly in the energy retail sector, and increased competition through product differentiation, the demand for both technical and customer service staff has increased significantly'<sup>23</sup>. Labour shortages mean that ActewAGL and other retailers must offer higher wages to attract suitable staff.

BIS Shrapnel forecast that wages growth in the electricity, gas and water sector will continue to outpace national wages growth over the next 6 years, with average weekly earnings forecast to increase by 5.7% per annum<sup>24</sup>.

Given these market conditions, escalating costs in line with the CPI is not adequate.

#### 3.3.1 Customer acquisition and retention costs

In line with the terms of reference set by the NSW Government, IPART explicitly takes account of the costs of new entrants and sets regulated tariffs 'in a way that reduces customers' reliance on regulated prices and facilitates retail competition'<sup>25</sup>. ActewAGL supports this approach. It recognises the need to ensure that the TFT does not represent an unreasonable barrier to retail competition.

While the Commission explains in the overview of the draft decision that it bases the TFT on the estimated costs of an incumbent, it does note later in the report that:

'The Commission is not tied to the need to estimate the costs of a new entrant retailer although it will have strong regard for the costs that such competitive players might experience in the marketplace.'<sup>26</sup>

ActewAGL notes that the Commission does make some allowance for customer acquisition and retention costs, recognising that 'the development of competition would likely be fostered by allowing these costs into the cost recovery for the TFT customer base'<sup>27</sup>.

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<sup>22</sup> ABS 2006

<sup>23</sup> ESC 2007, p. 7

<sup>24</sup> BIS Shrapnel 2007

<sup>25</sup> IPART 2007, p. 1

<sup>26</sup> ICRC 2007 p. 11

<sup>27</sup> ICRC 2007, p. 18

However, the allowance is too low. Instead of adding estimated customer acquisition costs that new entrants would face (as IPART did in its draft decision), the Commission adds an estimate of ActewAGL's likely additional per unit costs associated with loss and churn of TFT customers. It recognises that this cost is not as high as the costs for a new entrant retailer. This approach therefore does not align with the intention to foster competition by reflecting new entrant costs in the TFT.

### 3.4 Retail margin

In the draft decision the Commission adopts a retail margin of 4%, noting that it is 'in the range proposed by IPART but recognises that the IPART proposal will be transitional over three years whereas the 4% proposal by the Commission will apply immediately in 2007/08<sup>28</sup>.

In making this draft decision the Commission has:

- Taken the value at the bottom of the range used by IPART, but not provided any justification (IPART's range, based on analysis by Frontier Economics, was 4 to 6%); and
- Assumed incorrectly that IPART's proposed 5% margin will be phased in over 3 years, when the 5% would apply for each of the next 3 years<sup>29</sup>.

We also note that IPART's proposal involves an increase of 3 percentage points in the margin from a 2% retail margin in 2006/07 to 5% in 2007/08 (and 2008/09 and 2009/10). In contrast, the Commission is proposing an increase of only 1 percentage point in ActewAGL's margin, from 3% to 4%.

ActewAGL also notes that the recent draft decision by the Queensland Competition Authority proposed a margin of 5%, to apply from 2007/08<sup>30</sup>.

ActewAGL believes that the allowed retail margin should be consistent with the rate applied to comparable entities in other states and increased to at least 5%. If the draft decision to set energy costs well below market levels were implemented, then the margin would need to be set even higher, to take account of the additional risks that this will impose on ActewAGL.

### 3.5 Green costs

The Commission has taken ActewAGL's approved MRET and GGAS estimates for 2006/07 and escalated them by the change in the renewable power percentage mandated in Regulation 24 of the Commonwealth's Renewable Energy (Electricity) Regulations 2001 to arrive at values for 2007/08.

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<sup>28</sup> ICRC 2007, p. 19

<sup>29</sup> IPART 2007, table 8.1

<sup>30</sup> QCA 2007, p. 19

ActewAGL submits that the Commission should revise these estimates to reflect the costs applicable to the ACT.

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