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Malcolm Gray
Senior Commissioner
Independent Competition & Regulatory Commission
PO Box 161
Civic Square ACT 2608

Submitted online at icrc@act.gov.au

Dear Mr Gray

**Retail prices for franchise electricity customers from 1 July 2014.**

EnergyAustralia welcomes the opportunity to respond to the Issues paper, Retail prices for franchise electricity customers from 1 July 2014 released by the Commission in October 2013.

We have appreciated the ICRC's commitment to a transparent process including a demonstrated willingness to consult widely and take on board stakeholder feedback. We firmly believe that price deregulation will provide consumers with the benefits associated with competition and that the upcoming price determination should be viewed as stepping stone towards retail price monitoring. In light of this, it is vital that the cost components are accurately reflected and customer acquisition and retention costs and sufficient headroom are included to allow retailers to compete. These issues are explored in further detail in our submission.

If you would like more information on this submission, please contact me on (03) 8628 1242.

Yours sincerely

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# EnergyAustralia response to Independent Competition and Regulatory Commission for the

# Issues Paper – Retail prices for franchise electricity customers from 1 July 2014.

**November 2013**

# Contents

## 1. Executive Summary

As the second largest retailer of electricity and gas in the ACT, the regulated price reviews conducted by the ICRC are important for EnergyAustralia. We appreciate the opportunity to participate in the ICRC's investigation of pricing for the period from 1 July 2014.

We note that ICRC has highlighted the Terms of Reference set by the ACT Government in accurately trying to reflect the cost components which make up the cost of supplying retail customers with electricity in an efficient manner and have aimed to find a balance between price pressures on customers with the longer-term aim of delivering better customer outcomes through the competitive market. However, we have raised concerns that the ICRC appears to consider that the development of competition may not necessarily be achievable in the ACT and are concerned that a determination may sacrifice this objective for short term benefits.

We believe that the ACT should ultimately pursue an agenda of retail price deregulation and that the current price investigation should deliver an outcome which allows competition to further develop in the market under a regulated price cap. In order to do this, it is vital that the cost components of the retail price and appropriately determined and that incentives are provided for new entrants retailers to operate in the ACT.

These and other major points raised in our submission are outlined below.

## 2. Recent developments in the electricity market

In their outline of the ACT electricity retail market, ICRC indicates that only 11 of the 18 retailers licensed to supply customers in 2011-12 had supplied to customers during that time. EnergyAustralia notes that there are number of retailers are servicing only the commercial and industrial customer segment potentially as a result of the continued existence of price regulation in the small customer segment.

This outcome provides a strong indicator that regulated prices have been suppressed to unsustainable levels resulting in retailers, who compete strongly in other jurisdictions, avoiding the regulated segment of the ACT market.

### 2.1. Market Developments

EnergyAustralia notes comments about the relationship between New South Wales and ACT prices. While it is true that ACT is subject to the same wholesale price as New South Wales being part of that NEM region, we caution against an approach to mirror the IPART's calculation of wholesale price as the load shapes in the two jurisdictions can differ markedly. The application of the New South Wales load shape to the ACT market may result in a distortion to the underlying wholesale component of the cost stack.

EnergyAustralia also urges caution in relation to historical average price trends. While the Issues Paper acknowledges that volatility could increase in the future, the Australian Bureau of Meteorology considers that "The chances of the November to January maximum temperature exceeding the long-term median maximum temperature are greater than 60% over most of Australia",[1] indicating an increased possibility that price volatility may be greater than in the recent past.

### 2.2. Jurisdictional regulatory decisions

ICRC's referencing of jurisdictional regulatory decisions provides a useful insight to the various approaches taken by regulators in determining an appropriate regulated rate. EnergyAustralia has made contributions to the consultation processes around these decisions and has both positive and negative views on many aspects of the decisions. We consider that the ICRC's approach of drawing on these previous decisions is a pragmatic step towards achieving the optimal pricing outcome, noting of course the unique circumstances of each jurisdiction will distinguish them from any pricing outcome in the ACT.

**New South Wales**

EnergyAustralia agrees with IPART's view that higher retail operating costs (ROC) were the main cost driver in that jurisdiction. Although we consider that the Customer Acquisition and Retention Costs (CARC) mechanism adopted in New South Wales is a welcome addition to the cost stack, it does not fully address the difference in costs faced by an incumbent versus a new entrant retailer. The IPART final report considers "that the ROC allowance should be estimated based on the costs of retailers that have achieved economies of scale"[2]. Regardless of the attributes of the retailer chosen EnergyAustralia consider that the ROC, and CARC,

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[1] Bureau of Meteorology, National temperature outlook for November to January, Issued 23 October.

[2] IPART, NSW Electricity Regulated Retail Tariffs and Charges – 1 July 2013 to 30 June 2016

should be at a level that will encourage competition from new entrant retailers. Given that competition has yet to develop to the same extent in the ACT, we consider it vital that these inputs should encourage new entrants to compete.

**Queensland**

EnergyAustralia agrees with the QCA's view that energy costs were a key driver for increases in that state and their support for IPART increases in ROC. We consider however, that the allowance for these components are still understated eroding the into the 6.0 per cent retail margin and headroom allowance of 5.0 per cent.

**South Australia**

Although retail pricing in South Australia was deregulated in February 2013, we note that ESCOSA's first annual ministerial report on pricing, reports significant increases in pricing due to the introduction of a carbon price and considerable rises in network costs.

### 2.3. AEMC advice on best practice retail price regulation.

We note that the ICRC proposes to consider the AEMC's report on best practice pricing regulation in its draft report. EnergyAustralia acknowledges that the widespread adoption of a best practice approach to retail pricing in the jurisdictions where pricing has not yet been de-regulated would be a key step towards nationally consistent regulatory frameworks which will reflect the efficient costs of providing retail electricity services and facilitate competition.

While we agree with the need for a consistent approach to price regulation and the AEMC's assessment of items which should be included in the cost stack, namely: wholesale energy costs; transmission and distribution network costs; retail operating costs and retail margin; headroom to facilitate competition; and environmental and jurisdictional schemes, we do not believe that their approach (market based) to calculating wholesale energy costs is appropriate.

EnergyAustralia advocates a Long Run Marginal Cost (LRMC) floor approach on the basis that it represents the least-cost combination of generation plant required to meet forecast load. Under current market conditions the AEMC's market based approach creates an uncertainty and risk for retailers, leading to potentially adverse outcomes for customers if the competitiveness of the market decreases.

As outlined in our submission to the AEMC on this issue, EnergyAustralia believe that a long-term LRMC-based approach to recovering wholesale electricity costs also benefits customers as it leads to a more stable price year-to-year whereas market based approach will result in greater price volatility flowing from spot and contract markets and ultimately, non-cost reflective prices as estimating future wholesale costs is inherently uncertain.

We note that the AEMC acknowledges that a market based approach may not always be appropriate and where this is the case the "Commission considers that a method that approximates the long-term costs of generation (commonly known as a long-run marginal cost (LRMC) approach) should be used to estimate energy purchase costs"[3].

[3] AEMC FINAL REPORT Advice on best practice retail price methodology 27 September 2013

### 2.4 Review of electricity retailer margins in Victoria.

The Issues Paper refers to the Essential Services Commission of Victoria (ESC) Discussion Paper on retailer margins. The ESC paper draws conclusions from analysis conducted by Sinclair Knight Merz (SKM) which EnergyAustralia considers to be deeply flawed. The SKM analysis relies on IPART's calculation of ROC which cannot be meaningfully applied to Victoria given the considerable costs faced by retailers from the ongoing rollout of Advanced Metering Infrastructure. Further, IPART's most recent decisions for 2013-14 shows costs considerably higher than those used in the SKM analysis.

The Energy Supply Association of Australia has criticised SKM for using "their own methodology to calculate wholesale supply inputs. In this respect the report is scarce on detail. It would have been preferable if these inputs were based on a benchmark approach already used by a regulator (i.e. IPART). This would have been more transparent and allowed for comparison with margins in other jurisdictions."[4] It also leads to an appearance of 'cherrypicking' data given that in some aspects of the IPART approach were included in their entirety and others were wholly disregarded.

EnergyAustralia considers that the ESC Discussion Paper based on this analysis should not be relied upon for an accurate representation of the Victorian retail market. We also reject the assertion made that prices "by some estimates...have increased in Victoria by approximately 80 per cent over the five years to 2011-12"[5], given that a more recent report by the ESC indicates that "When residential electricity standing offers are adjusted for inflation, the average increase from 2008-09 to 2012-13 was 52 per cent, or 10.4 per cent per annum."[6]

## 3. The Commission's regulatory approach and pricing model.

### 3.1. Regulatory Approach

EnergyAustralia broadly agrees with the key attributes of the ICRC's regulatory approach.

A Weighted Average Price Cap is the approach which leads to the most cost reflective outcomes and ensures that consumers are protected on the basis that individual tariffs may be rebalanced within the broader suite but reduces the likelihood of substantial restructuring which may adversely impact customer segments.

EnergyAustralia also supports a relatively short, two to three year regulatory period on the basis that it provides the appropriate flexibility for retailers, however, it is vital that the regulatory principles which underpin the regulatory approach remain consistent across regulatory periods in order to relieve some of the uncertainty that a accompanies a short regulatory period.

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[4] Energy Supply Association of Australia, 2013, http://www.esaa.com.au/policy/so_competition_doesnt_work viewed 8 November 2013.

[5] Essential Services Commission, Retailer Margins in Victoria's Electricity Market Discussion Paper, May 2013

[6] Essential Services Commission 2013, Energy retailers comparative performance report—pricing 2012-13, October 2013

A two to three year regulatory period is also consistent with the SCER and COAG objective of having jurisdictions transition to price deregulation[7].

## Cost pass-through arrangements

The existence of an appropriate mechanism to capture unplanned events which may impose additional costs on retailers is a crucial element of any regulatory regime which seeks is seeking to foster competition in the market. Failure to recognise the possibility of unplanned events imposes a level of risk on retailers which provides a major disincentive to participating in the market.

As outlined in our submission to the AEMC's issues paper "Due to the heightened sensitivity to electricity prices and the interest in addressing peak demand and other challenges currently faced by the energy industry we are seeing a greater level of government and regulatory change."[8] A mechanism to recognise costs associated with regulatory change is required and must include appropriate an appropriate materiality threshold and range of trigger events which may include "any change that is made by a statutory or industry body that is outside of retailers' control. This includes decisions made by government, regulators and other government bodies, the tax office and distributors. It should also include events where an expected change is rescinded or substantially revised after costs have been incurred by retailers." [9]

### 3.2 Pricing Model

EnergyAustralia considers that the ICRC's pricing model may deliver a pricing decision which does not accurately reflect the costs of retailing in the ACT market and will ultimately deliver sub-optimal outcomes to consumers.

Although we are broadly satisfied with the figures used in the composition of regulated retail electricity costs for 2013/14 (figure 3.1 of the Issues Paper) we consider the following aspects of the model to be fundamental to the delivery of efficient outcomes.

| Issue | EnergyAustralia Comment |
|---|---|
| Incumbent vs new entrant retailer | Adopting an incumbent retailer approach indicates to EnergyAustralia that the ICRC is pessimistic about the development of competition in the ACT. We consider that the using a hypothetical efficient new entrant electricity retailer to indicate costs will provide cost effective operating costs and indicate to prospective retailers that the ICRC is genuinely seeking to develop a market in which they can compete with the incumbent. |
| Market based vs long run marginal cost | We continue to express a strong belief that a LRMC floor approach is the most appropriate means to calculating energy purchase costs. We have previously contended that "The benefits |

[7] COAG Energy Market Reform - Implementation Plan

[8] EnergyAustralia Response to the issues paper on advice on best practice retail price regulation methodology July 2012.

[9] Ibid

| | |
|---|---|
| | of this approach are that the LRMC is more stable over time than the market cost and this means more regulatory certainty for industry and a more stable price for customers. The major proportion of energy costs faced by retailers are most reflective of LRMC (e.g. physical plant, power purchase agreements) and even market based costs are expected to average out at the level of LRMC over time."[10] Given that investments in both generation and retail are necessarily long term, we consider LRMC to be the only sensible approach. |
| Specific competition allowance | EnergyAustralia supports ActewAGL's assertion that "In line with the AEMC's proposed objective ActewAGL views a 'competition allowance' or 'headroom' as an important part of ensuring that the regulated price outcomes reflect those that would be expected in a competitive market"[11] and once again question the ICRC's commitment to fostering competition in the ACT. |

## 3.3 Cost components of the pricing model.

### 3.3.1 Energy purchase cost

EnergyAustralia welcomes the ICRC's acknowledgement of the difficulties associated setting energy purchase costs and provides the following comments in response to the issues raised. We note with interest the principles outlined in the technical paper relating to simplicity, transparency and predictability; lack of bias; and repeatability. While these principles are laudable it is concerning that accuracy was not included as a high level principle. Although there is an expectation that any model produces accurate output, it should be made explicit that this is a requirement as there is little point in a model which meets the other principles but is inaccurate.

This observation aside, EnergyAustralia considers that the current approach to hedging should more conservative than is currently allowed for. A more conservative and consequently higher cost, hedging strategy is likely to be more typical as retailer seek to limit their exposure to low probability/high impact spot price events. The absence of an explicit volatility allowance in the cost stack will lead to this risk averse approach being the norm in the ACT.

Further, as previously expressed we consider that a long-run marginal costs must be considered in determining energy purchase costs.

An LRMC-based floor approach to the EPC component assists retailers to cover the long-run costs that are still incurred despite the prevailing market conditions. For retailers and generators who make a long-term commitment to the electricity retail and generation, an LRMC-based floor approach is more conducive to the ongoing viability and competitiveness of the industry whilst supporting the long-term interests of customers or to retail competition.

[10] EnergyAustralia Response to the draft determination on NSW regulated retail prices & charges for electricity 2013-16

[11] ICRC Issues paper Retail prices for franchise electricity customers from 1 July 2014, October 2013

As outlined by the AEMC[12], the LRMC-floor approach can be used to support retail competition. The dynamics of a retail business are such that retailers will use their utmost means to attract and retain customers and will not complacently enter into high priced hedges with generators. That is, a retail business is incentivised to 'compete away' any additional 'headroom' in the retail price that is not required to support the minimum level of generation costs required at that point in time.

**Carbon Uncertainty and the forward price.**

The Issues Paper recounts the difficulty of posed by the uncertainty surrounding the price on carbon in its previous investigation. Unfortunately uncertainty around carbon remains a key consideration in the current investigation.

EnergyAustralia agrees with the ICRC's approach to carbon, that is, using the over-the-counter contract approach and allowing for a pass-through if the uncertainty is not resolved. We note however, in its Energy Purchase Cost Information Paper of 2013[13], the difference between ASX futures price and the ICAP Carbon Inclusive price appears to be minimal and we suggest that further in depth analysis should be undertaken to accurately estimate the carbon price.

### 3.3.2 Large-scale Renewable Energy Target and Small-Scale Renewable Energy Scheme.

Although EnergyAustralia advocates for a long-run marginal cost approach to the Large-scale Renewable Energy Target (LRET), the inclusion of an ex-post adjustment is a welcome feature which will ensure that the allowance more accurately reflects retailer costs. A market based approach exposes retailers to considerable risk of volatility resulting from policy uncertainty.

Ideally, we would see a long-run marginal cost applied for the LRET while the Small-Scale Technology Certificates would be priced at $40 to reflect the clearing house price due to the lack of transparency around volumes traded in the secondary market.

### 3.3.3 Energy losses

EnergyAustralia has no issues with the ICRC's comments with regard to energy losses.

### 3.3.4 Energy contract costs

EnergyAustralia has no issues with the ICRC's approach to energy contracting costs.

### 3.3.5 National Electricity Market Fees

EnergyAustralia has no issues with the ICRC's approach to energy contracting costs.

### 3.3.6 Retail Operating Costs

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[12] AEMC, Issues Paper, Advice On Best Practice Price Regulation, June 2013

[13] ICRC, Retail prices for franchise electricity customers 2013–14 Energy purchase cost information paper, April 2013

Failure to appropriately recognise ROC will have the effect of further delaying the advent of genuine competition and ultimately disadvantage consumers.

EnergyAustralia is concerned that the ICRC has developed a pessimistic view towards the growth of competition in the ACT. When considered on a jurisdiction by jurisdiction basis, the ACT market is considerably smaller than many other NEM jurisdictions. The larger jurisdictions however, feature markets within markets in the form of multiple distribution networks many of which are comparable in size to the ACT. Competition exists within distribution zones and it follows that it is able to develop within the ACT. In light of this comparison, EnergyAustralia rejects the notions that competition cannot exist and that diseconomies of scale occur due to the size of the market.

Due to the size of the market however, the economies of scale which do exist are not realised to the same extent as in other jurisdictions and consequently the ROC for the incumbent in the ACT cannot be benchmarked to those in other jurisdictions. Further, limiting ROC to the efficient costs of the incumbent retailer may have a logical appeal on the basis that it reflects the current state of the market, however it impedes the pursuit of competitive outcomes. As outlined above, some economies of scale occur in the ACT and consequently the efficient costs of a retailer supplying in excess of 90% of the small customer market[14] will logically be considerably lower than for a new entrant retailer. The ROC should reflect this in order to encourage new entrants.

The issues paper refers to the QCA and IPART methodologies for making allowance for competition. Although EnergyAustralia has concerns about the extent to which they provide for customer acquisition and retention, the explicit recognition of a component to allow competition through either headroom or a customer acquisition and retention costs (CARC) mechanism above and beyond general operating costs is necessary. We feel strongly that in order to secure optimal outcomes for consumers in the medium to long term it is necessary to allow for acquisition and retention costs in the coming pricing determination.

This allowance wouldn't be required if the customers had no choice of retailer. In a competitive market, Standard Retailers incur significantly higher costs to maintain systems, staff and functions than in a non-contestable market. These costs are ongoing, but are a means to drive investment, and in turn, drive prices down to an efficient level that could not be achieved otherwise. The CARC allowance is therefore not an additional cost when other components of the retail price are driven to lower levels than achievable in a monopoly situation.

It should not be controversial that market-based prices are cheaper than the regulated price. In any competitive market there are always some customers paying more than others. If a choice is made to set up a competitive market, this is one of the corollaries that must be accepted.

### 3.3.7 Energy Efficiency Scheme costs

[14] ICRC Issues paper Retail prices for franchise electricity customers from 1 July 2014, October 2013

As outlined in our submission to the AEMC, EneryAustralia is advocating for a change to the methodology for calculating Energy Efficiency Scheme costs.
"The ACT EEIS is relatively new and the estimation of costs has recently been based on an ICRC methodology using costs supplied by ActewAGL.[15]

Going forward, we would like to see this methodology consider the efficient costs of both tier 1 and 2 retailers. As the scheme outlines different obligations for tier 1 and 2 retailers, the allowance should be set at the level of the tier 1 retailer (ActewAGL)[16], except when the price paid by tier 2 retailers is higher, in which case the tier 2 cost should be used instead. It would be detrimental to competition if the scheme design and the price regulation approach were to prevent tier 2 retailers from recovering their full (efficient) costs under this scheme."[17]

### 3.3.8 Network costs

As network costs are an unavoidable cost for retailers, there must be capacity for direct pass-through. We wish to impress on the ICRC that there is a risk of delays to the finalisation of network determinations, and that the network component must be treated in isolation to other cost components, and passed through in full, meaning that other costs cannot be adjusted to allow for a network result which does not reflect expectations.

### 3.3.9 Retail margin

On the basis that the Commission has previously determined that the research undertaken by IPART and its consultant was appropriate, we consider that a retail margin of at least 5.7 per cent is appropriate (as it has subsequently been deemed by QCA)[18].

A reasonable margin allowance must reflect the risk faced by retailers in the market. There is strong correlation between volume and price, which leads to asymmetric returns for a prudent energy retailer and an assumed margin can be quickly eroded when market conditions do not play out according to forecasts. Should usage per customer be below expectation, a prudent retailer with a fully hedged energy position will have surplus volume. Assuming lower per customer usage is systemic, this will result in excess supply of energy in the market. The retailer will sell its excess energy back into the market, leading to lower wholesale pool prices. This will result in a loss on the surplus energy position. Conversely, if usage is above expectation, the retailer will have a deficit energy position and will need to purchase additional energy from the market, leading to higher wholesale pool prices. The net result will be lower profitability per unit of energy sold.

## 4. Conclusion

EnergyAustralia is generally satisfied with that the ICRC's approach to setting the regulated price will reflect each of the cost components accurately. We are concerned however at the fact that there is now allowance to foster competition in the ACT. We agree with the IPART view that "for … a competitive market to develop while regulation exists, regulated prices

[15] ICRC, Retail Price Adjustment for Franchise Electricity Customers 2013–14, Final Decision, Report 4 of 2013, June 2013, pages 12-13

[16] The majority of electricity customers in the ACT are with incumbent retailer, ActewAGL.

[17] EnergyAustralia Response to the issues paper on advice on best practice retail price regulation methodology

[18] QCA, Final Determination Regulated Retail Electricity Prices 2013 - 14 May 2013

must be high enough to create incentives for retailers to enter the market and compete for customers, and for customers to seek out better offers in the competitive market."[19] In light of this assertion, it is a reasonable expectation that the regulated price will exceed the price paid by customers on market contracts and the view from the ACT Government that "The implication that consumers are required to make a financial contribution to support competition, beyond efficient costs is contradictory"[20] as a naive in its assumption that consumers will not be drawn to the benefits that competition will bring.  We urge this ICRC to strongly consider the development of competition in the ACT in its determination.

[19] IPART, NSW Electricity Regulated Retail Tariffs and Charges – 1 July 2013 to 30 June 2016

[20] ACT Government (2013) 'Advice on best practice retail electricity price methodology – Response to AEMC issues paper', ACT Government, Canberra.