Standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017

ActewAGL Retail response to the Independent Competition and Regulatory Commission Draft Report

28 March 2014

ActewAGL

for you

Contents

1. Introduction

The current price direction for the supply of electricity to franchise customers expires on 30 June 2014. The ACT Government issued terms of reference to the Independent Competition and Regulatory Commission (the Commission) on 20 September 2013 to provide a price direction for a further period, the length of which was at the discretion of the Commission.

The Commission released an Issues Paper on 4 October 2013 and ActewAGL Retail provided a response to that paper on 15 November 2013. The terms of reference was subsequently replaced by a revised terms of reference on 2 February 2014, prescribing a three year period for the price direction.

The Commission released a Draft Report and proposed price direction on 14 February 2014 and invited submissions by 28 March 2014. ActewAGL Retail is providing this submission in response to the Draft Report.

Overall, the stable and predictable regulatory framework applied by the Commission provides the necessary consistency for ActewAGL Retail and customers alike. ActewAGL Retail's main comments on the Draft Report are:

- the downward trend in the energy purchase cost model uplift factor is not consistent with the increasing peakiness of the ACT load requiring the uplift factor to be increased;
- the large-scale generation certificate component of the LRET should be based on the long run marginal cost approach to ensure cost reflectivity;
- the total retail operating cost allowance is insufficient, lower than both the allowances in New South Wales and Queensland, and does not account for lower economies of scale in the ACT;
- a margin of 6% on costs (equivalent to a margin of 5.7% of costs) should be applied to align with the commercial benchmark as applied by IPART and the QCA;
- ActewAGL Retail identifies for consideration the option to set two sets of prices, carbon inclusive and carbon exclusive, as a possible mechanism to facilitate a smooth and efficient price change with any change to the carbon price legislation (i.e. determine two Y-factors); and
- the *price variation triggers* included in the proposed price direction were unexpected and have not been justified. If the Commission prefers a *price variation trigger* for changes to carbon arrangements, ActewAGL Retail considers that further detail on what is intended should be provided.

ActewAGL Retail appreciates the opportunity to comment on the Draft Report and is available to discuss the matters raised in this submission.

2. Form of regulation

In this chapter ActewAGL Retail discusses the form of regulation applied to standing offer prices.

2.1 Weighted average price cap

The Commission's Draft Report proposes to continue to use a weighted average price cap to control regulated electricity tariffs in the ACT. The weighted average price cap is supported as it provides retailers with the flexibility to set individual tariffs and adjust individual tariffs to respond to market circumstances, provided the average percentage change is consistent with the determination.

The Commission's Draft Report proposed two adjustments to the way the weighted average price cap formula is presented to "improve the transparency of the formula".[1] ActewAGL Retail accepts the changes.

2.2 Price variation triggers

In the proposed price direction the Commission unexpectedly added 5 *price variation triggers*[2] which would allow the Commission to initiate a reference for a variation of the price direction.[3] The need for these *price variation triggers* are not discussed[4], and except for the carbon trigger, not mentioned in either the Draft Report nor signalled in the Issues Paper. This is of concern to ActewAGL Retail as the Commission itself has noted "...varying a price direction is no small matter and essentially requires the Commission to undertake the same process it would take when making a price direction."[5]

ActewAGL Retail notes that the Commission's is seeking an "additional safety net"[6] for a change in carbon legislation. If the Commission prefers a *price variation trigger* for changes to carbon arrangements, ActewAGL Retail considers that further detail on what is intended should be provided.

[1] ICRC 2014, *Draft report – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p.15
[2] The 5 triggers are: an act of terrorism, a major natural disaster, a significant change to ActewAGL Retail's financial or corporate structure, an unforeseen or *force majeure* event that severely restricts ActewAGL Retail's ability to provide services or a change/s made on or after 31 May 2014 and before 30 June 2017 to the price on carbon arrangements set out in the Clean Energy Act where the change/s cannot be passed through under Part B and its sub-clauses
[3] Independent Competition and Regulatory Commission Act 1997, Clause 20A(3)(c)
[4] Although the Commission did note that it will list a change in the price on carbon legislation as a price direction trigger event.
[5] ICRC 2014, *Draft report – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p.169
[6] ICRC 2014, *Draft report – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p.25

3. Response to cost components of the Draft Report

3.1 Energy purchase cost

Draft Report

The Draft Report includes significant discussion on the Commission's energy purchase cost (EPC) model. In summary, the Draft Report:

- refined major components of the EPC model;
- dismissed use of the long run marginal cost (LRMC);
- returned to an averaging period of 23 months for the forward price;
- returned to a 12 months averaging period for estimating the emission intensity factor; and
- continued the use of ICAP data to estimate the forward price.

The Commission's Draft Report calculates an EPC allowance of $72.04/MWh, using data until 31 January 2014, an increase of 2.5%. The EPC included a carbon component of $21.99/MWh.

Response to the Draft Report

ActewAGL Retail's preference is for a transparent, stable and open regulatory process that minimises the administrative burden. ActewAGL Retail maintains its position of using the LRMC[7] of generation as a reference point in establishing a deemed purchase cost for electricity. In New South Wales, IPART continues to reference LRMC in its determinations for regulated tariffs.[8] The Commission examined this matter in its Draft Report as well as in its 2010 and 2012 investigations and decided not to use LRMC in determining the energy purchase cost. Accordingly, ActewAGL Retail notes the Commission's preference to maintain, where possible, the current approach to the derivation of EPC for the retail prices for franchise electricity customers.

ActewAGL Retail's response to the Commission's Issues Paper stated:

> *ActewAGL is concerned that the total uplift factor produced by the EPC model has decreased each year since the EPC model was introduced and, that this trend is*

[7] ActewAGL 2009, *Model for determining the energy purchase cost component of the transitional franchise tariff – response to ICRC Issues Paper*, 23 October, pp 4-5
[8] IPART 2013, *Review of regulated retail prices and charges for electricity from 1 July 2013 to 30 June 2016 – Final report*, June, pp. 57-58

> *forecast to continue. This outcome contradicts the trend in ActewAGL's actual hedging costs which have been rising due to the increasing peakiness of the ACT load profile.*[9]

Specifically, ActewAGL Retail encouraged "the Commission to reconsider its 5% assumption by increasing the forward price margin uplift factor (FPMU) to a level that more closely reflects the relationship in the observed data".[10] The Commission's analysis also shows that the FPMU assumption is inadequate.

> *The Commission has extended its data analysis to 2012-13, to match that presented by ActewAGL Retail in its submission. … Based on this analysis, the Commission concurs with ActewAGL Retail's main point that the average difference between the forward price and time-weighted spot price in the last 4 years, at 18.9 per cent, is well above the 5 per cent provided for in the forward price margin. This contrasts with the average difference over the 9-year data period of 6.5 per cent. The other striking point to note is that a clear contango pattern has emerged, with the forward price consistently exceeding the expected spot price.*[11]

However, the FPMU, as it is applied within the EPC model, has the practical effect of not applying appropriate weight to the load ratio for the overall uplift factor. As noted by the Commission:

> *…the uplift factor has indeed trended down in recent years. This has been driven by a fall in the load shape, which with a 95 per cent weighting in the uplift factor formula, has more than offset the increase in the load ratio in recent years.*[12]

The load ratio is increasing as a result of falling average demand whilst maximum demand persists at existing levels. This measure of volume risk is further underlined by new maximum load ratios being observed in all of the last 4 quarters of available data for the ACT load profile. Despite evidence put forward and the Commission agreeing that the overall uplift factor is decreasing, the Commission did not change its approach to calculating the uplift factor in the Draft Report. This is in contrast to the Commission's statement in its 2010 final technical paper that:

> *…the Commission explicitly determined that it would take a precautionary approach to estimating the purchase cost of electricity.*[13]

---

[9] ActewAGL, Response to the ICRC Issues paper – retail prices for franchise customers from 1 July 2014, November 2013, p 13

[10] ActewAGL, Response to the ICRC Issues paper – retail prices for franchise customers from 1 July 2014, November 2013, p 15

[11] IPART 2013, *Review of regulated retail prices and charges for electricity from 1 July 2013 to 30 June 2016 – Final report*, June, p51

[12] IPART 2013, *Review of regulated retail prices and charges for electricity from 1 July 2013 to 30 June 2016 – Final report*, June, p 46

[13] ICRC 2010, *Final Technical Paper – The Energy Purchase Cost Component of the TFT 2010-12*, March, p 22

and:

> *the AC cost will be changed to permit the cost recovery of a conservative hedging strategy by a retailer (namely that swaps are purchased for maximum load)*[14]

ActewAGL Retail does not agree that the approach taken by the Commission to the uplift factor is either precautionary or models a conservative strategy[15]. The decreasing trend in the uplift factor, combined with a maximum load that has not fallen as much as the average load in recent years has resulted in an increased load ratio. Retailers require a higher hedge level (and incur higher costs to cover off for the increased difference between the 'normal' base load and the peak load). This is an unsustainable trend and illustrates how the Commission's EPC model does not reflect market movements.

In conclusion, ActewAGL Retail considers that the FPMU is presently undervalued at 5%. In the absence of a more robust method of evaluation, the Commission should increase the FPMU to at least its observed average of 6.5% since 2004 to represent the forward price margin for the duration of the 3 year price direction.

Over the counter prices and the carbon cost

The Commission's continued use of over-the-counter prices from ICAP in the Draft Report is supported by ActewAGL Retail.

In relation to the estimation of the carbon cost, ActewAGL Retail accepts the Commission's Draft Report to rely on 365 days averaging period with regard to the emissions intensity factor prior to 31 May in each year and its method of calculating the cost of carbon as set out in the price direction[16].

3.2 LRET and SRES costs

ActewAGL Retail's response to the Commission's Issues Paper suggested that the large-scale Renewable Energy Target (LRET) cost allowance be based on a long run marginal cost approach. However, should the Commission be predisposed towards a "market-based" model it should continue to:

1. Reference publically available closing prices of large-scale generation certificate traded in a liquid market;
2. Incorporate retailer holding costs (of at least 10%); and
3. Make appropriate allowances to recover costs associated with volume risk, liquidity risk, delivery risk and regulatory risk, and operational administration costs.

[14] ICRC 2010, *Final Technical Paper – The Energy Purchase Cost Component of the TFT 2010-12*, March, p 36
[15] ICRC 2010, *Final Technical Paper – The Energy Purchase Cost Component of the TFT 2010-12*, March, p 36
[16] ICRC 2014, *Proposed Price Direction – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p.8

ActewAGL Retail maintains that the current market based approach used by the Commission does not fully address the volume, liquidity and regulatory risks presently observed in the small-scale technology certificate (STC) market.

Since the Draft Report the final Renewable Power Percentage (RPP) and Small-scale Technology Percentage (STP) values for 2014 have become available. Consistent with the Commission's methodology, ActewAGL Retail has calculated an adjustment factor of $0.34/MWh for financial year 2013/14 to be included in the financial year 2014/15 prices.

ActewAGL Retail also notes that the Clean Energy Regulator (CER) has ceased providing non-binding estimates of the RPP for future years. For 2015, ActewAGL Retail considers that the RPP of 10.52% should be used consistent with previous indications. Until the RET review has been completed it is not possible to know what the future targets might be. ActewAGL Retail therefore suggests that this be discussed further once more information becomes available.

3.3 Energy losses

The Commission has changed its methodology to estimate energy losses for 2014/15. ActewAGL Retail accepts the change to the energy loss equation to apply the distribution loss factor on green cost and NEM fees, while maintaining the distribution and transmission loss factors on the EPC.

ActewAGL Retail notes, however, in the current determination (2012-2014), the loss factor applied to the EPC was ActewAGL Distribution's Distribution Loss Factor times the weighted transmission loss factor for energy from the Canberra and Fyshwick connection points. In its Draft Report for 2014/15, the Commission has calculated a loss factor applied to the EPC from only the Canberra connection point.

ActewAGL Retail considers the most appropriate approach is to use the weighted transmission loss factor for both Canberra and Fyshwick to the EPC, and to include Williamsdale should a separate loss factor become available.

3.4 Energy contracting costs

ActewAGL Retail confirms that the existing method of adjusting this cost component to reflect the change in the CPI is sufficient and supports the Commission's approach.

3.5 National Electricity Market fees

ActewAGL Retail accepts and supports the Commission's approach to adjusting NEM fees, by way of an annual CPI adjustment.

3.6 Retail operating costs

For retail operating costs (ROC) the Commission proposed the following in its Draft Report:

- a step up in the per MWh allowance for 2014/15 to match the value had the Commission continued with its per customer adjustment since 2007/08;
- an adjustment to the allowance each year by the change in the consumer price index; and
- to not make any adjustment for economies of scale.[17]

The Commission has made this proposed price direction on the basis that it "is not convinced of the need to further adjust the retail operating cost allowance to reflect any potential cost disadvantage associated with economies of scale."[18]

The Commission's "step-up" in the ROC allowance is a CPI adjustment to the Commission's original allowance per customer, rather than in per MWh terms. The allowance provided remains lower than those in other jurisdictions, such as New South Wales and Queensland. In these other jurisdictions the ROC has been adjusted over the years in order to reflect genuine cost movements. It is disappointing that the Commission has not acknowledged either the issues surrounding economies of scale apparent in the ACT market or ActewAGL Retail's discussion on relative costs in its submission to the Issues Paper.[19]

ActewAGL Retail is concerned that the Commission's discussion supporting its draft decision, to make no allowance for economies of scale in setting the benchmark efficient operating cost, is based on inconclusive analysis.

The Commission uses data on the customer bases of retailers operating in Victoria to cast doubt on whether the ACT customer base is large enough to generate similar economies of scale. It makes specific reference to two retailers with a similar number of Victorian electricity customers to the ACT customer base, Australian Power and Gas and Simply Energy. This comparison is not valid since the total number of electricity and gas customers served by these retailers nationally is around triple the ACT customer base at around 354,000[20] and more than 400,000, respectively.[21] It therefore cannot be concluded that the ACT customer base is large enough to enable an efficient retailer to operate with the same economies of scale as larger retailers operating in larger markets. ActewAGL Retail also notes that ACT customer base is less than one twentieth the size of Origin Energy's.[22]

---

[17] ICRC 2014, *Draft report – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p.78

[18] ICRC 2014, *Draft report – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p.77

[19] ActewAGL 2013, *ActewAGL Retail response to the ICRC's Issues Paper: Retail prices for franchise electricity customers from 1 July 2014*, November, p.21

[20] Australian Power and Gas Annual Report 2012-13, p.6

[21] http://simplyenergy.com.au/about-us/ accessed 3 March 2014

[22] Origin Energy's business snapshot indicate they have 4.3 million electricity, gas and LPG customers across Australia. See: http://www.originenergy.com.au/2/About, accessed 28 March 2014.

While ActewAGL Retail recognises that the Commission has increased the retail operating cost allowance, the increase is inconsistent with and lower than outcomes in other jurisdictions. For example, IPART has noted "information provided to us suggests that costs for retail electricity have, in recent years, risen faster than CPI"[23] and adopted a 33% increase in ROC for 2013/14 over its previous allowance in 2010. This increase was adopted by the Queensland Competition Authority in its decision for 2013/14 prices.[24] ActewAGL Retail also provided information to the Commission in its response to the Issues Paper[25] and in previous submissions that underlying cost components of its cost base have been increasing at rates greater than CPI over the ten year period since the Commission originally set the basis for its ROC.

In short, ActewAGL Retail does not consider that the Commission's Draft Report provides a sufficient increase in the allowance for an efficient and prudent retailer to fully recover this cost.

ActewAGL Retail further notes that the Commission has discussed in detail the merits of a competition allowance in electricity retailing.[26] The Commission has acknowledged that ActewAGL Retail has not sought a competition allowance.[27] Rather, ActewAGL Retail continued to propose the inclusion of costs necessary to retain customers in the face of the competitive environment and the threat of entry by rival retailers.

ActewAGL Retail has experienced serious attempts by rival retailers to win customers and actively responded, as noted by the Commission,[28] to retain its customer base. There is a clear cost of these responses. With retailers authorised and positioned to enter the ACT market, such events are inevitable. Under the Commission's proposed price direction, ActewAGL Retail is not recovering legitimate and appropriate commercial costs of providing retail services in a competitive market.

In relation to deregulating the market, the ACT Government is a signatory to the Australian Energy Market Agreement (AEMA) thereby committing to remove "retail price regulation for electricity and natural gas where effective retail competition can be demonstrated."[29] As noted

---

[23] IPART 2013, *Review of regulated retail prices and charges for electricity from 1 July 2013 to 30 June 2016*, June, p. 107
[24] QCA 2013, *Final Determination Regulated Retail Electricity Prices 2013-14*, May, p. 46
[25] ActewAGL 2013, ***ActewAGL Retail response to the ICRC's Issues Paper: Retail prices for franchise electricity customers** from 1 July 2014*, November, p.21
[26] ICRC 2014, *Draft report – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p.97
[27] On page 138 in its Draft Report the Commission correctly noted that "ActewAGL Retail made no comment about a specific competition allowance to promote competition. It maintained its view presented in previous price investigations that customer acquisition and retention activities impose legitimate costs in a competitive electricity market that should be incorporated in the benchmark cost build-up by the Commission".
[28] ICRC 2014, *Draft report – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p.97
[29] AEMA 2013, clause 14.11

by the Commission, this was accompanied by a further commitment for jurisdictions to work towards effective competition in retail electricity markets where it does not exist.[30]

ActewAGL Retail reiterates that retail price regulation should be removed, and has noted the potential benefits to customers of a competitive market.[31] The maintenance of a regulated price in a competitive environment stifles competition, product innovation and delivers less than optimal outcomes to consumers.

3.7 Energy Efficiency Improvement Scheme costs

ActewAGL Retail's approach to implementing the Energy Efficiency Improvement Scheme Costs (EEIS) was to design the program to ensure that the new obligations were met in the most efficient and effective way. To avoid unnecessary costs and apply best practice, it was considered essential to undertake consultation with product and service providers and consider regulatory performance publications from other jurisdictions who have implemented similar schemes. Program evaluation and design engagement between ActewAGL Retail and the ACT Government Environment and Sustainable Development Directorate (ESDD) commenced in July 2012.

A public presentation from the Essential Services Commission of Victoria indicates that during 2012 lighting and standby power controllers were the most effective for creation of Victorian Energy Efficiency Certificates and consequently carbon dioxide equivalent abatement. ActewAGL Retail focussed on eligible activities that have been recognised in other schemes as being relatively easy to implement and those that do not require a trade certificate.

Following consultation with other jurisdictions, as outlined extensively in previous submissions, ActewAGL Retail undertook a rigorous competitive tender process to find a contractor to conduct field activities. The 17 tenders received were carefully assessed based on their proposed solution, price, previous experience, risk and standard of submission. One contractor emerged as the preferred or equal preferred choice on all of these criteria, including the basis of value for money and cost effective delivery. The competitive tender between quotes ensured a commercial and efficient outcome. These costs represent over 85% of the total program costs.

On 30 January 2013, following finalisation of the EEIS requirements, ActewAGL Retail provided the EEIS Administrator (the Administrator) with its 2013 Compliance Plan. The document outlined, for the period 1 January 2013 to 31 December 2013, the resources, systems and processes and eligible activities to be implemented by ActewAGL retail to ensure that all obligations and responsibilities required by the Energy Efficiency (Cost of Living) Improvement Act and the Record Keeping and Reporting Code of Practice (Part 4) are met.

[30] ICRC 2014, *Draft report – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p. xv

[31] ActewAGL, Response to the ICRC Issues paper – retail prices for franchise customers from 1 July 2014, November 2013, p 3

On 5 February 2013, the Administrator informed ActewAGL Retail that the plan has been assessed and indicated that the obligations and responsibilities required by the Act will be met. The Administrator also provided comment on the eligible activities ActewAGL Retail proposed. Similarly, on 12 February 2014 the Administrator reviewed the Compliance Plan (attached) for the period 1 January 2014 to 31 December 2014 and found that the obligations and responsibilities required by the Act will be met. The 2014 Compliance Plan is included in attachment 1.

As part of the 2013/14 retail price reset in May 2013, ActewAGL Retail provided detailed substantive information of the makeup of the EEIS costs and information on their prudency and efficiency. ActewAGL Retail provided further substantive information in response to an information request of the Commission on 26 November 2013.

The Commission's Assessment of Efficiency and Prudence

ActewAGL Retail supports the Commission's proposal to take an ex ante approach to the prudence and efficiency assessment of ActewAGL Retail's forecast expenditure on the energy efficiency scheme for 2014/15 and subsequent years of the regulatory period. The Commission's Draft Report cited examples of evidence provided by ActewAGL Retail to justify that its processes result in an efficient outcome. The Commission concluded that it is satisfied that ActewAGL Retail undertook a robust expenditure decision making process to meet its EEIS compliance requirements[32] and that ActewAGL Retail's proposed abatement costs for the EEIS are efficient.[33] The Commission also considered that the expenditure was prudent as ActewAGL Retail was legally obligated to conduct the EEIS.[34] ActewAGL Retail supports this conclusion.

Future Uncertainty

ActewAGL Retail's November response to the Commission's Issues Paper noted that there is substantial uncertainty regarding the future cost of the EEIS.[35] At the time, it was unknown whether the abatement factors for AV and IT standby power controllers would change. In December 2013 the EEIS Administrator notified ActewAGL Retail that the current value of standby power controllers will be maintained at the current value until 30 June 2014. A depreciation plan will commence 1 July 2014 until 31 December 2014 and from 1 January 2015 the abatement factor will be reduced to 0.55 and 0.62 for AV and IT standby power controllers respectively.

The impact of the change to abatement factors for 2014/15 cannot at this stage be calculated by ActewAGL Retail for two reasons:

- The EEIS Administrator has not yet developed a depreciation plan to commence on 1 July 2014; and

[32] ICRC 2014, *Draft report – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p.152
[33] ICRC 2014, *Draft report – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p.154
[34] ICRC 2014, *Draft report – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p.151
[35] ActewAGL 2013, *Response to the ICRC Issues Paper – retail prices for franchise customers from 1 July 2014,* p. 28

- ActewAGL Retail is still investigating the cost effectiveness of alternative programs to replace the use of standby controllers.

Accordingly, substantial uncertainty regarding the future cost of the EEIS remains.

In light of the above, ActewAGL Retail supports the Commission's proposal for it to maintain its current approach to estimating the EEIS compliance costs for the next regulatory period, with the addition of an ex ante prudence and efficiency assessment of expected abatement costs. The mechanism, set out in the Draft Report, appropriately deals with the current regulatory uncertainty and, as shown by experience in the current regulatory period, is a practical approach. ActewAGL Retail proposes to notify the Commission of any changes in cost, with supporting evidence, as part of the annual reset process.

3.8 Network costs

Consistent with the established method, ActewAGL Retail supports the Commission's proposed price direction to pass through network costs as determined by the Australian Energy Regulator (AER). ActewAGL Retail will submit actual network costs as determined by the AER.

3.9 Retail margin

The inclusion of a retail margin allowance in electricity prices is to compensate retailers for systematic risks. As stated by the Commission, the margin provides the return the incumbent retailer earns on investment it must undertake to provide retail services.[36] The term 'margin' is used as an estimate of profit divided by sales, expressed as an earnings before interest, tax, depreciation and amortisation (EBITDA) margin.[37] It is intended to be an estimate of an appropriate EBITDA margin for the retailer to earn, rather than a 'mark-up' on its efficient costs.

In the response to the Issues Paper, ActewAGL Retail proposed that a retail margin of at least 6% should apply in the ACT market and be applied in a manner consistent with previous determinations.[38]

In proposing this, ActewAGL Retail noted that it is essential for the Commission to ensure it is comparing 'like for like' applications of the retail margin. It is important to explain the difference between applying a retail margin *on* costs (mark up) and applying a retail margin *of* costs (margin as a percentage of sales). The following illustrative example will assist in this explanation.

Table 3.1 shows the draft composition of costs for the regulated retail electricity price adjustment for 2014-15 under two scenarios. Scenario 1 shows the approach currently

[36] ICRC 2014, *Draft report – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p.86
[37] SFG 2013, *Estimation of the regulated profit margin for electricity retailers in New South Wales*, p.4
[38] ActewAGL 2013, *ActewAGL Retail Issues Paper response to the Independent Competition and Regulatory Commission* p.29

adopted by the Commission, whereby the retail margin is effectively applied as a 'mark-up' *on* total energy, retail and network costs. Scenario 2 shows the approach as intended by SFG and applied by IPART and the QCA, whereby an EBITDA margin is estimated as a percentage of total sales (margin as a percentage of sales).

As can be seen in table 3.1, the Commission calculated a margin allowance of $10.98 per MWh by applying a margin of 5.7% on total energy, retail and network costs. This translates into a 5.4% EBITDA margin *of* total costs. This approach is not consistent with how SFG calculated EBITDA margins (margin as a percentage of sales) or how IPART and the QCA have applied the retail margin, as shown in scenario 2.

Table 3.1 Application of the retail margin

	2014-15 $MWh
Scenario 1 – margin applied as a mark-up on costs	
total energy + retail +network costs	$192.59
ICRC retail margin (mark up)	= $192.59 x 5.7% = $10.98
Total costs	$203.57
Actual EBITDA margin (*of* costs)	**5.4%**
Scenario 2 – margin applied as an EBITDA margin (of costs)	
total energy + retail +network costs	$192.59
Total costs including the margin	= $192.59/(1 – 5.7%) = $204.23
Retail margin (*of* costs)	=$11.64
Actual EBITDA margin (*of* costs)	**5.7%**
Retail margin *on* cost terms (mark-up)	**= $11.64 / $192.59 = 6.0%**

ActewAGL Retail considers that it faces a comparable level of systematic risk to retailers in NSW and Queensland. Therefore, in acknowledgement of the extensive analysis undertaken by SFG for IPART, ActewAGL Retail considers it appropriate for the Commission to apply the outcomes of the analysis undertaken by SFG to reflect outcomes consistent with the approach of IPART and the QCA. This would be achieved either by applying the retail margin such that it is consistent with IPART and the QCA (that is *of* costs) or adjust the retail margin to reflect the change in approach to at least 6% as proposed by ActewAGL Retail.[39]

[39] An EBITDA margin of 5.7% is approximately equivalent to an *on costs* margin of 6.04%

4. Pass-through arrangements

In response to the Commission's Issues Paper, ActewAGL Retail submitted that the existing pass through arrangements should remain, with the addition of a flexible carbon policy pass through, to ensure that retailers do not bear the risk of unforeseeable and uncontrollable costs.

The Commission has proposed to include three pass through events for the next regulatory period: a regulatory change event, a tax change event and a carbon price event. The first two are similar to the existing pass through events. Generally, ActewAGL Retail supports the Commission's proposed approach but suggests three changes in relation to timing and Commission initiated pass through claims and the materiality threshold.

4.1 Timing limitations for a pass through event

The Commission has proposed to limit consideration of the regulatory and tax change pass through events to annual reset process to "reduce the administrative burden associated with the additional effort required for within-year reviews."[40] Requiring all pass through events be lodged as part of the annual reset process removes a potential mechanism to ensure prices reflect the costs of unforeseen events that are beyond ActewAGL Retail's control as soon as possible. ActewAGL Retail considers that the Commission should continue to allow pass through applications to be lodged throughout the regulatory period.

4.2 Commission-initiated pass through claims

ActewAGL Retail understands the Commission's intention for a symmetric pass through mechanism. Clause 8.1.4 of the proposed price direction states that the Commission may initiate pass through events without an application from ActewAGL Retail. The initiation and determination by the Commission will then occur as if ActewAGL Retail made the application for the pass through event.[41]

ActewAGL Retail is concerned that no provision has been put in place to provide reasonable and adequate notice that the Commission is considering a pass through claim or to allow ActewAGL Retail to respond to any potential claim. ActewAGL Retail considers that a pre-determined process should be established, such that:

- ActewAGL Retail is provided sufficient notice that the Commission has initiated a pass through event;
- Material that is relevant or to be relied on in the Commission's decision is disclosed to ActewAGL Retail; and

[40] ICRC 2014, *Draft report – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p.23
[41] ICRC 2014, *Proposed Price Direction – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p.9

- ActewAGL Retail is given an opportunity to provide a submission responding to the material before the Commission.

4.3 Materiality threshold

In the Draft Report the Commission considered a range from 0.25% to 1% of revenue to apply as a materiality threshold for any pass through claim. The Commission noted that it's rationale for introducing a specific materiality threshold was to avoid introducing administrative and regulatory burdens in addition to annual price resets and limit pass through events with a substantial cost impact.

ActewAGL Retail considers that the administrative burden of a pass through claim is a sufficient incentive not to seek to pass through costs unless they are material. All of the pass through events are related to events outside of ActewAGL Retail's control. Accordingly, it would be unreasonable for a specific threshold to apply as prices cannot adjust to reflect changes in cost occurring in an open market environment. ActewAGL Retail maintains that a specific materiality threshold is unnecessary and may unfairly deny a legitimate claim for costs that are unforeseen and out of control of the retailer.

4.4 Carbon price repeal

In its Draft Report, the Commission proposes that, in response to a removal of the carbon price, it would calculate a percentage adjustment factor that would be applied to all components of ActewAGL Retail's standing offer prices.[42] The Commission's proposal assumes that the carbon price is applied evenly on a proportional basis on all tariffs. However, that is not the case. ActewAGL Retail has identified the following issues with the method set out in the Draft Report:

- In the schedule of charges, the carbon price is applied only to energy (consumption) charges.
- The maximum demand and capacity charges are network charges that are passed through to ActewAGL Retail. Those charges do not include a carbon price component and should remain unchanged.
- For the remaining consumption charges, the carbon price has been applied evenly on energy charges at around 2 c/kWh.
- The fixed supply charges do not include any carbon price component. Hence, the potential removal of the carbon price should not alter the fixed charges.

Therefore, when the carbon price is removed it should not be removed on a proportional basis. For example, the carbon price reduction passed through to the general time of use peak time energy charge at 32c/kWh should be approximately 30c/kWh after a repeal of the carbon

[42] ICRC 2014, *Draft report – standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017*, February, p.170

price, a reduction of about 6%. For the off-peak (1) night tariff at 10 c/kWh should be reduced to approximately 8c/kWh, a reduction of 20%.

For retail tariffs to apply from 1 July 2014, ActewAGL Retail proposes that further discussion is needed with the Commission as one option in its final price direction would be to determine a carbon price inclusive and a carbon price exclusive Y-factor. This would allow ActewAGL Retail to determine and seek approval of two sets of prices:[43]

- one set to apply while ActewAGL Retail continues to pay the carbon price on the energy it purchases; and
- a second set to apply if the carbon price is removed from the wholesale cost of energy.

This approach would be consistent with the Commission's application of a weighted average price cap form of price control. The Queensland Competition Authority (QCA) has proposed a similar approach in their Draft Report.[44]

Noting the significant amount of uncertainty in relation to the specifics behind a repeal of the carbon price, the Commission must ensure that the final decision can address different approaches that may be taken by the Government. ActewAGL Retail believes that the above approach could better accommodate a repeal of the carbon price from a specific date in the next financial year. ActewAGL Retail would be pleased to work closely with the Commission to develop workable arrangements that would ensure a smooth transition. It is important to note that any changes, particularly in systems, will take time to implement.

[43] The Queensland Competition Authority (QCA) has proposed a similar approach in their Draft Report, See: QCA 2013, Draft Determination Regulated Retail Electricity Prices 2014-15, December, p. iv.
[44] QCA 2013, Draft Determination Regulated Retail Electricity Prices 2014-15, December, p. iv.

5. Annual price resets

The proposed price direction sets out the Commission's intentions for the reset of prices for 2015/16 and 2016/17. The method is similar to the current price reset applied for the 2012-14 period. ActewAGL Retail proposes that the standing offer price reset parameters should be set such that:

- Network costs passed through to customers as allowed by the AER and applied by ActewAGL Retail to the franchise customer load, and subsequently verified by the Commission;
- EPC calculated consistent with the model used for 2014/15, using updated data, with potential adjustments only for the impact of the change in legislation of carbon price on energy prices if this change is to apply from 1 July 2015;
- LRET and SRES costs calculated using the principles of the methodology as set out in section 3.3.2;
- Energy contracting costs, NEM fees and total ROC increased by CPI;
- Energy losses adjusted for the relevant AEMO published loss factors;
- ActewAGL Retail's forecast of efficient and prudent EEIS costs to be passed through;
- Retail margin remain fixed at a market reflective level of at least 6%; and
- Adjustments for any approved pass through applications.

Abbreviations and acronyms

AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
CER	Clean Energy Regulator
Commission, ICRC	Independent Competition and Regulatory Commission
CPI	Consumer price index
EEIS	Energy Efficiency Improvement Scheme
EPC	Energy purchase cost
ERAA	Energy Retailer Association of Australia
ESAA	Energy Supply Association of Australia
ESCV	Essential Services Commission of Victoria
FPMU	Forward price margin uplift
FRC	Full retail contestability
HC	Hedge cost
IPART	Independent Pricing and Regulatory Tribunal (NSW)
LGC	Large-scale Generation Certificate
LR	Load ratio
LRET	Large-scale Renewable Energy Target
LRMC	Long run marginal cost
LS	Load shape
MWh	Megawatt hour
NECF	National Energy Customer Framework
NEM	National Electricity Market
OTTER	Office of the Tasmanian Economic Regulator
QCA	Queensland Competition Authority
ROC	Retail operating cost
RPP	Renewable Power Percentage
SRES	Small-scale Renewable Energy Scheme
STC	Small-scale Technology Certificate
STP	Small-scale Technology Percentage
TFT	Transitional franchise tariff
TOR	terms of reference

Attachment 1 – The EEIS Compliance Plan 2014 (confidential)