



independent competition and regulatory commission

Final Decision
Retail Prices
for Non-contestable
Electricity Customers,
2009–2010

Report 3 of 2009
June 2009

The Independent Competition and Regulatory Commission (the Commission) was established by the *Independent Competition and Regulatory Commission Act 1997* to determine prices for regulated industries, advise government about industry matters, advise on access to infrastructure and determine access disputes. The Commission also has responsibilities under the Act for determining competitive neutrality complaints and providing advice about other government-regulated activities. Under the *Utilities Act 2000*, the Commission also has responsibility for licensing utility services and ensuring compliance with licence conditions.

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Foreword

The Attorney-General has made a reference to the Independent Competition and Regulatory Commission (the Commission) to provide a price direction for the supply of electricity to non-contestable franchise ('transitional franchise tariff' or TFT) customers for the period from 1 July 2009 to 30 June 2010. The minister's reference dated 23 December 2008 is made under sections 15 and 16 of the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act).

This reference makes the fifth price control arrangement for TFT customers following the introduction of full retail contestability (FRC). The four regulatory periods and the maximum regulated transition tariffs are listed below:

- A regulated maximum tariff was applicable to TFT customers for a period of three years from 1 July 2003 to 30 June 2006 (this included a 4.5% real increase in the first year and a 0.5% real increase for the remaining two years).
- The regulated maximum tariff applicable to TFT customers was extended for a period of one year from 1 July 2006 to 30 June 2007 (there was a zero real increase in that year).
- The regulated maximum tariff applicable to TFT customers was further extended for a period of one year from 1 July 2007 to 30 June 2008 (there was a 12.9% real increase in that year).
- The regulated maximum tariff applicable to TFT customers was extended once more for a period of one year from 1 July 2008 to 30 June 2009 (there was a 4.67% real increase in that year).

The current reference requires a regulated maximum tariff applicable to TFT customers for a further period of one year from 1 July 2009 to 30 June 2010.

In developing the price direction for the regulated maximum TFT applicable to customers eligible for these transition arrangements for the period from 1 July 2009 to 30 June 2010, the Commission is required to have regard to a number of matters, including:

- the requirements of section 20 of the ICRC Act
- the need to have a final report in sufficient time to allow ActewAGL Retail to make necessary administrative arrangements to its billing system and to provide information on the new tariff to customers.

This report sets out the Commission's final decision and price direction and reasons for the conclusions reached.

Paul Baxter
Senior Commissioner
June 2009

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1 Introduction

This chapter:

- discusses the background to the regulation of retail prices for non-contestable franchise ('transitional franchise tariff' or TFT) electricity customers in the ACT
- summarises the current investigation's terms of reference
- provides an overview of the retail electricity market in the ACT
- sets out the Commission's proposed timeline for the current investigation.

1.1 Background

In the ACT, the retailing of electricity to customers consuming more than 160 megawatt hours (MWh) per year (predominantly large businesses) was made contestable from 1998. The electricity supply industry in the ACT was opened for retail competition to customers consuming more than 100 MWh/year (mainly medium-sized businesses) from 1 July 2001.¹

Following the Commission's recommendation that full retail contestability (FRC) be introduced for all customers in the ACT², the government opened the market for customers using less than 100 MWh/year (those customers with an annual electricity bill of less than about \$13,000) to competition from 1 July 2003.³ This allowed small businesses and households to select the electricity retailer of their choice.

While the government decided to open the market to all customers, certain transitional arrangements were maintained. These were intended to ensure that customers consuming less than 100 MWh/year were able to remain on non-negotiated contracts with the incumbent retailer, ActewAGL Retail, if they did not wish to enter into a negotiated contract with one of the electricity retailers licensed in the ACT.

In December 2002, the Commission received a reference from the Treasurer, instructing it to provide a price direction for the supply of electricity to franchise customers (i.e. those on non-negotiated contracts) for a transitional period from 1 July 2003 to 30 June 2006. The Commission's first price direction was made at the time of the initial opening of the retail electricity market to competition for small customers (those consuming less than 100 MWh/year). Thus, at the beginning of that price direction, all small customers were on the regulated retail tariff.

The initial reference to the Commission instructed it to provide a three-year price direction. The Commission termed the resulting tariff from that price direction the 'transitional franchise tariff' (TFT). Customers who chose to remain on the regulated tariff are called 'franchise customers', and customers who opted for a negotiated tariff with an alternative retailer or with the incumbent retailer are called 'non-franchise customers'.

¹ Utilities (Non-Franchise Electricity Customers) Declaration 2001 (Disallowable instrument 2001-93).

² ICRC, *Final report: Full retail contestability in electricity in the ACT*, July 2002.

³ Utilities (Non-Franchise Electricity Customers) Declaration 2003 (No. 1) (Disallowable instrument 2003-20).

The Commission's first price direction allowed a 4.5% real increase in the franchise maximum tariffs for the first year and a 0.5% real increase for each of the remaining two years.⁴ The Commission made this determination based upon a rigorous examination of the costs incurred by ActewAGL Retail in providing retail electricity services to franchise customers. That price direction also allowed for a variety of pass-through events, including changes in network operating costs.

During this first designated transitional period, the government undertook to consider whether these arrangements would need to be extended for an additional period. In that investigation, the Treasurer sought advice from the Commission on the need for the transitional arrangements to continue and, if so, the form of price protection that should apply to franchise contracts in future and the duration of such protection.

The Commission issued its final decision in April 2006. In that report, the Commission recommended that the TFT cease to exist. The Commission concluded that there was evidence that the retail market in the ACT was sufficiently competitive to support the removal of the TFT.

However, the Commission was concerned at that time that the removal of the TFT could affect the status of the standard customer contract that covered all franchise customers by default. Thus, the Commission determined that the TFT should continue for the period from 1 July 2006 to 30 June 2007 to allow the ACT Government to make any necessary legislative changes to preserve the conditions of the standard customer contract.

The Commission's final decision, released in April 2006, allowed for a consumer price index (CPI) increase in franchise revenue for the period from 1 July 2006 to 30 June 2007.⁵ Thus, customers could expect no real increase in prices at that time. The final decision did not contain a complete build-up of the costs of retail electricity services in the ACT. The Commission's analysis at that time was that the offer of only a CPI adjustment to franchise revenue was reasonable, and that the CPI increase for 2006–07 represented an appropriate balance between the retail margin to sustain a competitive market and a reasonable outcome for consumers.

Before the second regulatory period expired on 30 June 2007, the Commission received a further reference from the Attorney-General⁶, instructing the Commission to provide a price direction for the supply of electricity to franchise customers for a further transitional period from 1 July 2007 to 30 June 2008.⁷ In undertaking that review, the Commission reverted to an analysis based on a rigorous examination of the costs incurred by ActewAGL Retail in providing retail electricity services to franchise customers. This was required because of the length of time since the first cost study during early 2003, coupled with evidence of large changes in wholesale electricity charges, which were a major cost input for ActewAGL Retail.

In its final report in June 2007, the Commission allowed for a 12.9% real increase in the franchise maximum tariff for the period from 1 July 2007 to 30 June 2008.⁸ The Commission also noted its concern that the reference required the TFT to be set for a 12-month period only. Then current

⁴ ICRC, *Final determination: Investigation into retail prices for non-contestable electricity customers in the ACT*, Report 5 of 2003, May 2003.

⁵ ICRC, *Final report: Retail prices for non-contestable electricity customers*, Report 8 of 2006, April 2006.

⁶ Under the ACT Government's administrative arrangement orders, the Attorney-General assumed portfolio responsibility for the *Independent Competition and Regulatory Commission Act 1997* in 2006.

⁷ ICRC (Price Direction for the Supply of Electricity to Franchise Customers) Terms of Reference Determination 2007 (No. 1) (Disallowable instrument DI2007-96).

⁸ ICRC, *Final decision and price direction: Retail prices for non-contestable electricity customers*, Report 7 of 2007, June 2007.

market data showed a large increase in the electricity pool price resulting from supply–demand imbalances in the wholesale electricity market, which in turn led to increases in energy purchase costs. The short reference period constrained the Commission in how it was able to allow cost changes resulting from that imbalance to be passed through to franchise customers by the incumbent retailer. This meant that the Commission was unable to transition any price changes over a longer period, as was decided in other jurisdictions—for example, the Independent Pricing and Regulatory Tribunal (IPART) in NSW and the Essential Services Commission of South Australia (ESCOSA)—at around the same time.

A further reference was received by the Commission on 7 February 2008 to determine any change to the TFT for the period from 1 July 2008 to 30 June 2009. In response, the Commission undertook another detailed build-up of the costs incurred by ActewAGL Retail in providing electricity to franchise customers. The final report was released in June 2008 and allowed for a real increase in the TFT of 4.67%.⁹

Table 1.1 summarises the changes (in real terms) to the TFT since its introduction in 2003–04.¹⁰

Table 1.1 Summary of real changes to the transitional franchise tariff

2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
4.50%	0.50%	0.50%	0.00%	12.90%	4.67%

1.2 Current investigation

The Attorney-General issued further terms of reference on 23 December 2008, requiring the Commission to provide a price direction for the supply of electricity to franchise customers for the period from 1 July 2009 to 30 June 2010.¹¹

In providing the price direction, the Commission is required to have regard to the requirement of section 20 of the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act), and it must produce its final report in sufficient time to allow ActewAGL Retail to make any necessary changes to its billing system and to provide information on the new tariff to customers.

The full terms of reference are set out in Appendix 1.

This report contains the Commission’s final decision and price direction.

1.3 Overview of the market

The TFT does not apply to all electricity customers in the ACT. Rather, it applies only to those small customers (residential and non-residential customers who consume less than 100 MWh/year) who have not elected to enter into a negotiated contract with either the incumbent retailer, ActewAGL Retail, or an alternative electricity retailer. In total, there are 17 licensed retailers in the

⁹ ICRC, *Final Decision and price direction: Retail prices for non-contestable electricity customers*, Report 4 of 2008, June 2008.

¹⁰ Nominal increases can be calculated by increasing the real figure to allow for any increase in inflation.

¹¹ ICRC (Price Direction for the Supply of Electricity to Franchise Customers) Terms of Reference Determination 2008 (No. 2) (Disallowable instrument DI200-305).

ACT, although not all of these retailers are currently active in the household segment of the market. Of the approximately 150,000 small customers in the ACT, nearly 31,000 (about 20% of customers) were on negotiated contracts at 30 June 2008.

1.4 Timeline

The Commission has adopted the following timeline for the current investigation.

Activities	Dates
Release of the issues paper	Wednesday 11 February 2009
Submissions on issues paper	Friday 6 March 2009, 5.00pm
Release of draft decision	Friday 3 April 2009
Submissions on draft decision	Friday 8 May 2009, 5.00pm
Final decision and final price direction	Friday 5 June 2009
ActewAGL Retail implementation of tariff changes	From 1 July 2009

The release of the final decision and price direction on 5 June will allow ActewAGL Retail enough time to make necessary changes to its billing system and provide information to customers, as required by the terms of reference.

1.5 Structure of the final decision

The remainder of this report is structured as follows:

- Chapter 2 provides an overview of the final decision.
- Chapter 3 sets out the methodology adopted by the Commission in determining the change in the TFT.
- Chapter 4 summarises the draft decision.
- Chapter 5 outlines the submissions received on the draft decision.
- Chapter 6 highlights developments in other jurisdictions.
- Chapter 7 provides a detailed analysis of the efficient costs of providing retail electricity services.
- Chapter 8 examines the following non-technical matters
 - the social implications of the Commission’s decision
 - the possible inclusion of pass-through arrangements
 - matters related to continued price regulation.
- Chapter 9 contains the Commission’s final price direction.
- Appendix 1 contains a full transcript of the terms of reference.

2 Overview of the final decision

Methodology

The Commission has determined the allowable change in retail electricity prices from 2008–09 to 2009–10 by estimating the change in the efficient cost base of an incumbent electricity retailer servicing a regulated customer segment. In making this decision, the Commission has been mindful of section 20 of the ICRC Act, which provides guidance on how to balance the Commission’s regulatory obligations. Those obligations include balancing a number of conflicting objectives, such as a safe and reliable supply, the efficient delivery of services with the incentive to reduce costs, the financially viable provision of services, and due regard to the social impacts of the tariffs on consumers.

In making its final decision, the Commission has drawn on cost information available from the market, regulatory decisions in other jurisdictions, submissions from electricity retailers (in particular ActewAGL Retail) and consumer advocacy groups, and the Commission’s own analysis.

Price increase

The Commission has used a cost build-up approach in which the cost components associated with providing the regulated service are estimated individually. Based on the movement in those cost components from 2008–09 to 2009–10, the Commission’s final decision is to allow a real increase in the TFT of 1.98%. This is equivalent to a nominal increase of 6.42%, given an inflation figure of 4.35%.

The change in the cost components from 2008–09 to 2009–10 and the allowable increase in the TFT are shown in Table 2.1.

Table 2.1 Composition of TFT retail price for 2009–10 relative to 2008–09: final decision

	2008–09 final decision	2009–10 final decision	% Change
Energy purchase costs (\$/MWh)			
Electricity purchase cost (\$/MWh)	67.62 ¹²	64.92	-3.99%
Energy contracting cost (\$/MWh)	0.72	0.75	4.35%
Green costs (\$/MWh)	4.87	5.12	5.17%
NEM fees (\$/MWh)	0.72	0.75	4.35%
Energy losses	4.86%	6.01%	1.15%
Total energy purchase cost (\$/MWh)	77.52	75.84	-2.17%
Retail operating costs (\$/MWh)	9.94	10.37	4.35%
Customer acquisition costs (\$/MWh)	–	–	
Total retail costs (\$/MWh)	9.94	10.37	4.35%
Network costs (\$/MWh)	56.06	66.52	18.66%
Total retail + network costs (\$/MWh)	143.52	152.73	6.42%
Retail margin (EBITDA, % of sales)	5.00%	5.00%	–
Total retail price (\$/MWh)	150.69	160.36	6.42%
X factor in CPI + X on MAR in \$/MWh		1.98%¹³	

Social implications

In making its final decision, the Commission has paid specific attention to the social implications of the decision. The Commission acknowledges that any increase in the price of electricity will have adverse impacts on consumers, especially low-income and more vulnerable consumers. To address these concerns, the Commission is recommending to the ACT Government that the total energy concession overall cap, as well as the per kilowatt hour rate, be linked to movements in the price of the TFT (or, should the TFT be removed, to the most commonly used electricity contract offered by ActewAGL Retail). Creating an automatic linkage between the price of electricity and the available concession will ensure that the level of rebate will not be eroded as prices rise.

Pass-through arrangements

The Commission has decided to include no specific pass-through arrangements based on its view that there is limited need to include pass-through provisions in a 12 month price direction and that the likelihood of the events identified by ActewAGL Retail occurring is small. However, the Commission notes that there is an ability, as with all of its price directions under the ICRC Act, for variations to price directions to occur should circumstances change from those that existed when the decision was finalised.

Risk of continued retail price regulation and removal of the TFT

In coming years, the ability of the regulator to forecast electricity prices accurately is likely to diminish. This is a result of the expected increase in volatility of electricity prices as a result of the introduction of the CPRS and other environmental initiatives. That volatility will increase the risk of the regulator setting an inappropriate price, with potentially significant consequences.

¹² This figure differs from that contained in the 2008–09 final report, as it has been updated for actual purchase cost information which was unavailable at the time of completing the inquiry.

¹³ Calculated using the Fisher equation: $(1 + 6.42\%) / (1 + 4.35\%) - 1$.

Should the regulated price be set too low, there is a real chance that it may drive retailers out of business. Should prices be set too high, customers will effectively be paying too much for their electricity.

The Commission considers that, in conjunction with a strengthening of consumer protection arrangements, the best way of dealing with these uncertainties is to remove price regulation and allow retailers to develop their own risk management strategies. A well-functioning competitive retail electricity market will include measures to address the uncertainties, while removing the risk of the regulator setting an inappropriate price. Such an approach has been adopted in Victoria.

However, should the ACT Government elect to maintain a regulated tariff, there is a need for the Commission to undertake a comprehensive review of the methodology used. Such a review would need to commence in the coming months to allow sufficient time to take account of all the necessary factors.

Should retail price regulation be maintained, a comprehensive review is necessary due to:

- the possibility that the methodology adopted in 2007–08 is no longer appropriate
- matters related to the most appropriate way to model electricity purchase costs, including
 - how to best take into account uncertainty regarding the introduction of the Australian Government’s CPRS and the volatility it is likely to bring to carbon prices and subsequently electricity prices
 - how to address the apparent thinness of the futures market
 - what is an appropriate allowance for additional energy purchase costs
 - the technical operation of the electricity purchase cost calculation.

3 Overview of methodology

The Commission determines the retail electricity price for the TFT by estimating the economically efficient cost base of an incumbent electricity retailer providing retail electricity supply services to a regulated customer segment. The Commission has developed a cost index with which it estimates the individual cost components incurred by ActewAGL Retail in providing electricity supply services to TFT customers and how those components track over time. Electricity prices are then adjusted to reflect movements in the index.

The individual cost elements which contribute to the TFT can be grouped into:

- energy costs
 - energy purchase costs
 - energy trading and management costs
 - green costs
 - energy losses
 - National Electricity Market fees
- retail costs
 - retail operating costs
 - retail margin
- network costs
 - transmission and distribution network costs.

A brief description of the individual components follows.

3.1 Energy purchase costs

Energy purchase costs represent the costs incurred by the incumbent retailer in purchasing electricity from the market (that is, from electricity generators) to supply TFT customers.

3.2 Energy trading and management costs

Energy trading and management costs represent the costs incurred by the incumbent retailer in managing an energy trading desk. An energy trading desk is necessary to manage electricity purchases, which are typically bought using a forward-looking portfolio approach, and the associated financial risks.

3.3 Green costs

A range of obligations imposed by government affect the cost of electricity. These include the Australian Government's Mandatory Renewable Energy Target (MRET) scheme and the ACT Government's Greenhouse Gas Abatement Scheme (GGAS).

3.4 Energy losses

Electricity is usually generated far from where it is consumed. For example, only 2% of the electricity consumed in the ACT is produced within the territory. The remaining 98% is sourced from various generators along the east coast of Australia. The transportation of electricity through transmission and distribution networks inevitably results in some energy loss. That loss imposes a cost on the retailer, as it must purchase more electricity than it is able to sell.

3.5 National Electricity Market fees

The National Electricity Market (NEM) is the interconnected electricity grid that covers most parts of Queensland, New South Wales, the ACT, Victoria, Tasmania and South Australia. The NEM is managed by the National Electricity Market Management Company (NEMMCO), which is funded via user fees that are ultimately borne by customers. The fees cover a range of functions provided by NEMMCO which are necessary for the safe and reliable delivery of electricity to all consumers.

3.6 Retail operating costs

Retail operating costs are the costs incurred by the incumbent retailer in providing retail services to TFT customers. These costs include:

- billing services, including meter reading
- call centre costs
- customer information costs
- general operating overhead costs.

3.7 Retail margin

The retail margin represents the return the incumbent retailer earns on the investment it must make to provide retail services. Without a retail margin, the incumbent retailer would be unable to attract the funds needed to provide those services.

3.8 Transmission and distribution network costs

Transmission and distribution network costs cover the costs paid by the retailer to transport electricity over the transmission and distribution network.

3.9 Treatment of cost components

In estimating the individual cost components, the Commission draws on benchmark cost information available in the marketplace, other regulatory decisions within the retail electricity sector in Australia, and information provided by ActewAGL Retail.

Once the individual cost components are estimated, they are added together to produce an overall price (in \$/MWh). That price is then compared to the price calculated for the previous year, and an allowable percentage change in the TFT is determined.

However, the TFT is not a single tariff. Rather, it applies to a range of non-negotiated tariffs offered by ActewAGL Retail. Therefore, the Commission adopts what is referred to as a ‘weighted average price cap’. Under a weighted average price cap, ActewAGL Retail is able to rebalance the individual non-negotiated tariffs offered to franchise customers as long as the adjustment in the weighted average price does not exceed the percentage change in the overall price determined by the Commission.

The Commission then reviews the movement in the final suite of tariffs proposed by ActewAGL Retail to ensure that any adjustment in prices remains reflective of the movement in the TFT as calculated by the Commission.¹⁴

¹⁴ The Commission approves a schedule of tariffs attached to the standard customer contract; see, for example, Utilities (Variation of Terms – Standard Customer Contract) Approval 2008 (No. 1) - Notifiable Instrument NI2008-242.

4 Summary of the draft decision

This chapter summarises the Commission's draft decision.¹⁵

The Commission released its draft decision in April 2009. The draft decision followed the release of an issues paper in February 2009, upon which six submissions from electricity businesses and consumer support and advocacy organisations were received. The Commission considered those submissions in preparing its draft decision.

Table 3.1 shows the Commission's draft decision on the cost components and how the components compared to the 2008–09 final decision.

Table 3.1 Composition of TFT retail price for 2009–10 relative to 2008–09: draft decision

	2008–09 final decision	2009–10 draft decision	% Change
Energy purchase costs (\$/MWh)			
Electricity purchase cost (\$/MWh)	67.62 ¹⁶	60.39	-10.69%
Energy contracting cost (\$/MWh)	0.72	0.75	4.35%
Green costs (\$/MWh)	4.87	5.12	5.17%
NEM fees (\$/MWh)	0.72	0.75	4.35%
Energy losses	4.86%	7.90%	62.55%
Total energy purchase cost (\$/MWh)	77.52	72.31	-6.72%
Retail operating costs (\$/MWh)	9.94	10.37	4.35%
Customer acquisition costs (\$/MWh)	–	–	
Total retail costs (\$/MWh)	9.94	10.37	4.35%
Network costs (\$/MWh)	56.06	66.34	18.34%
Total retail + network costs (\$/MWh)	143.52	149.02	3.84%
Retail margin (EBITDA, % of sales)	5.00%	5.00%	–
Total retail price (\$/MWh)	150.69	156.47	3.84%
X factor in CPI + X on MAR in \$/MWh		-0.49%	

The 2009–10 draft decision allowed for a nominal increase in prices of 3.84% which, assuming a CPI adjustment of 4.35%, translated into a real decrease in tariffs of 0.49%.

The Commission based its estimations of the individual cost components on benchmark cost information available in the marketplace, other regulatory decisions within the retail electricity sector in Australia, the Commission's own research and analysis, and information provided by ActewAGL Retail.

The most significant of the cost components relates to the calculation of electricity purchase costs. The Commission adopted a revised methodology for this calculation relative to previous years, based on concerns raised in response to the issues paper and updated market data.

¹⁵ ICRC, *Retail prices for non-contestable electricity customers, 2009–2010: Report 2 of 2009*, April 2009.

¹⁶ This figure differs from that contained in the 2008–09 final report as it has been updated for actual purchase cost information which was unavailable at the time of completing the inquiry.

The Commission believed that these costs were reasonable for an efficient incumbent retailer providing services to the TFT customer base in the ACT. In addition, the Commission considered that the calculation of the cost components addressed the requirements of section 20 of the ICRC Act.

In addition to the cost build-up, the Commission made a series of further comments relating to non-technical matters.

On the social implications of its decision, the Commission stated that it would recommend to the ACT Government that the electricity concession rates be amended to link the per kilowatt hour rate and the cap on the overall concession payment to movements in the TFT (a similar outcome to that for water and wastewater concessions, where payments are linked to the fixed charges). The Commission also stated that it would recommend that the government consider making a further cost allowance in its concession arrangements to account for costs associated with the feed-in tariff.

The Commission considered the four pass-through arrangements recommended by ActewAGL Retail. These were:

- the ACT Government's feed-in tariff
- unforeseen ACT and Australian government environmental initiatives
- the possible introduction of a smart metering trial or rollout of smart meters
- a change in network tariffs during the 2009–10 financial year.

Based on its consideration of these arrangements, the Commission stated that it preferred to include no pass-through arrangements, but that it would reassess the need when preparing its final report.

Finally, the Commission raised concerns about continued regulation of retail electricity prices in the ACT. The Commission argued that the removal of price regulation would be in the best long-term interests of consumers and suggested that a model such as that adopted in Victoria, where a price monitoring arrangement has been introduced, may be appropriate for the ACT.

5 Submissions on the draft decision

The Commission released the draft decision in April 2009 and received four submissions from:

- ActewAGL Retail
- AGL Energy Limited (AGL)
- Care Financial Counselling Service (Care)
- Origin Energy.

These submissions are summarised below.

5.1 ActewAGL Retail

ActewAGL Retail stated that it recognised the difficulties associated with setting a regulated price in a competitive market and supported the Commission’s view that the removal of price regulation was in the best long-term interests of consumers, as it would deliver benefits of ‘greater choice, lower prices, and new and innovative products and services’.¹⁷

ActewAGL Retail stated that it had a number of concerns with the draft decision and that:¹⁸

These relate to the proposed change in purchase cost method, the need to fully compensate for hedging costs in energy purchases, the need to reflect customer retention and acquisition costs and the need to include a number of important pass through provisions. ActewAGL seeks that these be addressed in the final decision.

Referring to the change in the purchase cost method, ActewAGL Retail stated that:¹⁹

The Commission did not provide any forewarning of its intended change in method and this possibility was not raised in the Issues Paper at the commencement of the review process. This highlights the regulatory uncertainty facing ActewAGL given that it would have been prudent for ActewAGL to continue to expect that any future regulated electricity tariff would continue to be based on the current methodology and to develop and implement its pricing strategy accordingly.

On the appropriate level of hedging costs, ActewAGL Retail stated that:²⁰

In its Draft Determination, the Commission has provided compensation for hedging equivalent to 5% of purchase costs for off-peak energy and 20% of purchase costs for peak time energy but noted that ‘the Commission intends investigating further the assumptions regarding appropriate hedging assumptions in preparing the final report.’ Whilst ActewAGL recognises this improvement, the total provisioning is still well below ActewAGL’s proposed commercial hedging position of 125% of the energy purchase.

ActewAGL wishes to reiterate the basis for the recommended 125% allowance as discussed in our original submission to the Commission, that is, to cover the real costs of hedging incurred during both peak and off-peak periods which are:

- (i) costs to a retailer of *buying additional energy* from the NEM when actual 30 minute demand leaves a retailer ‘*short*’ from the contracted swap position

¹⁷ ActewAGL submission on draft decision, p. 3.

¹⁸ ActewAGL submission on draft decision, p. 3.

¹⁹ ActewAGL submission on draft decision, p. 9.

²⁰ ActewAGL submission on draft decision, p. 11.

(ii) costs to a retailer of *selling surplus energy* from the NEM when actual 30 minute demand leaves a retailer 'long' from the contracted swap position (noting that pool prices, more often than not, are lower than the swap contracted price during these periods)

(iii) *insurance premium costs associated with cap products used to protect the retailer from excessively high spot prices.*

ActewAGL Retail argued for the inclusion of an allowance for customer acquisition and retention costs:²¹

ActewAGL has previously highlighted its view that the Terms of Reference does not preclude the Commission from basing their benchmark costs on the efficient costs of a mass market new entrant. Instead, 'the Commission determines the retail electricity price for the TFT by estimating the economically efficient cost base of an *incumbent* [emphasis added] electricity retailer.' ActewAGL believes that the Terms of Reference does not preclude the Commission from basing their decision on the efficient costs of a mass market new entrant and should therefore incorporate an allowance for customer acquisition and retention costs. If the Commission is to continue to define the market benchmark as being costs for an incumbent retailer, rather than a mass market new entry retailer, then costs of an incumbent related to retention by way of market based offers and contracts should then be factored into the benchmark customer service cost.

On pass-through mechanisms, ActewAGL Retail stated:²²

The Commission's reluctance to accept specific pass through events leaves ActewAGL exposed to potential changes in costs throughout the regulatory period. ActewAGL has identified the following four potential uncontrollable and unforeseeable events as pass through trigger events.

- Smart Metering
- Network Tariff Change
- Feed-in Tariff
- Environmental Initiatives

ActewAGL agrees with submissions from both Origin and TRUenergy's which insist that pass through events need not be individually identified and approved by the Commission as such events are, by definition, unforeseen. ActewAGL supports TRUenergy's suggestion that a more prudent approach would be to allow for a pass-through in circumstances where there is a material change in the retailer's cost base relative to the assumptions of the price determination.

Should the Commission choose to adopt specific pass through events, ActewAGL suggests that the four events outlined require pass through arrangements in the Commission's determination ...

ActewAGL Retail went onto to discuss the four possible events in detail.

In addition to these matters, ActewAGL Retail provided a description of developments in other Australian jurisdictions, including New South Wales, Queensland, Victoria, South Australia and Western Australia.²³

ActewAGL Retail agreed with the methodology adopted by the Commission in the draft decision for:²⁴

- energy, trading and management costs
- green costs

²¹ ActewAGL Submission on draft decision, p. 4.

²² ActewAGL Submission on draft decision, p. 20.

²³ ActewAGL Submission on draft decision, pp. 5–7.

²⁴ ActewAGL Submission on draft decision, pp. 12–17.

- energy losses
- National Electricity Market fees
- retail margin
- transmission and distribution network costs.

ActewAGL Retail stated that it only supported an increase in retail operating costs in line with inflation (as proposed by the Commission in the draft decision) if an additional allowance were granted for customer acquisition and retention costs.²⁵

Table 5.1 shows how ActewAGL Retail’s proposal compares with the 2008–09 final decision and the Commission’s 2009–10 draft decision.

Table 5.1 2008–09 final decision compared with the 2009–10 draft decision and ActewAGL Retail’s proposed decision

	2008–09 final decision	2009–10 draft decision	ActewAGL Retail proposed 2009–10
Energy purchase costs (\$/MWh)			
Electricity purchase cost (\$/MWh)	67.62	60.39	68.99
Energy contracting cost (\$/MWh)	0.72	0.75	0.75
Green costs (\$/MWh)	4.87	5.12	5.12
NEM fees (\$/MWh)	0.72	0.75	0.75
Energy losses	4.86%	7.90%	6.01%
Total energy purchase cost (\$/MWh)	77.52	72.31	80.16
Retail operating costs (\$/MWh)	9.94	10.37	10.37
Customer acquisition costs (\$/MWh)	–	–	2.2
Total retail costs (\$/MWh)	9.94	10.37	12.57
Network costs (\$/MWh)	56.06	66.34	65.12
Total retail + network costs (\$/MWh)	143.52	149.02	157.85
Retail margin (EBITDA, % of sales)	5.00%	5.00%	5.00%
Total retail price (\$/MWh)	150.69	156.47	165.74
X factor in CPI + X on MAR in \$/MWh		–0.49%	5.40%^a

a This figure differs from that contained in the ActewAGL Retail submission, as ActewAGL Retail adopted an alternative ‘Total retail price (\$/MWh)’ for 2008–09 based on an alternative load profile to that used in the 2009–10 draft decision. The ActewAGL Retail X factor was 5.54%.

ActewAGL Retail also commented on social impacts and stated that it:²⁶

believes that the best way for the Commission to take account of the social impact of its decision regarding the TFT is to implement measures that will best accelerate competition in the ACT, thereby improving the benefits to consumers that flow from a truly competitive market, free of regulatory constraints and distortions.

²⁵ ActewAGL submission on draft decision, pp. 13–17.

²⁶ ActewAGL submission on draft decision, p. 19.

ActewAGL Retail expressed its support for targeted concession programs. On the Commission's recommendation that concessions be indexed to changes in the TFT, ActewAGL Retail stated that it:²⁷

would like to point out that as long as the structural arrangements for the revised concession arrangements remain in their current form, it is able to implement these changes without cost. However, should the structure of the concession arrangements be altered, this could result in an administrative cost to ActewAGL that it would seek to pass on to customers.

5.2 AGL

AGL stated that it had concerns with the revised energy purchase cost methodology adopted by the Commission in the draft decision. AGL argued that the approach did not appear to have a precedent in other jurisdictions or conform with its expectations regarding the strategy a prudent retailer might adopt.²⁸

In addition, AGL stated that it maintained its view that an allowance for operating costs should be set at a level that includes the costs of attaining, retaining and servicing customers. AGL argued that, by not including an allowance for customer acquisition costs, the Commission might be setting a TFT that risks discouraging new retailers entering the market.²⁹

Finally, AGL argued for the inclusion of a general pass-through provision to allow the recovery of costs where there is a material change in the cost base of a retailer.³⁰

5.3 Care Financial Counselling Service

Care stated that it:³¹

acknowledges that increases in retail prices for non-contestable customers are inevitable; and is pleased that the proposed increase in the current draft decision is modest compared with recent substantial increases that have seen electricity charges increase by approximately 35% since 2004–05. However, any increase puts pressure on low income households, particularly on top of the recent increases and disproportionately affects low-income consumers.

With regard to the Commission's recommendation in the draft decision that concessions be indexed to electricity price changes, Care stated:

We agree with the Commission's view 'that there is a clear need to provide support mechanisms for low-income and vulnerable consumers' and acknowledge that the Commission has attempted to find a process to address this by suggesting that 'there are strong grounds for linking the value of the electricity rebate to increases in the retail price of electricity.'

Care identified a number of issues which related to concessions. These are summarised as:³²

- The increase on 1 July 2008 due to the introduction of the Network Facilities Infrastructure Tax was the first increase since 2004 and, while the ACT Government had identified concessions available to residents in 2008, there was no examination of the value or level of the concessions.

²⁷ ActewAGL submission on draft decision, p. 20.

²⁸ AGL submission on draft decision, pp. 1–2.

²⁹ AGL submission on draft decision, p. 2.

³⁰ AGL submission on draft decision, p. 2.

³¹ Care submission on draft decision, p. 1.

³² Care submission on draft decision, p. 2.

- An updated examination of the real value of energy concessions is required, given the significant winter heating costs in the ACT.
- If the energy concession is linked to increases in the retail price, increases should be automatic and not delayed.
- Low-income consumers, particularly those on Centrelink payments, should be exempt from paying supply charges and any concession for energy used should be in addition to that exemption.
- If the energy concession is linked to the retail price, the base rate should not be eroded if prices fall.
- The feed-in tariff scheme will adversely affect low-income households that are not able to benefit from it, and further compensatory mechanisms are needed.

Care made the following comments on broader considerations:³³

Electricity is an essential and not a choice; in a competitive market, adequate and pro-active provisions should be in place to protect vulnerable consumers:

- While concessions are a useful approach to issues facing low-income and vulnerable consumers; a purely concessions driven approach is unsustainable in the longer term.
- Care acknowledges the Commission’s comments that ‘the TFT is not intended to be a “safety net” to be used for social or targeted support to smaller consumers.’ We believe that energy retailers have a responsibility, as part of their core business planning to have in place hardship policies that are transparent, workable and responsive to customers who are unable to meet the payments on their electricity accounts. This should include early identification of customers experiencing financial difficulties and a range of flexible options that take into account the customer’s capacity to pay.
- Low-income consumers are generally at great disadvantage compared with other consumers due to living in insufficiently insulated dwellings with outdated appliances. Care believes there needs to be an investment in providing both structural and educational measures that assist with consumption reduction of energy costs especially for low income earners, public housing and private rental tenants, all of whom are very vulnerable to rising costs. This may assist in providing some protection against anticipated future steep rises in electricity costs.
- Expecting disadvantaged households to continue making reductions in energy usage when the dwelling they occupy is not designed to assist in their efforts is at best counter productive and at worst destructive; as the household simply cannot do what is asked of them, despite their efforts. While this particular Draft Decision contains a modest increase in electricity costs, those in the community without updated appliances, adequate insulation, appropriate energy efficient dwellings and educational support, will still feel the effects of the increase.

5.4 Origin Energy

Origin Energy stated that it:³⁴

supports the removal of price regulation to ensure customers receive the long term benefits of effective competition. However, while retail prices remains regulated for 2009–10, Origin consider the following adjustments in the setting of electricity retail prices are necessary to enhance competition in the Australian Capital Territory (ACT):

³³ Care submission on draft decision, pp. 2–3.

³⁴ Origin Energy submission on draft decision, p. 1.

- With the proposed introduction of Carbon Pollution Reduction Scheme (CPRS) from 2011, it is important that retail prices reach cost reflective levels and provide adequate retail margins in the preceding periods;
- Recognition that an allowance for customer acquisition costs is a necessary part of a retailer's operating cost and needs to be included in the regulated price in the ACT market;
- That the energy purchase cost used in the determination of regulated retail prices for 2009–10 is indicative of the actual change in wholesale energy cost as purchased by a prudent retailer; and
- Adequate provision of a pass through mechanism when a material change in retailer costs occurs during the determination period.

On energy purchase costs, Origin Energy disagreed with the Commission's proposal in the draft decision to change the methodology so that the model assumed that peak contracts were purchased only 12 months in advance, compared to the previous 24 month assumption. Origin Energy stated that no retailer would hedge only 12 months in advance, as that would expose it to unnecessary risk. Origin Energy stated that such a purchasing strategy was unrealistic. Therefore, Origin Energy suggested that the previous methodology be retained.³⁵

Origin Energy argued for the inclusion of an allowance for customer acquisition costs and noted that an allowance is granted in all other jurisdictions of the NEM. Origin Energy argued that if the TFT were set at the lowest possible price for the incumbent without providing for recovery of retention and acquisition costs then a new entrant may not be able to compete in the market, thus stifling competition.³⁶

In addition, Origin Energy argued that prices were currently not cost reflective and that this was denying the ACT market a transitional phase to allow:³⁷

new retailers to establish market position before innovation and vigorous competition emerges. As the name of the TFT implies, it is a transitional retail tariff, providing a cap on market prices whilst competition is propagated.

Origin has concerns that where the retail tariff is not cost reflective and is inhibiting competition, the consequent damage upon competition may be self-perpetuating and will require further significant interference to rectify the issue.

Origin Energy also expressed its support for a general pass-through mechanism, which would be triggered where there is a material change in the retailer's cost base relative to the assumptions made when determining the TFT.³⁸

³⁵ Origin Energy submission on draft decision, p. 2.

³⁶ Origin Energy submission on draft decision, pp. 3–4.

³⁷ Origin Energy submission on draft decision, p. 4.

³⁸ Origin Energy submission on draft decision, p. 5.

6 Developments in other jurisdictions

Since the release of the draft decision, there have been developments in Queensland and New South Wales regarding retail electricity price regulation as well as the release of the final decision of the Australian Energy Regulator (AER) on electricity distribution prices in the ACT.

6.1 Queensland

The Queensland Competition Authority (QCA) released its draft decision on retail electricity prices on 2 December 2008 for the period 1 July 2009 to 30 June 2010. The Commission's draft decision foreshadowed the release of QCA's final decision on retail electricity prices on 29 May 2009.

There have been interesting developments in Queensland since the release of the Commission's draft decision. AGL and Origin Energy, the two primary retailers in Queensland, challenged the QCA's 2008–09 final decision on retail electricity prices in the Queensland Supreme Court. The case was brought under the *Queensland Electricity Act 1994*. The judgment was handed down on 28 April 2009 and found against the QCA.³⁹ The court found that the QCA failed to exclude the load of large industrial electricity customers who are directly connected to the transmission network, and whose load should as such not be included as a component of the state's regulated electricity load. The court also found that the QCA erred in its approach in determining the updating process of the Benchmark Retail Cost Index (BRCI) from year to year.

Following the handing down of the judicial decision, the QCA issued a consultation paper on the issues raised in the judgment on 8 May 2009.⁴⁰ The consultation paper proposed changes to the QCA's calculation of the state electricity load used in the determination of the BRCI. Subsequent to the release of the consultation paper, the Minister for Mines and Energy in Queensland issued a new certificate of delegation which extends the delivery date of the QCA's final decision until 12 June 2009. Hence, the final changes in regulated retail electricity prices in Queensland will not be released until after the release of the Commission's final decision on the TFT in the ACT.

The Queensland judgment was made under the Queensland Electricity Act and relates to the calculation of the BRCI used to determine retail electricity prices in Queensland. The calculation of the BRCI is specified in that Act and is particular to the setting of retail electricity prices in Queensland. Hence, there does not appear to be any precedent that affects the Commission's determination of retail electricity prices in the ACT.

³⁹ *AGL Energy Ltd v Queensland Competition Authority & Anor; Origin Energy Retail Ltd v Queensland Competition Authority & Anor* [2009] QSC 90.

⁴⁰ Queensland Competition Authority, Consultation Paper, Benchmark Retail Cost Index for Electricity: 2009-10, May 2009.

6.2 New South Wales

IPART included in its three-year price determination (1 July 2007 to 30 June 2010) an annual review of the cost of purchasing electricity. IPART released its final annual report and determination on 20 May 2009 as part of the review of electricity purchase costs for 2009-10.⁴¹

IPART's final report confirmed the conclusions in its draft report. Customers covered by the regulated tariff in New South Wales will face significant price increases for electricity for 2009-10. IPART reports indicative nominal price increases of 21.7%, 21.1% and 17.9% for EnergyAustralia, Integral Energy and Country Energy, respectively.⁴² Approximately half of the price increase is due to increases in network costs in New South Wales. Increases in the purchase cost of electricity account for slightly more than one quarter of the price increase. The increases in retail electricity prices take effect on 1 July 2009 in New South Wales.

The Commission's draft decision highlighted the differences between the approach taken in New South Wales and that taken by the Commission in the ACT. The main points of difference between the two jurisdictions are the longer regulatory review in New South Wales, the approach to estimating the purchase cost of electricity and the inclusion of customer acquisition costs in New South Wales. Due to the approach taken by IPART in 2007, price increases for retail electricity have been lower in New South Wales over the past two years as compared to the increases in the ACT.

6.3 Australian Energy Regulator final decision

The AER released its final decision on ActewAGL Distribution's network charges on 28 April 2009. This decision is an important input into the Commission's final retail electricity decision, as the costs attributed to the distribution (35%) and transmission (5%) networks account for approximately 40% of the total cost of providing electricity services in the ACT. Costs associated with network charges are automatically passed through to electricity customers.

The approach taken by the AER to regulating ActewAGL Distribution follows the approach taken by the Commission and other jurisdictional regulators regarding electricity distribution regulation over the past decade, which is to set a five-year price path.⁴³ The five-year price path is constructed by determining the total efficient costs of providing the regulated service over the course of the regulatory period and matching revenue to recover the efficient costs.

The AER's draft decision on ActewAGL Distribution's electricity network, released in November 2008, resulted in an expected real increase in distribution charges of 13.82% from 2008-09 to 2009-10. The Commission in its draft decision reported that the AER's draft decision did not include any provision for the recovery of any costs incurred by ActewAGL Distribution as a result of the operation of the feed-in tariff scheme. The feed-in tariff scheme requires the distribution business to pay small producers of renewable energy, primarily electricity generated from rooftop photoelectric panels, the feed-in tariff rate less the retail cost of electricity.

⁴¹ IPART, *Market-based electricity purchase cost allowance—2009 review, Regulated electricity retail tariffs and charges for small customers 2007 to 2010, Electricity—Final report and determination*, May 2009

⁴² IPART May 2009 page 15.

⁴³ The AER became the regulator of electricity distribution networks on 1 January 2008, taking over the role held by the Commission since 1997.

The AER's final decision did not alter the increase in network charges anticipated for 2009–10. The AER has maintained the real increase in network charges at 13.82%. However, the AER has accepted ActewAGL Distribution's claim for the inclusion of the costs it will incur as a consequence of the implementation of the feed-in tariff scheme. Those costs are factored into the AER's final decision. The Commission estimates that ActewAGL Distribution's costs of the feed-in tariff are equivalent to approximately \$27 per customer per year if spread evenly over the five years of the price path.

In addition to the 13.82% real increase from 2008–09 to 2009–10, for the years 2010–11 through 2013–14, the AER has increased the real change in network charges from a 2% per year increase as estimated in the draft decision to a 4% per year increase in the final decision.

7 Analysis of efficient costs

This chapter discusses:

- the requirements of section 20 of the ICRC Act
- the methodology adopted by the Commission in determining the TFT
- the individual cost elements that contribute to the TFT.

The chapter concludes with a section that brings together the Commission's final decision on each of the cost elements and sets out the proposed change in the TFT.

7.1 Section 20 criteria

The terms of reference state that the Commission must have regard to the requirements of section 20 of the ICRC Act. Section 20 provides a list of issues (sometimes considered as objectives) that the Commission needs to address in determining the weighted average price cap under which the TFT levels for 2009–10 will be developed.

Section 20 states that:

- (1) At the conclusion of an investigation on a reference authorising the commission to make a price direction in a regulated industry, the commission must decide on the level of prices for services in relation to the period specified in the reference and give a price direction accordingly to each person providing regulated services.
- (2) In making a decision under subsection (1), the commission must have regard to—
 - (a) the protection of consumers from abuses of monopoly power in terms of prices, pricing policies (including policies relating to the level or structure of prices for services) and standard of regulated services; and
 - (b) standards of quality, reliability and safety of the regulated services; and
 - (c) the need for greater efficiency in the provision of regulated services to reduce costs to consumers and taxpayers; and
 - (d) an appropriate rate of return on any investment in the regulated industry; and
 - (e) the cost of providing the regulated services; and
 - (f) the principles of ecologically sustainable development mentioned in subsection (5);
 - (g) the social impacts of the decision; and
 - (h) considerations of demand management and least cost planning; and
 - (i) the borrowing, capital and cash flow requirements of people providing regulated services and the need to renew or increase relevant assets in the regulated industry; and
 - (j) the effect on general price inflation over the medium term; and
 - (k) any arrangements that a person providing regulated services has entered into for the exercise of its functions by some other person.
- (3) Also, in making a decision under subsection (1), the commission must allow a declared fee under section 4C (Declared fees to be passed on to consumers) to be passed on in full to consumers of the service.

- (4) In a price direction, the commission must indicate to what extent it has had regard to the matters referred to in subsection (2).
- (5) For subsection (2) (f), *ecologically sustainable development* requires the effective integration of economic and environmental considerations in decision-making processes through the implementation of the following principles:
 - (a) the precautionary principle—that if there is a threat of serious or irreversible environmental damage, a lack of full scientific certainty should not be used as a reason for postponing measures to prevent environmental degradation;
 - (b) the inter-generational equity principle—that the present generation should ensure that the health, diversity and productivity of the environment is maintained or enhanced for the benefit of future generations;
 - (c) conservation of biological diversity and ecological integrity;
 - (d) improved valuation and pricing of environmental resources.

One of the objectives of the Commission’s analysis is to ensure that the retail services are delivered in a reasonably efficient manner (s. 20(2)(c)) to reduce the costs paid by consumers, without the exploitation of monopoly power (s. 20(2)(a)), which might otherwise raise costs for consumers. The costs it considers for ActewAGL Retail (s. 20(2)(e)), however, must also allow for an appropriate rate of return (s. 20(2)(d)) and a financially viable outcome for the service provider (s. 20(2)(i)).

There is tension between these objectives. In part, the Commission balances them by considering actual cost information provided by ActewAGL Retail and by building a cost base from benchmark data derived from public sources or from market data. In practice, the Commission relies heavily on the latter information to address the information asymmetry that can arise between the incumbent and the regulator.

Throughout this chapter, the Commission notes how it has considered the requirements of section 20 of the ICRC Act.

7.2 Methodology

The Commission determines the retail electricity price for the TFT by estimating the economically efficient cost base of an incumbent electricity retailer providing retail electricity supply services to a regulated customer segment. It does this by estimating the individual cost components incurred by ActewAGL Retail in the provision of electricity supply services to TFT customers. The individual cost components are discussed in detail in Section 7.3.

Once the individual cost components are estimated, they are added together to produce an overall price (in \$/MWh). That price is then compared to the price calculated for the previous year, and an allowable percentage change in the TFT is determined. This index-based approach can be thought of as similar to the way in which the Australian Bureau of Statistics (ABS) compiles the CPI. The ABS selects a basket of goods and assigns relative weightings to each of the items. The CPI then measures how the cost of the basket of goods fluctuates over time.

The TFT is not a single tariff. Rather, it applies to a range of non-negotiated tariffs offered by ActewAGL Retail. Therefore, the Commission adopts a ‘weighted average price cap’. Under the cap, ActewAGL Retail is able to rebalance the individual non-negotiated tariffs offered to franchise customers as long as the adjustment in the weighted average price does not exceed the percentage change in the overall price determined by the Commission.

The Commission then reviews the movement in the final suite of tariffs proposed by ActewAGL Retail to ensure that any adjustment in prices remains reflective of the movement in the TFT as calculated by the Commission. The final approved retail tariffs that constitute the TFT are then published by the Commission as a notifiable instrument.⁴⁴

7.3 Retail electricity cost elements

The individual cost components which contribute to the overall retail cost of electricity can be grouped into the following categories:

- energy costs
 - energy purchase costs
 - energy trading and management costs
 - green costs
 - energy losses
 - NEM fees
- retail costs
 - retail operating costs
 - retail margin
- network costs
 - transmission and distribution network costs.

The remainder of this section discusses each of these elements in detail. Each cost element is discussed in terms of:

- its definition
- the methodology adopted in the 2009–10 draft decision
- any matters raised in submissions to the 2009–10 draft decision
- the methodology to be adopted for the 2009–10 final decision
- the Commission’s final decision
- how the Commission has considered the requirements of section 20 of the ICRC Act in reaching its decision.

7.3.1 Energy purchase costs

Definition

Energy purchase costs represent the costs incurred by the incumbent retailer in purchasing electricity from the market (that is, from electricity generators) to supply TFT customers.

⁴⁴ The approved schedule of tariffs is attached to the standard customer contract. For example, see Utilities (Variation of Terms—Standard Customer Contract) Approval 2008 (No. 1), Notifiable Instrument NI2008-242.

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The Commission cannot readily and directly observe the actual cost of electricity to the incumbent retailer, as that cost comprises myriad contracts and supply arrangements that are negotiated at various points in time in advance or over the year for which the TFT is set.

The approach adopted by the Commission has been to estimate the cost of purchasing electricity, using publicly available market data on historical and future electricity prices combined with a range of assumptions regarding purchasing activities of an electricity retailer.

The key elements of the Commission’s methodology relate to the:

- source of data
- forward purchasing strategy
- load profile shape.

In completing the 2008–09 and 2007–08 reviews, the Commission sourced its data from d-cyphaTrade, an electricity trading house. The Commission purchased data from d-cyphaTrade on electricity futures and swap prices and used that information to estimate average peak, shoulder and off-peak electricity prices.

The Commission then assumed a forward purchasing strategy in which the retailer begins to build its portfolio 24 months in advance. It is assumed that the forecast load is hedged for each 6-month period of future delivery.

Table 7.1 shows the position assumed by the Commission for the incumbent retailer at 30 June 2008 (as used in the 2008–09 decision) and illustrates how forward purchases are built up over the preceding 24-month period.

Table 7.1 Assumed forward purchasing strategy (for delivery 30 June 2008)

Purchase period (ending date)	June 2006	December 2006	June 2007	December 2008	Total
Forecast load hedged by contract (%)	25%	25%	30%	25%	105%

The Commission granted a total allowance of 105% of electricity purchase costs. Allowing a recovery of 105% of electricity purchase costs was designed to compensate ActewAGL Retail for a range of additional costs associated with purchasing electricity that are not captured in the forward purchase price of electricity.

The load profile shape assumed by the Commission is shown in Table 7.2. The load profile shape is used to estimate the relative proportion of purchases of peak, shoulder and off-peak electricity.

Table 7.2 Assumed load profile shape

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

In 2008–09 (and 2007–08), the Commission calculated its estimate of the electricity purchase costs using the d-cyphaTrade data, the assumed forward purchasing strategy and assumed load profile shape.

In response to developments in the electricity market and matters raised in submissions on the 2009–10 issues paper, the Commission re-examined its methodology.

The Commission adjusted the methodology in two key ways. First, the Commission considered the appropriateness of the d-cyphaTrade data. Based on an analysis of the data, the Commission concluded that data provided by d-cyphaTrade continued to be the most appropriate. However, the Commission identified the development of a ‘thinness’ in the forward purchase market for peak purchases. Therefore, the Commission adjusted the model such that peak purchases were made only 12 months in advance, as opposed to the 24 month assumption adopted previously. The Commission adopted this approach in an attempt to more accurately represent the current realities of the market.

Second, the Commission increased the allowance granted to ActewAGL Retail for purchasing electricity. The allowance covers costs incurred in forward purchasing electricity as well as an additional component to cover costs associated with buying additional electricity when ‘short’, selling excess electricity when ‘long’, and purchasing insurance ‘caps’.

The Commission increased the allowance for peak purchases only and increased the total allowance from 105% to 120%. This decision was based on submissions from ActewAGL Retail that the existing 105% allowance was insufficient. The 120% figure was determined based on the Commission’s research and investigation of the electricity market, analysis of a model prepared by ActewAGL Retail and analysis and discussions with other regulators.

These changes to the methodology are shown in Table 7.3.

Table 7.3 Assumed forward purchasing strategy (for delivery 30 June 2009)

Purchase period (ending date)	June 2007	December 2007	June 2008	December 2008	Total
Peak forecast load hedged by contract (%)			80%	40%	120%
Base forecast load hedged by contract (%)	25%	25%	30%	25%	105%

The Commission committed to investigating these matters further when preparing the final decision.

Matters raised in submissions on the draft decision

ActewAGL Retail noted the:⁴⁵

Commission’s proposal to implement a substantially changed wholesale purchase cost model. This has been proposed without the extensive consultation necessary for such a substantial change to a key input component to the decision process. While ActewAGL recognises the Commission’s intent to develop a more accurate forward purchase portfolio method to reflect the behaviour employed by a prudent retailer, this needs careful review and considered assessment as part of a more detailed and focussed consultation process.

The Commission has not provided ActewAGL with any forewarning of a change in method, which highlights the regulatory uncertainty facing ActewAGL given that it would have been prudent for

⁴⁵ ActewAGL submission on draft decision, pp. 3–4.

ActewAGL to continue to expect that any future regulated electricity tariff would continue to be based on the current methodology and to develop and implement its pricing strategy accordingly. In addition, the proposed variation to the forward purchasing strategy where, according to the Commission, 80% of energy is assumed to be purchased in June 2008 and 40% in December 2008 is unrealistic as it overly weights the more recent purchases in the portfolio approach.

ActewAGL supports the Commission's intention to reflect a more commercial hedging assumption in the purchase cost model equivalent to 120% of purchase costs for peak time energy and 105% of purchase costs for off-peak energy. Whilst ActewAGL recognises this improvement, the draft decision remains well below ActewAGL's proposed benchmark commercial hedging position of 125% on all energy purchases and this needs to be addressed in the final decision.

ActewAGL Retail submitted that it:⁴⁶

... has calculated a price for the energy purchase cost of \$68.99/MWh. This has been derived using the Commission's methodology as it applied in 2008/09 with an increased allowance for the hedging arrangements of a prudent retailer to 125% on both peak and off peak purchases, up from 105% in the 2008/9 final decision.⁴⁷ ActewAGL believes that a purchase price of \$68.99/MWh is required to more accurately reflect the prudent behaviour of a retailer in a commercial market environment.

Regarding the Commission's revised forward purchasing strategy, AGL stated that it:⁴⁸

has significant concerns with such an approach, as it does not appear to have any correlation with methodologies adopted in other jurisdiction, nor does it conform with AGL's expectations as to a 'prudent retailer' hedging strategy.

Origin Energy stated that it was surprised by the large reduction in energy purchase costs between 2008–09 and 2009–10 and that it did not believe that this accurately replicates the change in actual costs experienced by retailers.⁴⁹

On the Commission's revised forward purchasing strategy, Origin Energy stated that:⁵⁰

in reality, no retailer would begin to hedge its required peak load only 12 months prior to the start of the period in question as it would expose it to unnecessary risk as peak is usually the most volatile forward price ... [I]t has been assumed that 80 per cent of the peak purchases are made in the first half of the 12 months in question. i.e. 80 per cent purchase of peak contracts for 2009–10 are made up June 2008. Although hedging strategies vary considerably depending on circumstances and retailer's risk appetites, Origin would highlight that this is not a realistic scenario albeit it is made in hindsight.

Origin Energy proposed that the Commission retain the previous methodology, with peak purchases spread evenly over a two-year period.

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In preparing the draft decision, the Commission chose to adjust the methodology used to calculate energy purchase costs. It did this based on submissions made by ActewAGL Retail regarding the accuracy of the existing model. Therefore, the Commission rejects any claim by ActewAGL Retail that it had no forewarning of a changed methodology.

⁴⁶ ActewAGL Submission on draft decision, p. 8.

⁴⁷ Including a number of corrections to the application of the data set.

⁴⁸ AGL Submission on draft decision, p. 2.

⁴⁹ Origin Energy Submission on draft decision, p. 2.

⁵⁰ Origin Energy Submission on draft decision, p. 2.

Submissions on the draft decision focused on the Commission's revised forward purchasing strategy. Few submissions raised the matter of the data source. Therefore, the Commission considers that it has adequately addressed the question of the most appropriate data source, and takes this opportunity to restate its view that d-cyphaTrade data is the most appropriate data source for estimating energy purchase costs at this time.

Regarding the forward purchasing strategy and the allowance granted for costs not captured in the forward purchase price of electricity, ActewAGL Retail provided the following description of the costs:⁵¹

- (i) costs to a retailer of *buying additional energy* from the NEM when actual 30 minute demand leaves a retailer 'short' from the contracted swap position
- (ii) costs to a retailer of *selling surplus energy* from the NEM when actual 30 minute demand leaves a retailer 'long' from the contracted swap position (noting that pool prices, more often than not, are lower than the swap contracted price during these periods)
- (iii) *insurance premium costs associated with cap products used to protect the retailer from excessively high spot prices.*

Previously as part of this inquiry, these costs have been referred to as 'hedging costs'. However, that term is not strictly accurate. The term 'hedging' is used normally to describe a transaction used to reduce the risk of a future movement in the price of a particular good. For example, hedging is often used to 'lock in' the future price of a commodity such as oil, agricultural output, the price of a share on the stock market or a value of a foreign currency for a future transaction.

Therefore, to use the term 'hedging costs' when referring to the costs outlined by ActewAGL Retail is misleading. Rather, those costs relate to costs in addition to the actual purchase price of electricity as represented in the futures market.

An electricity retailer incurs additional energy purchase costs because of demand uncertainty. Because of that uncertainty, more often than not, electricity retailers have forward purchased either too little or too much electricity.

In simplified terms, when a retailer has forward purchased too little electricity, it must go to the market and purchase additional electricity.⁵² In these cases, it is likely that demand on the entire network will be high (for example, due to a hot day); therefore, the price of the additional electricity will be high, imposing an additional cost on the retailer.

In times when demand is low and the electricity retailer has purchased too much electricity, it will have additional electricity to sell back into the market. However, in those times, the price of electricity in the market is likely to be lower than that which the retailer initially paid. Therefore, the retailer is likely to make a loss on the excess electricity that it sells.

In addition to these situations where the retailer incurs additional costs due to uncertainty about demand, retailers purchase 'caps' as insurance against price spikes. The caps limit a retailer's exposure to high prices when it needs to purchase additional electricity from the market.

⁵¹ ActewAGL submission on draft decision, p. 11.

⁵² In practice, numerous complex financial instruments are used to buy and sell electricity. However, for the purposes of this discussion, the general principles are sufficient.

The combined affect of these factors is to impose costs on the retailer in addition to those which are captured by looking only at the forward purchase price of electricity. Therefore, there is a claim that the retailer should be compensated for those costs.

In the 2008–09 final decision and previous inquiries, the Commission allowed an additional 5% to be added to the purchase cost of electricity to account for these additional energy purchase costs. This was incorporated into the modelling, as shown in Table 7.1, where a cost allowance of 105% of electricity purchase costs was granted.

In the 2009–10 draft decision, the Commission acknowledged that an allowance of 105% was insufficient to compensate ActewAGL Retail for these costs. Therefore, the Commission adopted the revised purchasing assumptions as shown in Table 7.3. Under this assumption, ActewAGL Retail received the existing 105% allowance for baseload purchases and an allowance of 120% for peak-load purchases. In addition, the Commission suggested altering the purchase periods for peak-load purchases, given the thinness of the futures market for peak electricity contracts. The Commission did this by using a 12-month data period (as opposed to 24 months).

In response to the draft decision, the electricity retailers argued that the purchasing strategy suggested by the Commission did not reflect the operations of a prudent retailer. The Commission acknowledges that the manner in which it presented its preliminary view in the draft decision has led to a degree of confusion. It was the Commission’s intention to address the matter of the thinness of the futures market for peak electricity contracts while at the same time increasing the allowance for additional energy purchase costs. These two matters are discussed in further detail below.

Thinness of the futures market for peak electricity contracts

The thinness of the market for peak electricity contracts becomes a major issue for contracts available from Quarter 3, 2010. As identified by ActewAGL Retail, this is more of an issue for coming years, given the portfolio build-up approach adopted by the Commission. By proposing to adjust the model in the draft decision, the Commission was taking into account the current market realities and a potential problem of the thinness in the market for peak contracts which may arise in the future.

The Commission has reconsidered the need to address this concern at this time. The Commission now considers it to be more appropriate to retain the approach adopted in previous years, whereby the same purchasing strategy is applied to both peak-load and baseload forward purchases.

However, the Commission considers that, should there be a requirement for it to establish a regulated retail electricity price in future years, there is a need to conduct a thorough review of the methodology.

Allowance for additional energy purchase costs

The Commission has acknowledged the need for a revision to the allowance for additional energy purchase costs.

The Commission has considered the information contained in the ActewAGL Retail submission, which argued that an overall allowance of 125% be granted for energy purchase costs. ActewAGL Retail stated that it estimated that the average allowance for NSW retailers was equivalent to 128.5%.

The Commission has conducted its own research into an appropriate energy purchase cost allowance to capture both the cost of electricity and the additional costs associated with managing the uncertainty of demand. This has included an analysis of a model developed by ActewAGL Retail which attempts to estimate these costs, an assessment of other jurisdictions' regulatory decisions, and discussions with market participants. The Commission has concluded that an allowance of 117% to cover energy purchase costs is sufficient.

The Commission considers that the most appropriate way to adjust the purchasing cost model from 2008–09 to take this into account is that shown in Table 7.4.

Table 7.4 Assumed forward purchasing strategy (for delivery 30 June 2009)

Purchase period (ending date)	June 2007	December 2007	June 2008	December 2008	Total
Peak forecast load hedged by contract	29.25%	29.25%	29.25%	29.25%	117%
Base forecast load hedged by contract	29.25%	29.25%	29.25%	29.25%	117%

Final decision

The Commission considers that, should there be a continuing need for a regulated retail electricity tariff to be set, a thorough review of the methodology used to determine tariffs should be undertaken. Such a review is necessary to ensure that matters arising over the coming years are taken into account adequately. For example, should the thinness of the futures market for peak electricity contracts continue, it will become necessary to determine how to best take that into account. In addition, there are other matters which will grow in significance over coming years, such as the CPRS and the potential volatility that the scheme will add to electricity prices.

However, for the time being, the Commission considers that the methodology used to determine electricity purchase costs for 2008–09 remains adequate, provided that an additional allowance for additional energy purchase costs is included. Therefore, in the calculation of the electricity purchase costs for the 2009–10 final decision, the Commission used the same methodology as that adopted in previous years but adjusted to include a total allowance for energy purchase costs of 117%. This is incorporated into the forward purchasing strategy shown in Table 7.4.

This results in a cost component for electricity purchase costs of \$64.92/MWh.

Section 20 requirements

The Commission has adopted an approach based on independent and verifiable market data and a range of assumptions based on industry standards to provide a reasonable estimate of the cost of purchasing wholesale energy from a competitive market pool. In developing this approach, the Commission has developed a methodology which it considers provides a balance between the social imperatives of the provision of reliable electricity to TFT customers (ss. 20(2)(b),(g)), the reduction of market power through the setting of the lowest efficient prices in an open market pool (ss. 20(2)(a), (c), (h), (i) and (k)), and the need for the financially sustainable continuation of the TFT offer by the incumbent retailer in the ACT (ss. 20(2)(d), (e), (i) and (j)).

7.3.2 Energy trading and management costs

Definition

Energy trading and management costs represent the costs incurred by the incumbent retailer in managing an energy trading desk. An energy trading desk is necessary to manage electricity purchases, which are typically bought using a forward-looking portfolio approach, and the associated financial risks. These costs are distinct from those discussed in Section 7.3.1 relating to costs not captured in the futures purchase of electricity.

2009–10 draft decision methodology

The Commission adopted a methodology whereby an allowance for energy trading and management costs was based on the final decision from 2008–09, adjusted by the CPI. The Commission calculated a CPI figure of 4.35% using the following formula, populated using the ABS All Groups Index for the weighted average of eight capital cities:

$$CPI_t = \frac{CPI_{March(t-2)} + CPI_{June(t-2)} + CPI_{Sept(t-1)} + CPI_{Dec(t-1)} - 1}{CPI_{March(t-3)} + CPI_{June(t-3)} + CPI_{Sept(t-2)} + CPI_{Dec(t-2)}}$$

The formula produces a CPI figure of 4.35% to apply in 2009–10. This resulted in an allowance of \$0.75/MWh (0.72×1.0435) for energy trading and management costs for 2009–10.

Matters raised in submissions on the draft decision

ActewAGL Retail accepted the finding in the draft decision that an allowance for energy trading and management costs of \$0.75/MWh was appropriate.

2009–10 final decision methodology

The Commission considers it appropriate to retain the methodology whereby the previous year's cost estimate is adjusted for movements in the CPI.

Final decision

The Commission's final decision is to grant an allowance of \$0.75/MWh for energy trading and management costs for 2009–10. This is based on an adjustment of the 2008–09 cost allowance for movements in the CPI (0.72×1.0435).

Section 20 requirements

The recovery of costs associated with energy hedging, contract and management requirements meets the economic efficiency objective in s. 20(2)(c), as well as the cost-recovery provisions of s. 20(2)(e).

7.3.3 Green costs

Definition

Green costs cover a range of obligations, imposed by governments, that affect the cost of electricity. These include the Australian Government's Mandatory Renewable Energy Target (MRET) scheme and the ACT Government's Greenhouse Gas Abatement Scheme (GGAS).

Green costs can also cover other costs, such as costs incurred as part of the ACT Government's feed-in tariff scheme.

2009–10 draft decision methodology

Green costs allowed in the draft decision were based on information provided by ActewAGL Retail and subsequently verified by the Commission. This methodology is consistent with that adopted in previous years.

The draft decision included an allowance for green costs of \$5.12/MWh. This consisted of a cost of \$2.298/MWh to meet liabilities under the MRET scheme and \$2.824 to meet GGAS costs.

Matters raised in submissions on the draft decision

ActewAGL Retail accepted the allowance of \$5.12/MWh but noted that the ACT Government's feed-in tariff scheme may impose further green costs. It submitted that a pass-through provision should be included to allow for those costs.

2009–10 final decision methodology

The Commission considers it appropriate to accept the cost estimates provided by ActewAGL Retail, subject to verification by the Commission.

The possible inclusion of a pass-through provision for costs associated with the feed-in tariff is discussed in Section 8.2.

Final decision

The Commission's final decision is to include an allowance of \$5.12/MWh for green costs, based on a cost of \$2.298/MWh to meet MRET liabilities and \$2.824 to meet GGAS costs.

Section 20 requirements

The Commission considers that an allowance for green costs is consistent with s. 20(2)(e), which requires the Commission to have regard to the principles of ecologically sustainable development. In addition, including an allowance for green costs on a cost-recovery basis (s. 20(2)(e)) ensures that consumers are protected from the potential misuse of monopoly power (s. 20(2)(a)).

7.3.4 Energy losses

Definition

Electricity is typically generated far from where it is consumed. For example, only 2% of the electricity consumed in the ACT is produced within the territory; the remaining 98% is sourced from various generators along the east coast of Australia.

The transportation of electricity through transmission and distribution networks inevitably results in some energy loss. That loss imposes a cost on the retailer, as it must purchase more electricity than it is able to sell.

2009–10 draft decision methodology

In previous years, the Commission has established an energy loss cost component based solely on distribution losses. However, in response to the issues paper, ActewAGL Retail proposed that an allowance be granted which includes transmission losses as well as distribution losses.

The Commission confirmed that the electricity prices it uses are based on the price at the West Sydney reference node. Therefore, it is reasonable that transmission losses be included to account for the transmission losses associated with transporting electricity from western Sydney to the ACT.

The Commission included an allowance for transmission losses from 2009–10 as a one-off addition to the cost base. A ‘catch-up’ for previous years was not considered appropriate.

In preparing the draft decision, the Commission noted that the loss factors for 2009–10 had yet to be finalised. Therefore, the Commission based the figures in the draft decision on estimates of the loss factors for 2009–10. This resulted in an allowance of 7.90%.

Matters raised in submissions on the draft decision

ActewAGL Retail accepted the Commission’s decision to include both transmission and distribution losses. ActewAGL Retail noted that the bulk of electricity supplied through to the ACT comes through the 132 kV connection point and that, therefore, the transmission loss factor associated with that point should be used.

ActewAGL Retail stated that the combination of the distribution and transmission loss factors results in a combined loss factor of 6.01%.

2009–10 final decision methodology

The Commission considers it appropriate to calculate energy losses based on a combination of distribution and transmission losses using the following formula:

$$\text{Total losses} = (1 + \text{distribution losses}) \times (1 + \text{transmission losses}).$$

The 2009–10 distribution loss factor for ActewAGL Distribution’s low-voltage connection is 1.0478.

The 2009–10 marginal loss factor (i.e. transmission loss factor) for the Canberra 132 kV connection point is 1.0117.

Therefore, total energy losses are $(1.0478) \times (1.0117) = 1.0601 = 6.01\%$.

Final decision

The Commission’s final decision is to allow for energy losses of 6.01%.

Section 20 requirements

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

7.3.5 National Electricity Market fees

Definition

The NEM is the interconnected electricity grid that covers most parts of Queensland, NSW, the ACT, Victoria, Tasmania and South Australia. The NEM is managed by NEMMCO, which is funded via user fees that are ultimately borne by customers. The fees cover a range of functions provided by NEMMCO that are necessary for the safe and reliable delivery of electricity to all consumers.

2009–10 draft decision methodology

The Commission adopted a methodology in which an allowance for NEM fees was calculated based on an adjustment to the 2008–09 final decision figure by the CPI. The Commission calculated a CPI figure of 4.35%, which resulted in an allowance of \$0.75/MWh (0.72×1.0435) for NEM fees for 2009–10.

Matters raised in submissions on the draft decision

ActewAGL Retail supported the draft decision.

2009–10 final decision methodology

The Commission has adopted the methodology in which the final allowance from 2008–09 is adjusted for movements in the CPI.

Final decision

The Commission's final decision is to adopt an allowance for NEM fees of \$0.75/MWh. This is based on an adjustment of the 2008–09 cost allowance for movements in the CPI (0.72×1.0435).

Section 20 requirements

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

7.3.6 Retail operating costs

Definition

Retail operating costs are the costs incurred by the incumbent retailer in providing retail services to TFT customers. These costs include:

- billing services, including meter reading
- call centre costs
- customer information costs
- general operating overhead costs.

2009–10 draft decision methodology

In the 2009–10 draft decision, the Commission considered retail operating costs as two distinct elements. The first related to costs incurred in providing retail services, while the second related to whether an allowance for customer acquisition costs should be granted.

For costs incurred in providing retail services, the Commission considered it appropriate to retain the methodology developed in previous years. This involved adjusting the allowance from the final decision from the previous year for movements in the CPI. This resulted in a retail operating cost of \$10.37/MWh, which was based on an allowance of \$9.94 in 2008–09 and an adjustment for a change in the CPI of 4.35%.

The Commission considered granting an allowance for customer acquisition costs. In considering whether it was appropriate to include such an allowance, the Commission noted that the retail cost component already included an allowance for ActewAGL Retail to inform customers about the TFT arrangements. In addition, the Commission noted that ActewAGL Retail had provided no additional information that demonstrated the need to include customer acquisition costs and that the ACT Government had made no amendment to the terms of reference which required the Commission to grant such an allowance.

Furthermore, the Commission addressed the notion that including an allowance for customer acquisition costs might increase the level of competition in the market. The Commission stated that, while it acknowledged that vigorous competition is in the best long-term interests of consumers, it must also be guided by the provisions of section 20 of the Act, which addresses matters such as the protection of consumers against abuses of monopoly power, the cost of providing regulated services and the social impact of the Commission's decisions.

In balancing these objectives, the Commission did not consider that the potential longer term benefits to consumers from including an allowance for customer acquisition costs (on the basis that it may increase competition) would outweigh the potential negative short-term implications of the increased cost. The Commission noted that this highlights the fundamental 'market disconnect' that exists when having a regulated tariff in a competitive market.

The Commission concluded by noting that the Australian Energy Market Commission is to review the state of the ACT electricity market in 2010 and may recommend the removal of price regulation in the medium term.

Matters raised in submissions on the draft decision

ActewAGL Retail submitted that:⁵³

... an increase to operating costs in line with inflation is adequate only if the Commission also approves customer acquisition and retention costs of \$21.78 per customer (\$2.20 per MWh). An increase in line with inflation on operating costs only does not account for recent movement in these costs for the industry.

The allowed retail operating cost is based on the allowance that was determined for the 2003/04 Decision and has been adjusted for inflation since that time. Labour costs, by far the biggest component of retail operating costs, have increased at rates well in excess of inflation since that time.

⁵³ ActewAGL Retail submission on draft decision, p. 14.

According to the Australian Bureau of Statistics, wages and salaries per person employed in the electricity supply industry increased by 14% in 2006/07,⁵⁴ 11% during 2004–05⁵⁵ and over the period from 2001–02 to 2004–05, the electricity supply industry's wages and salaries have increased in current price terms by 15%,⁵⁶ which is well above the CPI.

Econtech's Labour Growth Forecasts (March 2009), discusses the forecast growth rates of overall CPI, wages and productivity in the ACT over the period 2004/05 to 2010/11. According to the report, Econtech, Access Economics and BIS Shrapnel are all forecasting expected labour cost growth to continue to outpace inflation for the next three years.

ActewAGL Retail also argued that it:⁵⁷

believes that the cost of communicating the TFT arrangements cannot be seen to reflect the full costs of maintaining market presence, brand awareness campaigns or the making of contractual offers and all the associated arrangements with customer acquisition and retention. This is a significant cost to ActewAGL that is designed specifically with customer service and retention in mind, regardless of whether these customers are to stay on the TFT or a contract.

Regarding customer acquisition costs, ActewAGL Retail stated that it considered an allowance of \$2.20/MWh to be appropriate and argued that:⁵⁸

While ActewAGL believes that the Terms of Reference does not preclude the Commission from basing their decision on the efficient costs of a mass market new entrant, if the Commission is to continue to define the market benchmark as being costs for an incumbent retailer, rather than a mass market new entry retailer, then costs of an incumbent related to retention by way of market based offers and contracts should be factored into the benchmark customer service cost. A market based estimate of this cost would be equivalent to the customer acquisition and retention cost of \$2.20/MWh.

Part of the costs of ActewAGL operating in a competitive market place is to lead and counter offers made by other retailers to retain its customer base. Retention of customers is important for retailers to retain economies of scale as any reduction in the total customer base means that fixed costs need to be spread amongst fewer customers.

AGL stated that it:⁵⁹

... maintains its view that an allowance for operating costs should be set at a level that includes all costs in attaining, retaining and servicing customers. Most importantly, they should be set in such a manner so as to allow and encourage a greater number of retailers to compete in the ACT market. It is common practice for new entrant retailers to use the regulated tariff by way of a benchmark tariff and apply a discount against this benchmark when competing for customers.

The Commission itself has identified that it plays a crucial role in setting the price for both negotiated and non-negotiated contracts. By way of excluding acquisition costs from the total Transitional Franchise Tariff (TFT), the Commission is in effect setting a TFT that risks discouraging new entrant retailers entering the ACT market.

AGL also notes that it is also important to ensure cost parity with other jurisdictions for similar services/products where applicable.

⁵⁴ Australian Bureau of Statistics (ABS) 2008, *Electricity, gas, water and sewerage operations, Australia*, catalogue no. 8226.0, latest issue released 9 July 2008.

⁵⁵ ABS 2006, *Electricity, gas, water and sewerage operations, Australia*, catalogue no. 8226.0, latest issue released 13 October 2006.

⁵⁶ ABS 2006, *Electricity, gas, water and sewerage operations, Australia*, catalogue no. 8226.0, latest issue released 13 October 2006.

⁵⁷ ActewAGL Retail submission on draft decision, p. 14.

⁵⁸ ActewAGL Retail submission on draft decision, p. 15.

⁵⁹ AGL submission on draft decision, p. 2.

Origin Energy argued for the inclusion of an allowance for customer acquisition costs and noted that an allowance is granted in all other jurisdictions of the NEM. Origin Energy argued that if the TFT were set at the lowest possible price for the incumbent without providing for recovery of retention and acquisition costs, then a new entrant may not be able to compete in the market, thus stifling competition.⁶⁰

In addition, Origin Energy argued that prices were currently not cost reflective and that this was denying the ACT market a transitional phase to allow:⁶¹

... new retailers to establish market position before innovation and vigorous competition emerges. As the name of the TFT implies, it is a transitional retail tariff, providing a cap on market prices whilst competition is propagated.

Origin has concerns that where the retail tariff is not cost reflective and is inhibiting competition, the consequent damage upon competition may be self-perpetuating and will require further significant interference to rectify the issue.

2009–10 final decision methodology

This discussion of the 2009–10 final decision methodology is split into two parts. The first looks at cost incurred in providing retail services. The second discusses the appropriateness of allowing the recovery of customer acquisition costs.

Costs incurred in providing retail services

Costs incurred in providing retail services are based on an estimate of \$85 per customer in 2003–04. The cost per customer was then translated into a cost per megawatt hour so that it could be included in the Commission's cost build-up. In subsequent years, the figure has been adjusted for movements in the CPI.

ActewAGL Retail argued that data from the ABS indicates that wages and salaries of people employed in the electricity supply industry have increased by greater than movements in the CPI. ActewAGL Retail cites ABS report series 8226 on electricity, gas, water and waste services and argues that:⁶²

wages and salaries per person employed in the electricity supply industry increased by 14% in 2006/07,⁶³ 11% during 2004–05⁶⁴ and over the period from 2001–02 to 2004–05, the electricity supply industry's wages and salaries have increased in current price terms by 15%,⁶⁵ which is well above the CPI.

⁶⁰ Origin Energy submission on draft decision, pp. 3–4.

⁶¹ Origin Energy submission on draft decision, p. 4.

⁶² ActewAGL Retail submission on draft decision, p. 14.

⁶³ ABS 2008, *Electricity, gas, water and sewerage operations, Australia*, catalogue no. 8226.0, latest issue released 9 July 2008.

⁶⁴ ABS 2006, *Electricity, gas, water and sewerage operations, Australia*, catalogue no. 8226.0, latest issue released 13 October 2006.

⁶⁵ ABS 2006, *Electricity, gas, water and sewerage operations, Australia*, catalogue no. 8226.0, latest issue released 13 October 2006.

ABS report series 8226 defines the electricity supply industry using the Australian and New Zealand Standard Industrial Classification (ANZIC) system. ANZIC defines the electricity supply industry:⁶⁶

as consisting of those businesses mainly engaged in electricity generation and/or transmission and/or distribution and/or the on-selling of electricity via power distribution systems operated by others.

The Commission has concerns regarding the applicability of ABS report 8226 to the cost incurred by ActewAGL Retail in providing retail services which are predominantly focused on customer service. Rather, ABS report 8226 is focused on the technical and operational side of the electricity industry—that is, workers involved in electricity generation, transmission and distribution activities.

The on-selling of electricity via power distribution systems, which includes a component for electricity retailing, represents approximately 8%⁶⁷ of the electricity supply industries' wages and salaries expenses as reported in ABS report 8226. Therefore, the Commission considers there is little that can be drawn from that report which supports the claim that the costs incurred by ActewAGL Retail in providing retail services have increased, as suggested by an initial high-level examination of the ABS report.

ActewAGL Retail also argued that:⁶⁸

Econtech's Labour Growth Forecasts (March 2009), discusses the forecast growth rates of overall CPI, wages and productivity in the ACT over the period 2004/05 to 2010/11. According to the report, Econtech, Access Economics and BIS Shrapnel are all forecasting expected labour cost growth to continue to outpace inflation for the next three years.

Regarding possible increases in labour costs which exceed inflation, the Commission notes the observation from IPART that for electricity retailers:

historical trends [indicate that] ... higher wages growth has not led to real increases in these [retail operating] costs.

IPART argued that any increase in wages is offset by increased productivity, such that retail operating costs remain constant in real terms. IPART fixed retail operating costs in real terms, allowing only an annual increase for movements in the CPI for the period from 1 July 2007 to 30 June 2010.⁶⁹

Furthermore, the Essential Services Commission of South Australia factored in a 4.1% real annual reduction in retail operating costs due to efficiency gains over the period from 1 January 2008 to 30 December 2010.⁷⁰

The Commission considers it appropriate to retain the methodology whereby the previous year's cost estimate is adjusted for movements in the CPI. The Commission considers that such a methodology allows ActewAGL Retail to recover the efficient costs of providing retail services.

⁶⁶ ABS 2008, Electricity, gas, water and sewerage operations, Australia, catalogue no. 8226.0, latest issue released 9 July 2008, p. 8.

⁶⁷ Calculation based on ABS 2008, Electricity, gas, water and sewerage operations, Australia, catalogue no. 8226.0, latest issue released 9 July 2008, p. 11, wages and salaries expenses.

⁶⁸ ActewAGL Retail submission on draft decision, p. 14.

⁶⁹ IPART, *Promoting retail competition and investment in the NSW electricity industry*, pp. 93–99.

⁷⁰ ESCOSA, *2007 Review of retail electricity price path: Final inquiry report and price determination*, November 2007, p. A–59.

The Commission's final decision for 2008–09 was an allowance of \$9.94. Adjusting this figure for movement in the CPI results in a cost allowance of \$10.37/MWh (9.94×1.0435) for 2009–10.

Customer acquisition costs

Customer acquisition costs are those costs that an electricity retailer who is actively seeking new customers would incur above and beyond the costs of providing retail services. Examples include the costs incurred in developing and implementing an advertising campaign or a door-to-door sales force. The issue the Commission faces is whether it is appropriate to include these costs in the build-up of the efficient cost of providing retail services.

Clearly, a mass market entrant would need to incur these costs if it were to attract new customers. However, the Commission must consider whether it is appropriate, as suggested in submissions from electricity retailers, for it to include an allowance which increases the price of electricity in an attempt to foster further competition in the ACT retail electricity market.

In the draft decision, the Commission stated:⁷¹

The Commission does not consider it appropriate to allow the inclusion of an allowance for customer acquisition costs in an attempt to increase the level of competition in the market. While it acknowledges that vigorous competition is in the best long-term interests of consumers, it must also be guided by the various requirements of section 20 of the ICRC Act. These include matters such as the protection of consumers against abuses of monopoly power, the cost of providing regulated services and the social impact of its decisions. In balancing the objectives of the Act, the Commission does not consider that the potential longer term benefits to consumers from including an allowance for customer acquisition costs (on the basis that it may increase competition) outweigh the potential negative short-term implications of the increased cost. This is especially the case, given customers' apparent apprehension about switching to negotiated contracts.

The Commission's view is that this conclusion remains valid.

There is a related issue regarding the magnitude of any customer acquisition costs. The level of customer acquisition costs as proposed by ActewAGL Retail would increase prices by approximately 1.5%. The Commission does not consider that a 1.5% increase in the TFT would result in a significant increase in the number of active competitors, or an increase in the level of vigorous competition from existing market participants. Rather, the Commission considers that this would simply represent a transfer from customers to retailers without compensatory benefits in terms of lower overall prices or the development of alternative services. Thus, the Commission does not consider it appropriate to include any customer acquisition costs in the efficient retail operating costs at this time.

Whether or not an allowance should be granted for customer acquisition costs also raises the issue of the role of a regulated price in a market that has been declared competitive by the government. This is an issue that is explored in depth in Section 8.3.

Final decision

The Commission's final decision is to grant an allowance for retail operating costs of \$10.37/MWh, based on an increase of the 2008–09 allowance for movement in the CPI.

No allowance is considered appropriate for customer acquisition costs.

⁷¹ ICRC, *Retail prices for non-contestable electricity customers, 2009–2010: Report 2 of 2009*, April 2009, page 48.

Section 20 requirements

The Commission considers that the allowance granted for retail operating costs is a reasonable balance between the need to allow cost recovery (s. 20(2)(e)) and the need to require the incumbent to operate efficiently (s. 20(2)(c)). In addition, the Commission has had regard for the social impacts of its decisions (s. 20(2)(g)) by not including a customer acquisition cost on the basis that such a cost is necessary to encourage competition.

7.3.7 Retail margin

Definition

The retail margin represents the return the incumbent retailer earns on the investment it must undertake to provide retail services. Without a retail margin, the incumbent retailer would be unable to attract the funds needed to provide those services. In addition, the existence of a retail margin together with an allowance for other legitimate costs of providing the retail service allows room for other retailers to enter the market and competitively offer alternative electricity supply contracts, assuming they can operate more efficiently or achieve other economies (including savings on the retail margin) that can be passed through to customers in the form of lower prices.

2009–10 draft decision methodology

In its draft decision, the Commission considered a retail margin of 5% to be appropriate. The Commission noted that 5% is consistent with the margin adopted in other jurisdictions. A retail margin of 5% represented an increase from the 4% granted in 2008–09.

Matters raised in submissions on the draft decision

ActewAGL Retail noted the Commission's decision to apply a retail margin of 5%. In addition, ActewAGL submitted that submissions from retailers in other states have advised that a retail margin of 5% falls short of a competitive market rate.

2009–10 final decision methodology

The Commission proposes to maintain a retail margin of 5% as proposed in the draft decision.

Final decision

The Commission's final decision is to adopt a retail margin of 5%.

Section 20 requirements

The Commission believes this approach meets the objectives of s. 20(2)(d), to allow an appropriate return on investment, and s. 20(2)(i), to meet the borrowing, capital and cash flow requirements of the business.

7.3.8 Network costs

Definition

Transmission and distribution network costs are the costs paid by the retailer to transport electricity over the transmission and distribution networks.

2009–10 draft decision methodology

The costs charged by transmission and distribution network owners are determined by the AER. These costs are unavoidable, and so are passed directly through into retail prices.

In the draft decision, the Commission adopted an estimate of network costs of \$66.34/MWh. This was based on estimates of transmission costs and the AER's draft decision on ActewAGL Distribution's prices. Therefore, the Commission noted that the figure would need to be updated following the release of the AER's final decision on distribution prices. It was also noted that the customer load profile would need to be updated between the draft decision and final decision.

Matters raised in submissions on the draft decision

ActewAGL Retail noted that the AER had released its final decision on ActewAGL Distribution's prices and that ActewAGL Distribution was then required to submit its distribution prices to the AER for final approval. In addition, ActewAGL Retail noted that it had updated its customer load profile to reflect a full 12-month period from 1 April 2008 to 31 March 2009.

ActewAGL Retail submitted a network cost of \$65.12/MWh, to be updated following final approval of ActewAGL Distribution's prices by the AER.

2009–10 final decision methodology

The AER approved ActewAGL Distribution's prices on 29 May 2009. The combination of transmission costs, the approved distribution charges and the updated load profile result in a network cost of \$66.52/MWh.

Final decision

The Commission will adopt a cost of \$66.52/MWh for network costs for 2009–10.

Section 20 requirements

The Commission believes that allowing the recovery of actual costs incurred meets the objective of s. 20(2)(a) by protecting consumers from abuses of monopoly power, while at the same time accepting that the recovery of network cost pass-throughs is a legitimate activity for the retailer and meets the objectives of ss. 20(2)(c), (d), (e), (i) and (k).

7.4 Final decision on cost elements

The Commission's final decision on each of the cost components for 2008–09 and 2009–10, along with the calculation of the X factor, is shown in Table 7.5.

Table 7.5 Composition of TFT retail price for 2009–10 relative to 2008–09: final decision

	2008–09 final decision	2009–10 final decision	% Change
Energy purchase costs (\$/MWh)			
Electricity purchase cost (\$/MWh)	67.62 ⁷²	64.92	-3.99%
Energy contracting cost (\$/MWh)	0.72	0.75	4.35%
Green costs (\$/MWh)	4.87	5.12	5.17%
NEM fees (\$/MWh)	0.72	0.75	4.35%
Energy losses	4.86%	6.01%	1.15%
Total energy purchase cost (\$/MWh)	77.52	75.84	-2.17%
Retail operating costs (\$/MWh)	9.94	10.37	4.35%
Customer acquisition costs (\$/MWh)	–	–	
Total retail costs (\$/MWh)	9.94	10.37	4.35%
Network costs (\$/MWh)	56.06	66.52	18.66%
Total retail + network costs (\$/MWh)	143.52	152.73	6.42%
Retail margin (EBITDA, % of sales)	5.00%	5.00%	–
Total retail price (\$/MWh)	150.69	160.36	6.42%
X factor in CPI + X on MAR in \$/MWh		1.98%⁷³	

In reaching conclusions on the various cost components for 2009–10, the Commission has identified a need to undertake a comprehensive review of the methodology should price regulation continue in the ACT. Such a review would need to commence in the coming months to allow sufficient time to take account of all the necessary factors. A comprehensive review is necessary due to:

- the possibility that the methodology adopted in 2007–08 is no longer appropriate
- matters related to the most appropriate way to model electricity purchase costs, including
 - how to best take into account uncertainty regarding the introduction of the Australian Government’s CPRS and the volatility it is likely to bring to carbon prices and subsequently electricity prices
 - how to address the apparent thinness of the futures market
 - what is an appropriate allowance for additional energy purchase costs
 - the technical operation of the electricity purchase cost calculation.

⁷² This figure differs from that contained in the 2008–09 final report, as it has been updated for actual purchase cost information which was unavailable at the time of completing the inquiry.

⁷³ Calculated using the Fisher equation: $(1 + 6.42\%) / (1 + 4.35\%) - 1$.

8 Non-technical matters

This chapter considers non-technical matters, including:

- social implications
- pass-through arrangements
- issues involved in continued price regulation.

8.1 Social implications

The Commission is required under section 20(2)(g) of the ICRC Act to address matters relating to the social implications of its decisions for vulnerable customers.

This section provides:

- an overview of the Commission’s analysis in the draft decision
- a summary of submissions received on the draft decision
- a discussion of the Commission’s conclusions on the social implications of the TFT.

8.1.1 Overview of the draft decision

In the draft decision, the Commission restated its position that the TFT is not intended to be a ‘safety net’ tariff to be used for social or targeted support for smaller consumers. The Commission noted that setting the TFT at a level that low-income and vulnerable customers can afford would lead to market distortions, including making full cost recovery unlikely, altering investment decisions, and possibly encouraging excessive use of electricity, leading to negative environmental consequences.

The Commission noted that competition was in the best long-term interests of consumers as it would ensure appropriate prices and the development of alternative products and levels of service. The Commission pointed to experiences in the United Kingdom as an example of such an outcome.

In addition, the Commission reaffirmed its support for the use of targeted government concessions programs as the most appropriate way to support low-income and vulnerable customers. Furthermore, the Commission noted that for energy markets to work well there is a need for customers to be well informed, involved and active, that any financial support programs should be accompanied by information and education campaigns, and that there is a role for government to develop programs aimed at improving the energy efficiency of housing stock and appliances.

Regarding the actual level of government concession programs, the Commission noted that the current concession is applied differently for energy supply⁷⁴ compared to water and wastewater

⁷⁴ Prior to 1 July 2004, there was a separate electricity rebate (paid by the ACT Government) and gas rebate (paid by ActewAGL Retail). On 1 July 2004, these were combined into a single energy rebate which is paid by the ACT Government. The energy rebate is paid only on electricity consumption, as it is assumed that all gas customers are also electricity customers.

concessions, where it is linked directly to the fixed charge. This direct linkage means that, if the water or wastewater fixed charge is increased, the concession is increased automatically.

The Commission also noted that the energy rebate is based on a per kilowatt hour rate that varies between winter and summer and that the overall maximum level of the energy rebate had been adjusted only once since 2004, when it was increased from \$189.11 to \$194.87 to compensate consumers for the introduction of the Network Facilities Infrastructure Tax. This represents a gradual decline in the real value of the concession, as electricity charges have increased by around 35% since 2004–05.

In response, the Commission stated that it would recommend to the ACT Government that the energy concession rates be amended so that the concession payment (the overall cap and the per kilowatt hour rate) would be linked to movements in the TFT. The Commission also stated that it would recommend that the government consider making a further cost allowance in its concession arrangements to account for costs associated with the feed-in tariff.

8.1.2 Summary of submissions received on the draft decision

Care stated that it:⁷⁵

acknowledges that increases in retail prices for non-contestable customers are inevitable; and is pleased that the proposed increase in the current draft decision is modest compared with recent substantial increases that have seen electricity charges increase by approximately 35% since 2004–05. However, any increase puts pressure on low income households, particularly on top of the recent increases and disproportionately affects low-income consumers.

Regarding the Commission’s recommendation in the draft decision that concessions be indexed to electricity price changes, Care stated:

We agree with the Commission’s view ‘that there is a clear need to provide support mechanisms for low-income and vulnerable consumers’ and acknowledge that the Commission has attempted to find a process to address this by suggesting that ‘there are strong grounds for linking the value of the electricity rebate to increases in the retail price of electricity.’

Care made the following comments on broader considerations:⁷⁶

Electricity is an essential and not a choice; in a competitive market, adequate and pro-active provisions should be in place to protect vulnerable consumers:

- While concessions are a useful approach to issues facing low-income and vulnerable consumers; a purely concessions driven approach is unsustainable in the longer term.
- Care acknowledges the Commission’s comments that ‘the TFT is not intended to be a ‘safety net’ to be used for social or targeted support to smaller consumers.’ We believe that energy retailers have a responsibility, as part of their core business planning to have in place hardship policies that are transparent, workable and responsive to customers who are unable to meet the payments on their electricity accounts. This should include early identification of customers experiencing financial difficulties and a range of flexible options that take into account the customer’s capacity to pay.
- Low-income consumers are generally at great disadvantage compared with other consumers due to living in insufficiently insulated dwellings with outdated appliances. Care believes there needs to be an investment in providing both structural and educational measures that assist with consumption reduction of energy costs especially for low income earners, public housing and

⁷⁵ Care submission on draft decision, p. 1.

⁷⁶ Care submission on draft decision, pp. 2–3.

private rental tenants, all of whom are very vulnerable to rising costs. This may assist in providing some protection against anticipated future steep rises in electricity costs.

- Expecting disadvantaged households to continue making reductions in energy usage when the dwelling they occupy is not designed to assist in their efforts is at best counter productive and at worst destructive; as the household simply cannot do what is asked of them, despite their efforts. While this particular Draft Decision contains a modest increase in electricity costs, those in the community without updated appliances, adequate insulation, appropriate energy efficient dwellings and educational support, will still feel the effects of the increase.

ActewAGL Retail stated that it believed that best way for the Commission to take account of the social impact of its decisions was to implement measures that will best accelerate competition in the ACT. ActewAGL Retail expressed its support for targeted concession programs. On the Commission's recommendation that concessions be indexed to changes in the TFT, ActewAGL Retail stated that it:⁷⁷

would like to point out that as long as the structural arrangements for the revised concession arrangements remain in their current form, it is able to implement these changes without cost. However, should the structure of the concession arrangements be altered, this could result in an administrative cost to ActewAGL that it would seek to pass on to customers.

8.1.3 Discussion

In making decisions on matters such as electricity, water and wastewater pricing, the Commission is required to consider the social impacts of its decisions under section 20(2)(g) of the ICRC Act. In those considerations, the Commission is guided by organisations such as the ACT Civil and Administrative Tribunal, Care Financial Counselling Service, ACTCOSS, SoftLaw Community Projects and other support and advocacy agencies.

The Commission is mindful of the impact rising utility bills can have on low-income and vulnerable consumers. In its response to the issues paper, Care identified the following potential adverse impacts:⁷⁸

- the social isolation that accompanies a disconnected supply
- the potential health effects of inadequate heating or cooling
- going without other life essentials, such as medication or food.

In its draft report, the Commission noted that the regulated retail tariff was never intended to be a 'safety net' to be used for smaller customers. The Commission identified that setting:⁷⁹

the regulated retail tariff, which any customer regardless of their income can access, at a level to ensure that low-income and vulnerable customers can afford their electricity bills creates several market distortions. If the price of electricity reflects the ability of the most disadvantaged electricity customers to afford their purchases, then full cost recovery for the provision of retail electricity services is unlikely. This would result in signals to utility service providers that distort their investment and electricity purchasing decisions, and would require large government subsidies to support the service. Competition in other sectors of the electricity market, especially for large customers, implies that there can be no cross-subsidies between customer classes. That is, large customers should not (and cannot under current market structures) be required to cross-subsidise small customers. Finally, setting the regulated retail tariff too low would encourage excessive use of electricity, which has negative environmental consequences.

⁷⁷ ActewAGL submission on draft decision, p. 20.

⁷⁸ Care submission on issues paper, p. 2.

⁷⁹ ICRC, *Draft decision: Retail prices for non-contestable electricity customers, 2006–2010*, April 2009, pp. 55–56.

In its response to the draft decision, Care acknowledged that the TFT was never intended to be used as a safety net. However, Care stated that energy retailers have a responsibility to have in place hardship policies that are transparent, workable and responsive to customers who are unable to meet the payments of their electricity accounts.⁸⁰ In addition, Care argued for an updated examination of the real value of the energy concession.⁸¹

Table 8.1 shows the value of electricity concessions over recent years for a household with typical consumption. The level of the concession is set in nominal terms. This differs from how similar arrangements operate for wastewater concessions, where the concession is set as a fixed proportion of the overall charge, ensuring that the real value of the concession is not eroded as price increases.

Table 8.1 Annual electricity bill (8,000 kWh) and available concessions for a typical residential household

Year	Electricity (8000 kWh)	Concession \$	Concession %
2004–05	\$993	\$189	19.0%
2005–06	\$1,025	\$189	18.4%
2006–07	\$1,065	\$189	17.7%
2007–08	\$1,243	\$189	15.2%
2008–09	\$1,324	\$195 ⁸²	14.7%

The Commission considers that factors such as the ACT Government’s feed-in tariff and the introduction of the Australian Government’s CPRS are likely to add to any electricity price rises and therefore further decrease the real value of the electricity concession. As an indication of the likely cost of the feed-in tariff arrangement, the Commission notes that the AER’s final decision on ActewAGL Distribution’s allowable prices granted an allowance of approximately \$48 million over the coming five years to offset the cost of the ACT feed-in tariff scheme.⁸³ This is the equivalent to a charge for a typical household of around \$27 per year if allocated evenly over the five years.⁸⁴

An alternative approach to having a fixed nominal value for a concession is to link the value of the concession to movements in the price of the utility service. This is demonstrated by the wastewater concession, for which the real value of the concession is fixed. It was initially set at 65% but was increased to 68% in 2008–09 in recognition of the increase in water and wastewater charges.

In the draft decision, the Commission stated that it would recommend to the ACT Government that the value of the electricity concession be linked to movements in the TFT (or, should the TFT be removed, to the most commonly used electricity contract offered by ActewAGL Retail). The Commission retains this view and considers it appropriate that the electricity rebate (the overall dollar cap and the per kilowatt rate) be linked to movements in the TFT.

⁸⁰ Care submission on issues paper, p. 3.

⁸¹ Care submission on issues paper, p. 2.

⁸² Increased to account for the introduction of the ACT Government’s Network Facilities Infrastructure Tax.

⁸³ AER, *Final decision: Australian Capital Territory distribution determination 2009–10 to 2013–14*, 28 April 2009, p. 85.

⁸⁴ \$48 million divided by five years divided by total usage of 2,831,000 MWh multiplied by a typical household usage of 8,000 kWh per year.

On the implementation of such an approach, ActewAGL Retail stated that it:⁸⁵

would like to point out that as long as the structural arrangements for the revised concession arrangements remain in their current form, it is able to implement these changes without cost. However, should the structure of the concession arrangements be altered, this could result in an administrative cost to ActewAGL that it would seek to pass on to customers.

The Commission acknowledges the concerns of ActewAGL Retail and considers that, should the structure of the concessions arrangement be altered in such a way that ActewAGL Retail incurs costs, there is a legitimate claim for those costs to be recovered.

The Commission also notes that IPART has recommended that a similar arrangement be introduced in NSW. IPART recommended to the minister that the rebate available to pensioners be indexed rather than left at a fixed rate. IPART stated that it considers:⁸⁶

that the Government should consider indexing the pensioner rebate to energy prices rather than the CPI as this more closely tracks the costs that the rebate is alleviating. A more equitable, but potentially more expensive alternative would be for the Government to consider making the pensioner rebate a percentage of the bill, rather than a fixed amount.

Furthermore, the Commission is conscious that the level of concessions is only one element of a well-rounded social support framework. The Commission reaffirms its position, as expressed in the draft decision, that the most appropriate manner in which support can be provided to low-income and vulnerable customers is to adopt a holistic approach. A holistic approach consists of a combination of:

- utility bill concession programs
- government-funded energy efficiency programs aimed at reducing overall energy consumption
- information and awareness campaigns.

By adopting a coordinated approach across these three streams, the effectiveness of each can be increased.

There already exists a wide range of government-funded energy efficiency programs which are aimed at reducing overall energy consumption. These include Australian Government programs, such as the rebate available on the installation of insulation.⁸⁷ In addition, the ACT plays an active role in national policy development, including through its involvement with the National Framework for Energy Efficiency overseen by the Ministerial Council on Energy. The framework implements policies on such matters as minimum energy efficiency standards for appliances.

There is also a range of ACT Government funded programs. For example, the ACT Government has committed \$20 million over the next 10 years for improving the energy efficiency of public housing. This includes improving energy efficiency through wall and ceiling insulation and draught seals as well as high-efficiency hot water systems and heating appliances for new and existing dwellings. The ACT Government has also allocated \$1 million in additional emergency relief funding as part of the 2008–09 Second Budget Appropriation. Of that \$1 million, \$850,000 was allocated to Regional Community Services and existing ACT-funded emergency relief providers, such as St Vincent de Paul, the Salvation Army and Uniting Care Kippax, to help vulnerable Canberrans with bills, groceries and other essentials.

⁸⁵ ActewAGL submission on draft decision, p. 20.

⁸⁶ IPART, *Market-based electricity purchase cost allowance – 2009 review: Regulated electricity retail tariffs and charges for small customers 2007 to 2010, Electricity – Final report and determination*, May 2009, p. 19.

⁸⁷ www.environment.gov.au/rebates/

Information and awareness campaigns can also play a role in drawing attention to ways in which consumers can adjust their behaviour and subsequently reduce consumption. In addition, such campaigns can be used to highlight government efficiency programs. There is a range of existing Australian and ACT Government information and awareness campaigns.

A well-coordinated combination of concession arrangements, efficiency programs and information and awareness campaigns is the most effective way to support low-income and vulnerable customers.

8.2 Pass-through arrangements

This section:

- provides a definition of pass-through arrangements
- discusses the pass-through arrangements contained in the 2009–10 draft decision
- summarises the submissions received on the draft decision
- discusses the submissions received
- sets out the Commission’s final decision on pass-through arrangements.

8.2.1 Definition

Pass-through arrangements are often included in regulatory decisions to allow for an adjustment to prices if unforeseen events occur during the life of a price path. If a pass-through ‘trigger’ event occurs, a new investigation can be undertaken to update the prices or an automatic adjustment may be made.

Pass-through arrangements typically apply to events that are unforeseen, or whose extent is uncertain, and which are beyond the ability of the regulated entity to control. Therefore, the need for triggers increases with the length of the price path. For a price path of only 12 months, as with the TFT, such an arrangement is less necessary.

8.2.2 2009–10 draft decision methodology

In response to the issues paper, ActewAGL Retail submitted that the Commission consider four pass-through arrangements. These were:

- the ACT Government’s feed-in tariff
- unforeseen ACT and Australian government environmental initiatives
- the possible introduction of a smart metering trial or rollout of smart meters
- a change in network tariffs during the 2009–10 financial year.

Based on its consideration of the proposed events, the Commission stated its preference to include no pass-through arrangements. However, it stated that it would reassess the need for pass-through provisions when preparing this final report.

8.2.3 Matters raised in submissions on the draft decision

ActewAGL Retail stated:⁸⁸

The Commission did not entirely accept any of ActewAGL's proposed pass through provisions in its Draft Decision. The Commission's reluctance to accept specific pass through events leaves ActewAGL exposed to potential changes in costs throughout the regulatory period. ActewAGL has identified the following four potential uncontrollable and unforeseeable events as pass through trigger events.

- Smart Metering
- Network Tariff Change
- Feed-in Tariff
- Environmental Initiatives

ActewAGL agrees with submissions from both Origin and TRUenergy's which insist that pass through events need not be individually identified and approved by the Commission as such events are, by definition, unforeseen. ActewAGL supports TRUenergy's suggestion that a more prudent approach would be to allow for a pass-through in circumstances where there is a material change in the retailer's cost base relative to the assumptions of the price determination.⁸⁹

Should the Commission choose to adopt specific pass through events, ActewAGL suggests that the four events outlined require pass through arrangements in the Commission's determination and each is discussed in turn below.

ActewAGL Retail then provided additional detail on each of the four pass-through events.

AGL stated that it:⁹⁰

... advocates the inclusion of a general pass through provision to allow the recovery of efficient and prudent costs where there is a material change in the cost base of a retailer in comparison to that allowed by the Commission when the price path, being the TFT in this instance, is determined.

Origin Energy stated that it:⁹¹

... supports a general pass-through mechanism similar to that put forward by TRUenergy in its submission to the Issues Paper. That is, a pass-through event will be triggered where there is a material change in a retailer's cost base relative to the assumptions made in the price path determination.

With the uncertainties surrounding the introduction of CPRS, there is potential for extreme volatility in the wholesale energy market that has not been appropriately incorporated within the Draft Decision. Accordingly, Origin does not believe the proposed 3.84 per cent increase is a true representation of the underlying cost increases for 2009–10 and believes a cost pass-through is warranted.

8.2.4 Discussion

The need to include pass-through arrangements increases with the length of the regulatory period, as cost forecasts become less reliable over time. There is generally little need to include pass-through arrangements in a regulatory decision that lasts only 12 months.

⁸⁸ ActewAGL Retail submission on draft decision, p. 20.

⁸⁹ TRUenergy submission on issues paper, p. 2.

⁹⁰ AGL submission on draft decision, p. 2.

⁹¹ Origin Energy submission on draft decision, p. 5.

In the 2008–09 final decision, the Commission included pass-through arrangements for matters related to the ACT Government’s feed-in tariff and the Australian Government’s CPRS. Since the finalisation of the 2008–09 decision, the uncertainty surrounding these events has diminished. The ACT Government has introduced Stage 1 of its feed-in tariff (although Stage 2 has been foreshadowed) and the Australian Government has announced a start date of 1 July 2011 for the CPRS.

ActewAGL Retail has argued for the inclusion of specific pass-through events in the 2009–10 final decision related to:

- smart metering
- network tariff changes
- feed-in tariff (specifically Stage 2)
- environmental initiatives.

These are discussed in turn.

Smart metering

ActewAGL Retail argued for a smart metering pass-through on the grounds that the ACT Government may issue a requirement for a smart metering trial.

The Commission notes that any requirement for a smart metering trial would be in addition to the current trial being developed and undertaken by ActewAGL Distribution, referred to as ‘Project MIMI’. The Commission considers it unlikely that an additional trial, effectively in parallel with Project MIMI, would be required by the ACT Government. In addition, it is probable that any additional smart metering trial would also be undertaken by ActewAGL Distribution. Therefore, it is not clear that any costs incurred by ActewAGL Retail would be material, and the Commission does not consider it necessary to include a pass-through for a smart metering trial.

Network tariff change

While there is an ability under the National Electricity Law for the AER to alter network charges mid year, the Commission considers the likelihood of such an outcome to be small. At present, the AER adjusts network tariffs on a financial year basis. The Commission can see no reason why the AER would elect to alter charges more often than once a year, although that is within its powers.

The nature of the regulation of transmission and distribution networks is such that, should an additional cost be imposed upon a distribution business, it can be compensated via a ‘catch-up’ in the following year. For example, should a pass-through event occur mid-year, prices can be adjusted from 1 July of the following year and an allowance granted to compensate for the costs incurred (including the ‘time value of money’). Therefore, the Commission does not consider it necessary to include a pass-through arrangement for a change in network tariffs event.

Feed-in tariff event

ActewAGL Retail argued that a pass-through event should be included for Stage 2 of the ACT Government’s feed-in tariff. Stage 2 refers to the extension of eligibility for participation in the scheme to those with a production capacity above 30 kW. The ACT Government is currently investigating the feasibility of Stage 2.

The feed-in tariff operates in such a way that retail electricity businesses pay scheme participants the designated rate per kilowatt hour for electricity produced. The retailers then recover the net cost (that is, the cost of purchasing the electricity less an allowance for the retail sale of that electricity) of purchasing electricity from the distribution business, which in turn recovers its costs through distribution charges.

Therefore, the retail businesses, including ActewAGL Retail, are able to recover their costs. Additional costs incurred by the retail businesses relate to administrative costs and possibly a cost regarding the ‘time value of money’ based on a lag between making payments to scheme participants and being able to recover the money from the distribution business.

The Commission considers the potential extent of these costs to be minor and notes that ActewAGL Retail has not made a claim for costs associated with Stage 1 of the feed-in tariff arrangements in its application for the 2009–10 TFT. However, the Commission notes the argument from ActewAGL Retail that the introduction of Stage 2 will potentially enable the introduction of larger generators which may have effects on ActewAGL Retail’s load profile and subsequently its purchases from the NEM. The Commission accepts these concerns but considers that, given the likely timing of a decision by the ACT Government regarding Stage 2, and the time it will then take any large scale producers to design and install capacity, those impacts will likely be small during 2009–10. Therefore, the Commission does not consider it necessary to include a pass-through for costs associated with Stage 2 of the feed-in tariff. Should larger generating capacity units be authorised under Stage 2 and then commence operation during 2009–10, ActewAGL Retail will still be able to recover the market cost of the electricity from the distribution business.

Environmental initiatives

ActewAGL Retail argued for the inclusion of a pass-through event to cover possible environmental initiatives implemented by the Australian or ACT governments. It submitted that, given the prominence governments are attaching to environmental matters, there was a likelihood that unforeseen government initiatives may emerge, imposing a cost on ActewAGL Retail.

The Commission accepts that there is a possibility that government may introduce an unforeseen environmental policy or initiative over the coming 12 months. The Commission notes that the Australian Government’s CPRS has been postponed until 1 July 2011. Regarding ACT-specific initiatives, the Commission notes the current ACT Legislative Assembly Standing Committee on Climate Change, Environment and Water inquiry into possible greenhouse gas reduction targets for the ACT. The inquiry is due to report by 30 July 2009. This is to be followed by the ACT Government’s response once it has considered the matters identified. As such, the Commission does not consider it likely that there will be any significant measures which flow from the completion of the inquiry which will have a material affect on ActewAGL Retail’s costs during 2009–10.

Therefore, the Commission considers it unlikely that any environmental initiatives requiring the development of a pass-through arrangement will emerge over the coming 12 months, and does not consider it necessary to include a pass-through arrangement for such initiatives.

8.2.5 Final decision

The Commission has considered the various pass-through events proposed by ActewAGL Retail and concluded that it is not necessary to include any specific pass-through arrangements. However,

the Commission notes that there is an ability, as with all of its price directions under the ICRC Act, for variations to price directions to occur should circumstances change from those that existed when the decision was finalised.

8.3 Continued price regulation

Competition and the role of price regulation in the retail electricity market is an issue the Commission has addressed many times over the past seven years. The Commission's first review of competition in the retail electricity market was conducted in 2002, when the Commission recommended full retail contestability for customers with annual electricity consumption levels below 100 MWh per year by 1 January 2003.⁹² Full retail contestability was introduced in the ACT on 1 July 2003 and the Commission released its first price direction for the TFT in May 2003.⁹³ In 2006, the Commission was asked for advice on whether the TFT should be phased out.

The question that was asked of the Commission was:

Is there sufficient evidence that the market is suitably competitive to allow a removal of the regulated tariff?

The Commission found there to be sufficient competition to allow for the removal of the regulated tariff and that the TFT should be replaced with a monitoring scheme.⁹⁴ However, that recommendation was not accepted by the ACT Government.

The Commission maintains its view regarding the ability to remove a regulated price. Given that the Commission has addressed the matter of the competitiveness of the market, this section focuses on a set of related questions germane to the issue of competition in the retail electricity market. These questions are:

- What is the role of the regulated price in a market that is notionally competitive?
- What problems will price regulation create in an increasingly complex market?

The first question addresses the function of the TFT. The function could be to set the TFT at the level that the regulated price would be if there were no competition in the market. Alternatively, the TFT could be set at the level of the 'competitive' price in the market. Closely related to this question is the issue of whether there are any unanticipated consequences of maintaining a regulated price in a notionally competitive market.

The second question explores the possible future consequences of maintaining a regulated price in the face of increasing complexity and turbulence in electricity markets. Environmental policy changes at the ACT and Australian government levels will alter electricity markets in manners that may change the role of the TFT or result in a need to change the approach to setting the TFT.

8.3.1 The role of a regulated price in an otherwise competitive market

The Commission is concerned about the continued role of a regulated price in a market that has been otherwise declared competitive. The setting of a regulated price by the Commission puts it in a difficult position. There is an inherent contradiction between maintaining lower prices and

⁹² ICRC, Full retail contestability in retail electricity in the ACT, Final report, July 2002.

⁹³ ICRC, Investigation into Retail Prices for Non-Contestable Electricity Customers in the ACT, Final Determination, May 2003.

⁹⁴ ICRC, Retail price for non-contestable electricity customers, Final report, April 2006.

therefore potentially limiting competition and raising prices with the intention of fostering competition. This was a theme raised in submissions from electricity retailers, especially when it came to the issue of the Commission allowing ActewAGL Retail to recover customer acquisition costs.

Origin stated in its submission on the draft decision:⁹⁵

Origin agrees with the ICRC that the removal of price regulation is in the best long-term interest of all consumers. However, the ICRC states it is not blind to the potential problems that might occur in the transition to a fully deregulated competitive market. Origin sympathises with the sentiment of the ICRC, however the present approach of the ICRC denies the ACT retail market of the transition phase which is necessary for competition to succeed, that is, providing a cost reflective price to enable new retailers to establish market position before innovation and vigorous competition emerges.

In a similar vein, AGL stated:⁹⁶

The Commission itself has identified that it plays a crucial role in setting the price for both negotiated and non-negotiated contracts. By excluding acquisition costs from the total Transitional Franchise Tariff (*TFT*), the Commission is in effect setting a TFT that risks discouraging new entrant retailers entering the ACT market.

ActewAGL Retail stated in its submission to the draft decision:⁹⁷

While ActewAGL believes that the Terms of Reference does not preclude the Commission from basing their decision on the efficient costs of a mass market new entrant, if the Commission is to continue to define the market benchmark as being costs for an incumbent retailer, rather than a mass market new entry retailer, then costs of an incumbent related to retention by way of market based offers and contracts should be factored into the benchmark customer service cost. A market based estimate of this cost would be equivalent to the customer acquisition and retention cost of \$2.20/MWh.

The common theme present among all of the retailers' submissions, including the incumbent retailer's, was that the regulated price needed to be raised to increase the level of competition. However, none of the submissions identified an overall economic benefit from a rise in prices. The benefit implied appears to relate solely to increased competition. This is made without any reference to the determination of the overall economic benefits.

The economics of this issue are subtle. The retailers that call for higher regulated prices are effectively arguing that low regulated prices are leading to a lack of competition (a claimed negative outcome) and that higher regulated prices would lead to increased competition (a claimed preferable outcome). The implication of this argument is that the goal is competition and not overall economic efficiency. The Commission is concerned that 'true' competition can never eventuate in the market as long as a regulated price remains. Raising the regulated price to encourage additional competitive activity is unlikely to realise the full range of benefits that will accrue should the regulated price be removed completely.

The implicit assumption being made is that competition will eventually result in improved economic efficiency. The submissions from the retail businesses imply that there are effectively two prices in the market—a regulated price and a competitive market price—and that the regulated price is too low to promote competition and the competitive price results in vigorous competition.

⁹⁵ Origin submission page

⁹⁶ AGL submission page

⁹⁷ ActewAGL submission page 15.

This illustrates the dilemma faced by regulators—that is, whether the regulator is setting a regulated price or trying to mimic the competitive price. It is likely that an efficiently set regulated price is, initially following the introduction of competition, lower than the competitive price. This occurs as a consequence of the fact that a pure regulated price will not include any of the costs that a competitive firm would need to expend in order to attract customers. The premise of the competitive market view is that over time the process of competition will result in lower prices as productive efficiencies are exploited. In addition, new services are developed and higher levels of service achieved.

Consider a simple example. Suppose the regulated price in a market were set at \$100 per unit. At this price, potential competitors claim there are insufficient margins for them to enter the market; hence, no competition occurs. As long as the regulated firm is not forced to sell at a loss, the outcome is sustainable. Now suppose that the regulator acquiesces to the potential competitors' pleas and raises the regulated price to \$110 per unit and vigorous competition ensues. (Note that the regulated business may also be calling for higher prices as well—an incentive that needs to be examined.) If competition results in prices above the original regulated price of \$100, then economic efficiency is reduced in the short run. This reduction in efficiency occurs until the dynamic benefits of competition, such as innovation, an expanded variety of service offerings, and increased incentives for efficient provision of retail electricity services, flow through the market. This can be thought of as the price dropping below \$100.

The response to a higher regulated price depends on the nature of the market—predominantly, how customers respond to price discounts. If all customers switched immediately to the lowest price, then whichever business offered the lowest price would get the entire market. This is the assumption made in models of contestable markets popularised in the 1980s. This is a common assumption for competitive markets, but the evidence observed in the retail electricity market does not support this assumption. We do not observe mass switching to the lowest price competitor in the ACT or any other jurisdiction in Australia where retail competition is permitted. Clearly, switching of electricity retailers by customers occurs more slowly than predicted under the contestable markets assumption.

There are several potential reasons for the apparent slowness in the rate of switching in competitive electricity markets. Possible explanations include the existence of customer switching costs or brand loyalty.

Customers could face, or perceive that they face, costs when they switch electricity retailers. That is, for some electricity customers the costs of organising a switch to an alternative retailer may exceed the potential benefits from switching. One implication of this would be that the greater the discount offered by a competing retailer, the greater the number of customers who opt to switch. A typical customer may switch electricity retailers when the competing offer promises a 5% reduction in electricity bills, but not when the offer only promises a 3% reduction.

An alternative explanation could be that some electricity customers have strong levels of brand loyalty to the incumbent retailer. This could arise from years of service experience and perhaps a failure by many customers to understand the nature of the electricity market. If a customer does not appreciate the difference in the roles played by the retail service provider and the distribution service provider with respect to the quality of service the customers experience, then the customer may be hesitant to switch retailers. Customers may not realise that if they switch retailers they will not face any change in most of the measures of quality of service for electricity, such as the

number and duration of outages, which are dependent on the level of service provided by distribution service provider.

Without a thorough study of the electricity market and customers' expectations and understanding of the market, it is impossible to perfectly identify the reasons for the apparent unwillingness of many customers to opt for competitive market offers in the ACT even when there is active marketing by competing retailers. However, this indicates that the way in which the market operates (in terms of the competition among the businesses active in the market) does not support the perfectly contestable market theory.

The next question is the relevance of this observation to setting a regulated price and the role of a regulated price in a competitive market. If all customers instantly flocked to the lowest priced retail electricity provider, then the role of a regulated price would not particularly matter. This is because, if the regulated price exceeded the competitive price, customers would leave the regulated price and move to the most attractive competitive offer. No customers would remain on the regulated price. Similarly, if the regulated price were set below the competitive price, no customers would leave the regulated price.

Under the assumption of quick switching by customers, the prudent exercise for the regulator would be to aim for the competitive price.⁹⁸ Price under this assumption allows rival retailers the ability to compete for customers and to explore opportunities that provide customers with a greater variety of service options that are valued by customers. However, if switching by customers is slow, then this should be considered by the regulator.

Given the evidence available to the Commission, the Commission is of the view that the regulated price would need to be raised well above the current level to encourage vigorous competition in the ACT. If the goal were purely to foster competition, the Commission could double or triple the current price with the view that all customers would accept one of the many resulting competitive offers that would arise. This is an unacceptable outcome, given the Commission's considerations under the ICRC Act, as any customer who remained on the regulated tariff would see their electricity bills rise dramatically. This is an outcome clearly in conflict with the requirements of section 20 of the ICRC Act.

The conclusion is that a regulator setting a regulated price in an otherwise competitive market is in a quandary. If the regulator raises prices to encourage competition and the level of competition *does not* result in competitive prices lower than the current regulated price, then all customers are worse off and only the electricity retailers are better off.

If the regulator raises prices to encourage competition and the level of competition *does* result in competitive prices lower than the current regulated price, then all customers who remain on the regulated tariff are worse off and only those customers who switch to competitive offers below the level of the regulated price actually benefit. Retailers other than the incumbent retailer are better off, as no retailer would offer a tariff at a discount that resulted in losses. The incumbent retailer is also potentially better off, as the regulated price acts as an instrument to allow the regulated business to price-discriminate between customers who are price sensitive and those who are not

⁹⁸ Note that this is effectively what IPART was required to do when determining the regulated price in New South Wales in 2007. The terms of reference that IPART faced required them to determine the cost of electricity a mass market new entrant would have if it entered the market. Thus, IPART included in their build-up of costs the amount of customer acquisition costs that an entrant would be expected to incur upon entry when trying to attract customers. The addition of customer acquisition costs would increase the regulated price of electricity in the ACT by approximately 2% and there is no reason to assume that this is no different in New South Wales.

price sensitive. Only when large numbers of customers have switched will the benefits of competition occur.

One solution is to remove the regulated price from the market. If the incumbent retailer is required to set its own price, it will be forced to internalise the effects of potential competition in its pricing decisions. Potential entrants will then be able to set prices in an effort to capture market share without reference to a regulated price. The regulated price, unless it is set so high that it forces customers to seek alternatives, acts as a barrier to competition. The removal of the regulated price would advance competition in the market, leading to the benefits of competition which would flow to all market participants.

8.3.2 The role of a regulated price in an increasingly complex market

The electricity market in Australia is facing a level of change unseen since the creation of the National Electricity Market. Government policies at the national level, as well as the state and territory level, regarding environmental initiatives have the potential to alter the electricity market by adding additional layers of uncertainty.

Additional uncertainty will arise from several sources. The price of electricity in the future will necessarily increase as more expensive green energy is brought into the market and the cost of carbon is factored into the wholesale price of electricity. Until the market settles down and the full impact of the CPRS is understood by the market, there will be uncertainty about electricity prices, especially futures prices. Furthermore, the introduction of an emissions trading scheme will add an additional level of variability to the wholesale price of electricity, as any variability in the price of carbon will flow through as increased variability in the wholesale price of electricity. In future, this additional uncertainty will result in an increase in the complexity of the market and make the regulation of the retail electricity market more difficult.

The Australian Energy Market Commission (AEMC) is currently undertaking a review of the effects of climate change policies on energy markets. The review was initiated by the Ministerial Council on Energy, which issued terms of reference on 13 June 2008. The terms of reference require the AEMC to issue a scoping paper, two interim reports and a final report. The scoping paper was released on 10 October 2008, and the first interim report was released on 23 December 2008. Submissions have been received on the first interim report, and the AEMC has held public forums with interested parties. Several consultant reports have also been sought on all aspects of the electricity market with respect to the effects of climate change policies.

The first interim report includes a section on the effect of climate change policies on the retail segment of the market. One of the conclusions reached by the AEMC in the first interim report is that the higher costs will result from the introduction of climate change policies. The AEMC states:⁹⁹

These higher costs also mean higher prudential costs for retailers. We do not consider that the current retail price regulation arrangements are sufficiently flexible to be able to cope with the potentially large and rapid changes in retailer costs.

⁹⁹ AEMC, Review of Energy Market Frameworks in light of Climate Change Policies 1st Interim Report, December 2008.

Frontier Economics, in a recently released report to the AEMC review, reports that the range of increases in electricity prices is from \$10/MWh to \$40/MWh in the first few years of the CPRS.¹⁰⁰ In this review, the Commission has determined the cost of electricity purchased as \$65/MWh. Hence, there could be sizable increases in the retail price of electricity as a result of the implementation of the CPRS. Furthermore, electricity retailers could face significant risks of the wholesale price of electricity exceeding the regulated retail price minus the network costs, thus causing a situation in which the retailer would prefer to shut down. This is a similar scenario to that which occurred in California in 2000 and 2001 when retailers cut supply, leading to rolling blackouts across the state.

The implications for the regulator are clear. The regulator faces the problem of determining a regulated price for the duration of the regulatory period, as given in the terms of reference. Even yearly price reviews face this risk, although the longer the regulatory period, the more magnified is the effect. The regulator will be in the position of having to estimate a price for carbon and the subsequent effect on the wholesale price of electricity.

The AEMC's review, as it applies to retail regulation, seems to focus on providing retail regulators with guidance on factoring in the effects of climate change policies. Most of the discussion of the first interim report focused on potential regulatory inflexibility. The AEMC concludes its discussion with the comment:¹⁰¹

As such, the existing levels of flexibility in the regulatory arrangements represent a significant risk for retailers given the large forecast cost increases related to the CPRS and expanded RET.

The obvious alternative is to remove the regulated price from the market so as to allow the retail electricity service providers the opportunity to directly respond to any emerging market consequences of climate change policies and develop their own risk management strategies.

Changing market conditions are more likely to result in potential failures of market participants. This means that there need to be safeguards for customers of any retailer that exits the market due to financial pressures caused by changing market conditions. The retailer of last resort arrangements need to be examined closely to ensure that sufficient protections are in place. There is no guarantee that having a regulated retail price in the market will lessen the likelihood of a retail electricity business facing financial distress. Rather, an inappropriate regulated price, and its subsequent inflexibility, may act to increase the likelihood of a retailer failing.

Under current market practices, where all prices are pegged to the regulated price, the real risk to the market and regulators is concurrent market failures of several retailers. This puts additional pressure on the regulator to ensure that the regulated price correctly takes into account the consequences of climate change policies. It may be better to remove the regulated price and let the market deal with the consequences of pricing the effects of climate change policies. The Commission's conclusion is that there needs to be discussion on the best way of dealing with additional market complexity, and one solution to consider is the removal of the regulated price.

8.3.3 Conclusion

The Commission has considered the role of the regulated tariff in an otherwise contestable market and highlighted the dichotomy that exists when attempting to set a tariff which attempts to balance

¹⁰⁰ Frontier Economics, Impacts of climate change policies on electricity retailers, a report prepared for the Australian Energy Market Commission, May 2009.

¹⁰¹ AEMC, First interim report page 54.

the concern of setting an appropriate tariff to protect consumers from excessive prices but also encourages the development of competition over the longer term. In addition, the Commission identified increasing complexity in the electricity market due predominantly to an increased focus by government on environmental initiatives, such as the Australian Government's CPRS and possible further Territory initiatives such as those which may result from the findings of the Legislative Assembly's inquiry into possible ACT Greenhouse Gas Reduction Targets.

The Commission has concluded that the most appropriate manner in which to address these concerns is via the removal of a regulated retail price for electricity. The removal of the regulated retail tariff would be matched by continual improvements in the Consumer Protection Code administered by the Commission (which the Commission is currently reviewing) and a price monitoring arrangement along similar lines to that operating in Victoria.

The removal of the tariff would also allow the market to find the most appropriate pricing structures and encourage competition in the development of alternative products and levels of service. In addition, it would remove the risk of the regulator setting an inappropriate price (either too high or too low) and would encourage retailers to develop their own risk management strategies to address the volatility likely to result from the range of emerging climate change policies.

The maintenance of a regulated tariff in what is otherwise a contestable market runs the real risk of causing major distortions. However, should the ACT Government wish to maintain a regulated tariff, there is an urgent need for a comprehensive review to be undertaken to develop an appropriate methodology.

9 Price direction

This chapter contains the Commission's draft price direction for the TFT for the period from 1 July 2009 to 30 June 2010.

1 Period of the direction

The provisions below will apply to the period from 1 July 2009 to 30 June 2010.

2 Variation to price of retail electricity services

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

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

Where:

P_{ij}^t is the proposed 2009–10 price for component j of the regulated retail tariff i

P_{ij}^{t-1} is the actual 2008–09 price charged by ActewAGL Retail for component j of the regulated retail tariff i

Q_{ij}^R is the reference quantity for component j of the regulated retail tariff i defined as the actual quantity (in both customer numbers or MWh) as reported by ActewAGL Retail for the 12-month period ending 31 March 2009

CPI = 4.35%

X = 1.98 %

Appendix 1 Terms of reference

Australian Capital Territory

Independent Competition and Regulatory Commission (Price Direction for the Supply of Electricity to Franchise Customers) Terms of Reference Determination 2008 (No 2)

Disallowable instrument DI2008–305

Made under the

Independent Competition and Regulatory Commission Act 1997 (the Act), section 15 (Nature of industry references) and section 16 (Terms of industry references)

Reference for investigation under section 15

Pursuant to subsection 15(1) of the Act, I refer to the Independent Competition and Regulatory Commission (the ‘Commission’) the provision of a price direction for the supply of electricity to franchise customers for the period 1 July 2009 to 30 June 2010.

Terms of reference for investigation under section 16

Under the Act, section 16(1), I require that the Commission consider the following matters in relation to the conduct of the investigation:

1. In undertaking the review, the Commission should have regard to the requirement of section 20 of the Act.
2. The Commission must produce its final report in time sufficient to allow ActewAGL Retail to make any necessary changes to its billing system and to provide information on the new tariff to customers.

Simon Corbell MLA

Attorney-General

23 December 2008

Abbreviations and acronyms

ABS	Australian Bureau of Statistics
ACT	Australian Capital Territory
ACTCOSS	ACT Council of Social Service
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
Care	Care Financial Counselling Service
Commission	Independent Competition and Regulatory Commission (ACT)
CPI	consumer price index
CPRS	Carbon Pollution Reduction Scheme
ESCOSA	Essential Services Commission of South Australia
FRC	full retail contestability
GGAS	Greenhouse Gas Abatement Scheme (ACT) Greenhouse Gas Reduction Scheme (NSW)
IPART	Independent Pricing and Regulatory Tribunal (NSW)
kW, kWh	kilowatt, kilowatt hour
MIMI	multi-utility integrated metering infrastructure
MRET	Mandatory Renewable Energy Target
MW, MWh	megawatt, megawatt hour
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company
QCA	Queensland Competition Authority
TFT	transitional franchise tariff