Retail Prices for Non-contestable Electricity Customers 2009-2010

8 May 2009

ActewAGL Retail Response to Independent Competition and Regulatory Commission Draft Decision - Retail Prices for Non-contestable Electricity Customers 2009-2010

Contents

1. Introduction

On 23 December 2008, the ACT Government issued a Terms of Reference requiring the Independent Competition and Regulatory Commission (the Commission) to provide a price direction for the supply of electricity to non-contestable customers for the period from 1 July 2009 to 30 June 2010. The Commission released an Issues Paper on 11 February 2009. Following receipt of submissions on the Issues Paper, the Commission released its Draft Decision on 3 April 2009 and seeks responses by 8 May 2009.

ActewAGL Retail (ActewAGL) made a submission in response to the Issues Paper on 6 March 2009 and provides these comments on the Draft Decision. Overall, ActewAGL is concerned that the Draft Decision does not fully reflect market based retail costs with the potential to further reduce retail electricity competition in the ACT.

ActewAGL recognises the very difficult circumstances involved in setting a regulated price in a competitive market and supports the Commission's statement that it "considers that the removal of price regulation is in the best long-term interests of all consumers."[1] This will allow competition to fully develop in the ACT, delivering to all customers the benefits of greater choice, lower prices, and new and innovative products and services.

ActewAGL also supports the Commission's view that "the Commission considers that the adoption of a regulatory arrangement similar to that in Victoria would be in the long-term best interests of consumers in the ACT"[2] where regulation has been replaced by a price monitoring scheme. ActewAGL notes the view that "The Commission would like to see the review by the [Australian Energy Market Commission] AEMC brought forward to 2009…[to] allow enough time for those changes to be made before the need to reset the TFT on 1 July 2010, should the AEMC conclude that the market is effectively competitive."[3]

ActewAGL has a number of concerns with the draft decision. 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.

ActewAGL has noted 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.

[1] ICRC 2009a, p. 69
[2] ICRC 2009a, p. 69
[3] ICRC 2009a, p. 69

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 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 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."[4] 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.

In addition, the draft decision did not adopt any of the proposed pass through provisions and this would impose significant risk that ActewAGL seeks to be addressed in the final decision.

ActewAGL has noted the concurrent review of regulated retail prices in NSW by the Independent Pricing and Regulatory Tribunal (the Tribunal) and that the Tribunal's draft decision provided for increases of between 18 and 20% for 2009/10 to pass through increases in network charges and to bring retail prices into line with 'market-based electricity purchase costs'. This compares to the ACT where the Commission has proposed a real decrease to ActewAGL's retail prices in 2009/10.

The main components of ActewAGL's submission are as follows:

- ActewAGL proposes the Commission retain its current purchase cost modelling method and include prudent commercial hedging assumptions to determine a purchase cost for 2009/10 of $68.99/MWh.

[4] ICRC 2009a, p. 28

- ActewAGL proposes retail operating costs, which have been increased by CPI resulting in $102.65 per customer ($10.37 per MWh), plus customer acquisition and retention costs of $21.78 per customer ($2.20 per MWh).
- ActewAGL believes that the allowed retail margin should remain set to at least 5% applied to total retail sales in 2009/10.
- Full pass through of network costs, with the Australian Energy Regulator (AER) providing for CPI + 13.82% for 2009/10.
- ActewAGL proposes that pass through arrangements for the feed-in tariff and other environmental initiatives apply in 2009/10 as well as a pass through of network costs and smart metering.

Given the final decision by the AER for a real increase in network costs of 13.82% in 2009/10, and the factors identified above, ActewAGL estimates a real price increase for the current TFT of around 5.5**%** is required for 2009/10. This is necessary to ensure prices fully pass through the increased network costs which represents the majority of the proposed increase and to ensure the retail outcome is better aligned with market based costs.

2. Developments in other jurisdictions

Benchmarking of commercial retail costs in a competitive market environment is a key element to forming appropriate cost allowances and permitting competition growth. The Commission advises that it "draws on benchmark cost information available in the market place or in other regulatory decisions within the retail electricity sector in Australia."[5]

2.1 NSW

ActewAGL notes the Commission's explanation for the substantial disparity in the draft price increases for NSW retailers compared to its draft decision for ActewAGL for 2009/10 as being partly because "the methodology adopted in NSW to determine retail electricity prices had not initially factored in the spike in wholesale electricity prices that occurred during 2007." However, ActewAGL is aware that IPART conducts annual reviews of the wholesale purchase cost assumption, guided by Frontier Economics. The 2008 annual review concluded that electricity purchase costs had not altered by the trigger amount (10%) and the price path remained unchanged.[6] It is ActewAGL's assessment that the 2007 price increases must already have been reflected in NSW prices to some degree, for IPART to have drawn this conclusion.

In its Draft Decision, the Commission has identified Integral Energy as the "NSW retailer considered most similar to ActewAGL Retail for 2009-10."[7] However, Integral Energy's

5 ICRC 2009b, p. 7
6 ICRC 2009a, p. 24
7 ICRC 2009a, p. 25

purchase cost allowance for 2009-10 is around $65/MWh in the Tribunal's draft decision.[8] This is almost $5/MWh above the Commission's estimate of $60.39/MWh for ActewAGL. This disparity confirms the need to reassess the ACT wholesale purchase cost allowance for the final decision.

ActewAGL has also compared the retail component of regulated prices between the NSW retailers and ActewAGL based on the NSW 2009 Draft Decision and the ACT Draft Decision for 2009/10. ActewAGL has determined that its retail outcome is around 10% below the average NSW retailer for 2009/10, based on the respective draft decisions. A comparison chart is provided in section 3.

2.2 Queensland

The Commission's draft decision points out[9] that the Queensland Competition Authority's (QCA's) Draft Decision on the Benchmark Retail Cost Index (BRCI) provided for a nominal increase of 13.6%. ActewAGL notes that the Final Decision will be released on 29 May 2009.

ActewAGL notes the recent decision by the Queensland Supreme Court that the QCA had set the QLD BRCI too low for 2008/09[10]. The 2009/10 increase, outlined in the Draft Decision, is driven by the revised market-data-based estimate of electricity purchase costs.[11]

In August 2008, AGL Energy Limited (AGL) and Origin Energy lodged applications for judicial review of the QCA's final determination of the 2008/09 BRCI. The BRCI forms the basis for setting the regulated electricity tariff in the following year.[12]

Specifically, AGL contended that the QCA:

- used the incorrect electricity load profile with the consequence that it has underestimated the wholesale cost of electricity to retailers; and
- significantly reduced the rate of change in costs captured by the 2008/09 BRCI by restating the BRCI for the 2007/08 base year.

The difference between the QCA's final determination of the 2008/09 BRCI of 5.37% and its earlier draft determination of 7.01% represented approximately $9 million in revenue for AGL in FY09[13]. This demonstrates the importance of setting a regulated electricity tariff that closely reflects the efficient costs of a prudent and efficient retailer.

[8] IPART, 2009, p. 9
[9] ICRC 2009a, p. 22
[10] AFR 2009, p. 48
[11] ICRC 2009a, p. 10
[12] AGL 2008
[13] AGL 2008

2.3 Victoria and South Australia

Since 1 January 2009, electricity retail prices in Victoria are unregulated and have been replaced by a price monitoring scheme. This development follows findings by the Australian Energy Market Commission (AEMC) that the Victorian and South Australian retail electricity markets were competitive and a consequent recommendation for the removal of price regulation. ActewAGL endorses the Commission's opinion that the model adopted in Victoria could provide a starting point for considering the next step in facilitating Full Retail Contestability (FRC) in the ACT.[14]

The AEMC has intentions to conduct a similar review of the ACT retail electricity markets in 2010.[15] ActewAGL is concerned that recent declines in competitive activity may hinder the successful removal of retail price regulation as a result of the TFT being set below commercial market levels.

2.4 Western Australia

In February 2009, the West Australian Office of Energy recommended that power prices rise by 91% over three years, starting with a 52% increase from July 2009[16]. This dramatic increase is the result of an extended period of prices being held below cost. The changes to network tariffs will be automatically passed through for all classes of regulated retail electricity tariffs[17]. The WA decision demonstrates that retail tariffs need to keep pace with wholesale market conditions to avoid the advent of an end-user cost shock.

3. Analysis of efficient costs

3.1 Methodology

As stated in ActewAGL's response to the Issues Paper, ActewAGL believes that the method applied by the Commission is still appropriate:

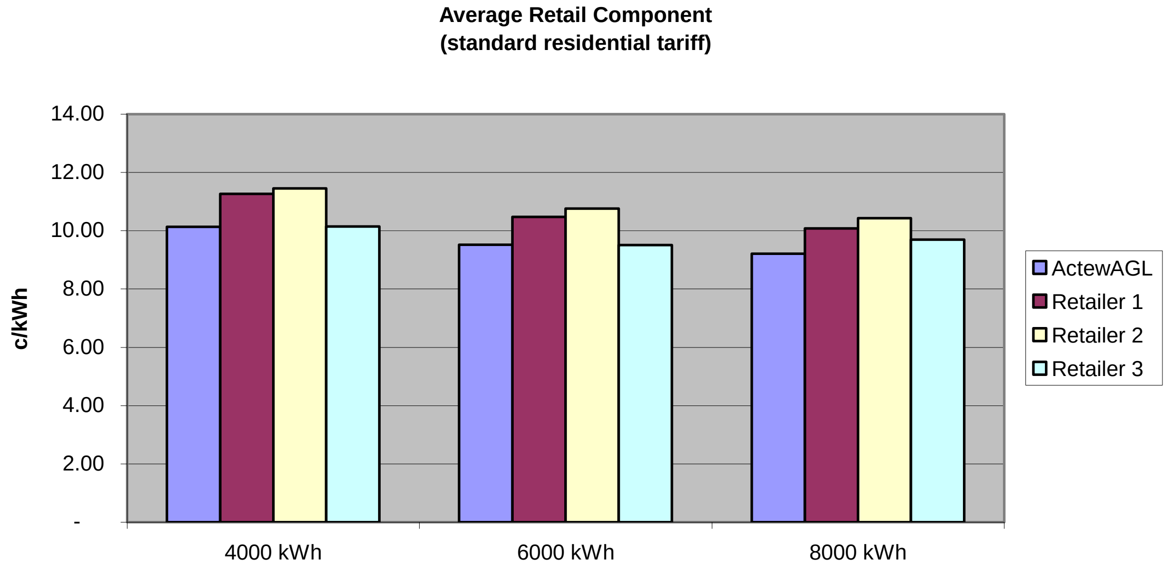
> In estimating the individual cost components, the Commission draws on benchmark cost information available in the marketplace or in other regulatory decisions within the retail electricity sector in Australia.[18]

However, ActewAGL has previously highlighted its view that the Terms of Reference does not preclude the Commission from basing their decision on the efficient costs of a mass market new entrant. It is not required that the Commission define the commercial benchmark as "estimating the economically efficient cost base of an *incumbent* [emphasis added] electricity

[14] ICRC 2009a, p. 25
[15] MCE 2007
[16] Government of Western Australia Office of Energy 2009, p. 2
[17] Government of Western Australia Office of Energy 2009, p. 4
[18] ICRC 2009b, p. 7

retailer providing retail electricity supply services to a regulated customer segment."[19] Instead, ActewAGL believes that the Commission's position on this issue, which is not required or specified in the Terms of Reference, is resulting in cost allowances that do not reflect market realities.

The following chart shows the emerging disparity in the retail component of tariffs between NSW retailers and ActewAGL based on the NSW 2009 Draft Decision and the Commission's draft decision for 2009/10. It is estimated that ActewAGL's outcome is around 10% below the average NSW retailer for 2009/10.



Source:

* Prices for standard residential tariffs were calculated based on the increases indicated in IPART's Draft Report on Market-based electricity purchase cost allowance 2009-10 and the Commission's Draft Decision on retail prices for non-contestable electricity customers.

3.2 Energy purchase costs

ActewAGL 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.[20] 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.

[19] ICRC 2009b, p. 7

[20] Including a number of corrections to the application of the data set.

In its draft decision, the Commission introduced an alternative portfolio method without seeking advice to guide this decision in order

> …to address concerns about the thinness of the peak futures market in coming years, it will adjust its model so that the model includes only peak data for the coming 12-month period. Base contract information will continue to be taken from the coming 24-month period.[21]

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.

In addition, the proposed variation to the forward purchasing strategy where, according to the Commission, 80% of energy is purchased in June 2008 and 40% in December 2008 is unrealistic as it overly weights the more recent purchases in the portfolio approach.

While ActewAGL notes the Commission's view that "If it can be shown that there is a technical problem in the operation of the model used to calculate the index, the model should be updated."[22] However, this review process needs to be conducted as part of a dedicated and extensive consultation program.

The Commission's hedging allowance in the Draft Decision is still well below ActewAGL's proposed hedging cost of 125% of the energy purchase. Whilst ActewAGL acknowledges that the Commission has increased the allowance from 105% within its Draft Decision for peak energy, the total provision is still well below ActewAGL's proposed hedging cost of 125% for all energy purchases. ActewAGL's submission detailed the typical purchasing challenges facing a prudent retailer, summarised in section 3.2.2 and demonstrated that the hedging costs of a prudent retailer would average 125% of the average swap contract price over all periods. The Commission's revised hedging position assumed that hedging is more costly during peak periods. ActewAGL can advise that total hedging costs are approximately equal during peak and off-peak periods.

3.2.1 Change to purchase methodology

ActewAGL notes and endorses the Commission's assessment that "the issue of the wholesale energy market clearing price is extremely important in the decision about the TFT level."[23]

While ActewAGL recognises the Commission's intent to better reflect the forward purchase cost decisions faced by a prudent retailer in its purchase cost portfolio method, it is unable to support the implementation of a significantly changed purchase cost method at short notice and without any prior consultation to derive price outcomes for 2009/10.

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[21] ICRC 2009a, p. 37
[22] ICRC 2009a, p. 36
[23] ICRC 2009a, p. 9

ActewAGL has not had forewarning from the Commission of a change in methodology which highlights the regulatory uncertainty facing ActewAGL. It would have been prudent for ActewAGL 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.

While ActewAGL had noted its "ongoing concerns that the model may not present a reasonably accurate or valid measure of purchase costs, particularly in recent times because of the lack of trades to populate the model given continuing uncertainty with electricity market structure and ownership in NSW and the prospect of a carbon pollution trading scheme"[24] it had specifically noted that these issues were more relevant to the setting of prices from 2010/11, and for this reason ActewAGL supported continued use of the current purchase cost model and process in 2009/10.

ActewAGL has argued that consistency and certainty are vital in the assessment of forward purchasing costs. ActewAGL initially expressed concern with a number of elements of the portfolio purchase model when it was first introduced in 2007.

> That basing the energy purchase cost allowance on a set of assumptions about hedging behaviour, without prior warning or precedent, highlighted the regulatory risk facing ActewAGL given that it would have been prudent for ActewAGL to continue to expect that any future regulated electricity tariff would continue to reflect wholesale market-based costs, and to develop and implement its purchasing policy accordingly.[25]

However, once implemented, and given the explicit publication of the method and assumptions, ActewAGL accepted that it provided certainty in that it is able to apply the method and update the Commission's purchase cost model with current market data, to establish its estimate of an equivalent price.

In relation to the proposed changes to the model by the Commission to "address concerns about the thinness of the peak futures market in coming years"[26], it is noted that the Commission's method actually continues to rely to some extent on peak data for the coming 24-month period because the Commission's preferred forward contract price data source, d-cypha, records 'peak' and 'base' prices (the quoted 'base' prices are in fact a weighted average of the relevant peak and off-peak contract prices). The Commission derives off-peak prices by using d-cypha's published 'peak' and 'base' prices. By calculating off-peak prices in this way, the Commission has also not actually addressed its perceived problem of 'thinness' in the market for 2009/10, noting also ActewAGL's advice that liquidity and market data was more an issue for 2010/11.

The Commission's proposed variation to the forward purchasing strategy, as set out below, assumes that 80% of energy is purchased in June 2008 and 40% in December 2008. ActewAGL believes that this assumption is unrealistic as it overly weights the more recent purchases in the portfolio approach.

[24] ActewAGL 2009, p. 7
[25] ActewAGL 2008, p. 8
[26] ICRC 2009a, p. 37

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

ActewAGL did not propose any change to the portfolio modelling method for 2009/10 because it is important that this be the subject of separate and focussed consultation to ensure it receives detailed and thorough assessment in deriving any new model that would be applied for future regulatory reviews if required for and from 2010/11.

3.2.2 Hedging costs should be provisioned at 125%

In its Response to the Issues Paper, ActewAGL stated "the current assumption in the purchase cost model that a retailer hedges to 105% of forecast load does not represent the behaviour of an efficient and prudent operator."[27] ActewAGL is pleased to note that the Commission has responded to this issue and partially adjusted this hedging assumption.

> The Commission investigated the extent of these additional costs and its preliminary view is that an adjustment to the model to incorporate a cost allowance of 120% for peak electricity purchases is a fair representation of the costs likely to be incurred by a prudent retailer.[28]

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."[29] 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

(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

27 ActewAGL 2009, p. 8
28 ICRC 2009a, p. 37
29 ICRC 2009a, p. 37

Using its model on hedging arrangements, ActewAGL estimates that the average hedging allowance necessary for NSW retailers in 2005/06 would have been 128.5% and even this presumes the retailers had perfect foresight of their load. These results provide evidence to confirm a commercial estimate can be used to demonstrate the hedging costs for the year using swap and cap levels, which are based on the load profile for that particular year. The following table summarises the benchmarking of NSW retailers during 2005/06.

	Hedging requirement 05/06
Retailer A	121.4%
Retailer B	123.7%
Retailer C	140.4%
Average	128.5%

3.2.3 Hedging costs should apply equally to peak and off-peak energy

Whilst ActewAGL recognises the improvement in the hedging allowance for peak energy within the Draft Decision, it finds no sound basis for distinguishing between the hedging cost for peak and off-peak energy.

The Commission's hedging provision was based on incorrect assumptions about the purchasing method, that is, hedging is more costly during peak times. Consequently, the Commission has only allowed 120% for additional hedging costs during peak periods and left hedging at 105% for base load.

ActewAGL's hedging calculations are estimated over the total load, including both off-peak and peak time energy. About 88 per cent of this load is hedged using base load swap contracts. This is a contract for a flat load 24 hours per day, 7 days a week for 3 months. The contract price does not distinguish between peak and off-peak energy. The nature of these contracts mean that the retailer is likely to make difference payments to the generator during off-peak times, thereby raising the cost of energy at off-peak times. At peak energy times, the generator is likely to make difference payments to the retailer, thereby reducing the cost of energy at peak times. These offsetting payments are assumed in the price of the flat price contact. It is not possible to say that the cost of hedging are any lower or higher for peak or off-peak prices because they are integrated in the flat contract price.. ActewAGL therefore recommends that the proposed allowance of 125% should apply equally to both peak and off-peak swap contract prices.

3.3 Energy, Trading and Management Costs

In its submission, ActewAGL estimated the energy, trading and management cost component of the purchase cost at $0.75 per MWh, an increase in line with inflation on the 2008/09 price. The Commission adopted this amount in its draft decision and ActewAGL accepts that this figure be retained for the final decision.

3.4 Green Costs

ActewAGL estimates that its Green Costs for 2009/10 are $5.122 per MWh. This estimate is made up of a cost of $2.298 per MWh to meet liability under the Mandatory Renewable Energy Target (MRET) and $2.824 per MWh to meet liability under the Greenhouse Gas Abatement Scheme (GGAS). ActewAGL has provided the Commission with a spreadsheet outlining these estimates and how they were derived. ActewAGL accepts that "the Commission has verified the…estimate of green costs and proposes to adopt those values."[30]

The ACT Government's Feed-in Tariff scheme was introduced on 1 March 2009. As noted by the Commission, the minister foreshadowed a possible extension of the scheme to give larger producers the opportunity to take advantage of the feed-in tariff. ActewAGL believes that this raises uncertainty regarding the impact upon ActewAGL Retail and therefore proposed a pass through arrangement in the event that it is unable to recover the costs of implementing the feed-in tariff scheme. ActewAGL's proposed pass through and its response to the Commission's draft decision on the pass through is discussed further in section 4.2.

3.5 Energy Losses

ActewAGL proposed that both transmission and distribution losses be included in the cost build up for 2009/10, the first time that transmission losses have been included. ActewAGL accepts that the Commission found that "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 loss factors for 2009/10 have now been finalised.

The Commission has stated that the "figures will…be updated before the release of the final report, following the finalisation of the relevant figures for 2009/10 by NEMMCO."[31] and has proposed a formula for calculating the loss allowance. ActewAGL agrees with the formula and notes that it suggested in its submission that "as the bulk of the supply to TFT customers in the ACT is through the 132 kV supply point, it is proposed to use the transmission loss factor for that supply point."[32] This results in a combined loss factor of 6.01%.

3.6 National Electricity Market Fees

In its submission, ActewAGL proposed that the NEM fees for 2009/10 be the same as those that the Commission adopted for the 2008/09 TFT adjusted for inflation. ActewAGL notes that the Commission has adopted this methodology, resulting in NEM fees of $0.75 per MWh.

3.7 Retail operating costs

ActewAGL believes that the operating cost allowed by the Commission in its Draft Decision of $102.65 per customer $(10.37/MWh), an increase on the 2008/09 allowance in line with

[30] ICRC 2009a, p. 40
[31] ICRC 2009a, p. 41
[32] ActewAGL 2009, p. 10

inflation, does not "reflect the approach suggested by ActewAGL Retail".[33] ActewAGL submitted that 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.

According to the Australian Bureau of Statistics, wages and salaries per person employed in the electricity supply industry increased by 14% in 2006/07,[34] 11% during 2004-05[35] 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%,[36] 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.

The Commission states that "in the Commission's 2003 decision on the TFT, an allowance for 'sales and marketing, being primarily the costs of communicating the TFT arrangements' was included in the list of costs making up retail operating costs."[37] ActewAGL 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.

ActewAGL is focused on both efficiency and customer service which has been reflected by the recent ranking of the ActewAGL Contact Centre as equal second out of 51 utilities surveyed in Australia for period January - March 2009. This is an improvement over the previous two quarters where ActewAGL was ranked 3rd. ActewAGL is proud of its ability to provide superior customer service while keeping costs at an efficient level.

Customer acquisition and retention costs

ActewAGL believes that customer acquisition and retention costs of $21.78 per customer ($2.20 per MWh) should be included in the Commissions' regulatory decision as discussed below.

[33] ICRC 2009a, p. 44
[34] ABS 2008
[35] ABS 2006
[36] ABS 2006
[37] ICRC 2009a, p. 44

ActewAGL notes the Commission's assertion that:

> ActewAGL Retail has provided no new information that demonstrates the necessity of including customer acquisition costs for regulated retail services, or the extent to which it incurs such costs. In addition, the ACT Government has made no amendment to the Commission's terms of reference from last year that would require the Commission to take account of customer acquisition costs.[38]

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.

The Commission notes the "high level…of brand loyalty among ACT customers towards ActewAGL Retail"[39] and claims that "much of that brand loyalty was established during the time that electricity services were provided by a wholly government-owned entity, most recently known as ACTEW."[40] ActewAGL is proud of the level of brand loyalty that it has achieved amongst ACT customers and disputes the implication that the level of brand loyalty would necessarily have been maintained had it not vigorously supported and defended its position in the market place. Contrary to the Commission's statement that it "does not envisage that ActewAGL Retail will be actively promoting the TFT in a marketing campaign, either to attract customers who have previously left the TFT to return to the TFT or to encourage customers not to leave the TFT"[41], any promotion of the ActewAGL brand and its market presence is aimed at strengthening ActewAGL's customer base regardless of whether these customers remain on the TFT or move to an ActewAGL contract.

ActewAGL believes that the Commission's assertion that "the high level of brand loyalty may be affecting the willingness of retailers to enter the market"[42] needs to be based on fact or evidence. A number of ActewAGL's competitors have provided submissions to the Commission that are quite clear in stating that they find it difficult to compete because the transitional franchise tariff has been held below market based levels, and that outcome is exacerbated by the fact that customer acquisition and retention costs are not included in the TFT as it is in other jurisdictions, such as NSW.

[38] ICRC 2009a, p. 45
[39] ICRC 2009a, p. 47
[40] ICRC 2009a, p. 47
[41] ICRC 2009a, p. 45
[42] ICRC 2009a, p. 48

The Commission has reiterated its belief "that it considers vigorous competition to be the most appropriate way to protect the long-term interests of consumers."[43] ActewAGL agrees with this statement. However, ActewAGL is concerned that in concluding that it "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," the Commission is not allowing ActewAGL to recover the costs of an efficient, prudent retailer.

The Commission has determined that "it does not consider the potential longer term benefits to consumers from including an allowance for customer acquisition costs…outweigh the potential negative short-term implications of the increased cost."[44] While not agreeing with this decision in past reviews, ActewAGL could see the basis of this argument in the last two pricing decisions when prices were increasing above CPI. However for the 2009/10 prices, the draft decision has not even provided for a price increase in line with inflation, so this reason for excluding acquisition costs is no longer valid.

It is also clear, from the reduced level of competition in recent years, that the behaviour exhibited by non incumbent retailers supports their claims that;

> In the ACT, regulated electricity tariffs have been held below market-based levels, whereby the development of competition in the market remains well below that achieved in other Australian jurisdictions.[45]

And

> it is important to ensure transitional franchise tariffs (TFT) are set at cost reflective levels. AGL strongly recommends the inclusion of an allowance for acquisition costs as part of the efficient retail operating costs.[46]

And

> Origin submits a retailer's cost includes the acquisition cost. Whilst these costs are excluded from the franchise price second tier retailers are unable to compete on a level playing field and/or incumbent retailers are not able to retain scale.[47]

The Commission itself has noted that "the proportion of customers who have switched to negotiated contracts is lower in the ACT than in other jurisdictions"[48] and ActewAGL agrees that "there are potentially significant impacts if the Commission sets an incorrect TFT…setting the TFT price too low could result in retailers temporarily withdrawing from the competitive market or, in extreme cases, leaving the industry altogether. This would reduce the competitiveness of the market and be contrary to the best interests of consumers."[49]

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[43] ICRC 2009a, p. 45
[44] ICRC 2009a, p. 48
[45] TRUenergy 2009 p. 1
[46] AGL 2009, p. 1
[47] Origin Energy 2009, p. 2
[48] ICRC 2009a, p. 47
[49] ICRC 2009a, p. 67

One factor that is not presenting a barrier to retail entry is in relation to the ACT Government's Feed-in Tariff. Two retailers who had not vigorously marketed to households in the ACT in the past, have introduced competitive offers selling solar panels, and offering 'free installs' or interest free payment plans in response to the ACT Government's Feed-in Tariff scheme.

3.8 Retail margin

Notwithstanding that recent submissions by similar retailers in other states have advised that a 5% retail margin still falls short of a competitive market rate[50], in its submission, ActewAGL required that a retail margin of at least 5% be applied to total retail costs for the 2009/10 period, consistent with the margin applied to comparable entities in other states. ActewAGL notes that the Commission "proposes to maintain a retail margin of 5% on the total retail costs of ActewAGL Retail."[51]

3.9 Transmission and Distribution Network Costs

ActewAGL notes that the Commission "proposes to adopt the estimate of network costs of $66.34/MWh while noting that the figure will need to be updated in the preparation of the final report after the AER's release of the final determination of distribution costs."[52]

The AER's Final Decision: Australian Capital Territory distribution determination 2009-10 to 2013-14 was released on 28 April 2009. It provided for an increase in distribution costs of CPI + 13.82% for 2009/10. Based on this decision, ActewAGL Retail has estimated that the network costs for TFT customers are $65.12 per MWh. The figure will be finalised when the AER has approved ActewAGL's network tariff variation, which is expected before the Commission's final decision of 5 June 2009.

3.10 ActewAGL's proposal on cost elements

ActewAGL has calculated its TFT proposal using the 2007/08 methodology as the established method for this purpose, adjusted to incorporate an appropriate hedging cost as detailed in the submission.[53] ActewAGL has calculated a real price increase of 5.5% as necessary for 2009/10 in order to ensure regulated retail prices are better aligned with market based costs and to fully pass through the 13.82% real increase in network costs[54] (based on the AER's Final Decision, April 2009) including the cost of the Feed-in Tariff. ActewAGL notes that the majority of this increase is attributable to passing through the increased network cost as approved by the AER.

[50] See ActewAGL 2009, p. 12-13
[51] ICRC 2009a, p. 50
[52] ICRC 2009a, p. 51
[53] Including a number of corrections to the application of the data set.
[54] Final network prices are still to be approved by the AER.

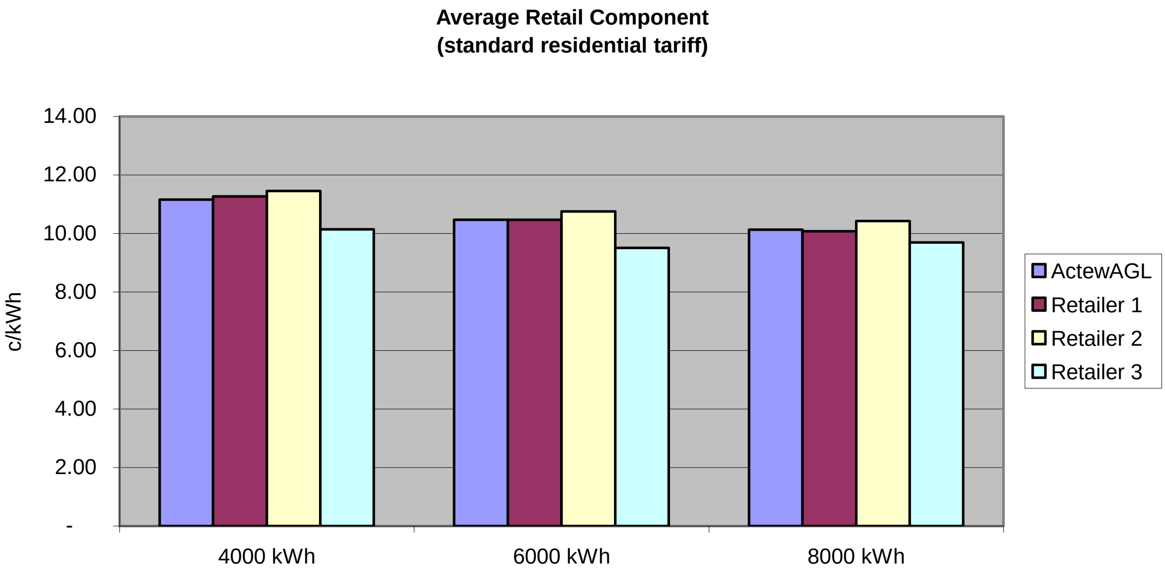
ActewAGL notes the real price impacts, of the electricity network final decision, estimated by the AER. "For an average end user, annual electricity costs are expected to increase by 4.15%.[55]

The average TFT price based upon ActewAGL's calculations is $165.73/MWh. The calculations used to derive these prices are presented in the following table.

	ICRC ($/MWh per Cust)	ActewAGL ($/MWh per Cust)
Energy purchase costs per Customer	**2008/09**	**2009/10**
Electricity purchase cost ($/MWh)	68.90	68.99
Energy contracting cost ($/MWh)	0.72	0.75
Green costs ($/MWh)	4.87	5.122
NEM fees ($/MWh)	0.72	0.75
Energy losses	4.86%	6.01%
Total energy purchase cost ($/MWh)	78.86	80.15
Retail operating costs ($/MWh)	9.94	10.37
Customer acquisition costs ($/MWh)		2.20
Total retail costs ($/MWh)	9.94	12.57
Network Costs ($/MWh)	56.06	65.12
Network Costs ($/MWh)	56.06	65.12
Total Retail Costs ($/MWh)	144.86	157.84
Retail margin (% of sales, EBITDA)	5.00%	5.00%
Total Retail Revenues ($/MWh)	152.10	165.73
Prices with 2008/09 Load Profile adjusted 0809 price	150.49	165.73
Assumed CPI Change	2.33%	4.35%
X Factor in CPI+X on MAR in $/MWh	**3.56%**	**5.54%**

The chart below illustrates the disparity between the retail component when comparing the outcome of the NSW 2009 Draft Decision with ActewAGL's proposal for 2009/10. When viewed in comparison with the chart in section 3, it shows that ActewAGL's proposal is reasonable and reflects the benchmark costs of an efficient and prudent retailer. It would bring the retail component more into line with the draft outcome in NSW.

[55] AER 2009a, p. 144



Source:

* Prices for standard residential tariffs were calculated based on the increases indicated in IPART's Draft Report on Market-based electricity purchase cost allowance 2009-10 and Commission's Draft Decision on retail prices for non-contestable electricity customers.

4. Non-Technical Matters

4.1 Social Impacts

ActewAGL 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. To support this position, ActewAGL has proposed a number of measures to achieve this in its response to the draft decision.

In accord with the Commission, ActewAGL supports the use of targeted concession arrangements as the best means of supporting vulnerable customers to manage their electricity accounts.[56] ActewAGL notes the comments by SoftLaw Community Projects that it believes that "the Commission needs to be far more specific about the need for concession increases when it addresses the social impacts of its Price Determinations."[57]

[56] ICRC 2009a, p. 57
[57] SoftLaw Community Projects, p. 1

ActewAGL notes the Commission's recommendation:

> that the ACT Government amend the electricity concession rates to index both the kilowatt hour rate and the cap on the concession payment to movements in the TFT. Furthermore, the Commission will recommend that the government consider making a further cost allowance in its concession arrangements to account for costs associated with the feed-in-tariff.[58]

ActewAGL 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.

4.2 Pass-through arrangements

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.[59]

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.

[58] ICRC 2009a, p. 60
[59] TRUenergy 2009, p. 2

Smart metering

ActewAGL maintains its position in the Response to Issues Paper, that a pass through event for a smart meter rollout should be approved by the Commission for the 2009/10 regulatory period. In the Draft Decision, the Commission has said it does not consider a smart meter rollout likely in 2009. It considers, “the logistics and timetable for a possible rollout of smart meters would be worked out with all affected parties well in advance.”[60]

ActewAGL does not accept the Commission’s Draft Decision to reject its proposed smart meter pass through event. ActewAGL submits that the AER’s electricity network final decision to approve a smart meter pass through event, as well as the proposed scope of the National Electricity Law (NEL) smart meter determination should be considered by the Commission.

The AER initially rejected the smart meter pass through event proposed by ActewAGL Distribution in its 2009-14 Regulatory Review. The AER reversed this decision in its final decision stating that the;

> MCE released an exposure draft of amendments to the NEL to facilitate and support the accelerated rollout and trials of smart meters in participating jurisdictions. It is therefore reasonable to suggest that a smart meter event is expected to occur during the next regulatory control period.[61]

While ActewAGL agrees with the Commission that a rollout of smart meters is unlikely in 2009/10, there is a greater chance that a pilot or trial determination may take place in 2009/10 potentially imposing unknown costs upon ActewAGL. ActewAGL considers it appropriate that the 2009/10 determination reflect the possibility that the ACT Government will issue a smart metering trial, pilot or rollout determination on ActewAGL Distribution which could also lead to additional costs for ActewAGL Retail.

Network tariff change

ActewAGL proposed an allowance for the pass through of changes to distribution tariffs during a regulatory year. However, the Commission was not convinced of the need to consider mid-year adjustments. ActewAGL maintains that it should not have to carry the risk of a change in network tariffs. The Commission has said, when the AER’s Final decision is released, “the Commission will reassess the necessity to include a pass-through for changes in distribution network tariffs.”[62]

In its Final Decision, the AER does not specifically address the timing of pass through events or whether they would occur in line with annual pricing adjustments. ActewAGL notes that the National Electricity Rules (NER) requires a DNSP to make an application to the AER for approval of a pass through event within 90 business days of the event occurring[63]. The NER do not limit the scope for costs to be passed through during a financial year.

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[60] ICRC 2009a, p. 66
[61] AER 2009a, p. 132
[62] ICRC 2009a, p. 67
[63] National Electricity Rules, 2009, Version 28 Chapter 11 Transitional Rules, Clause 6.6.1(c)

ActewAGL notes that the gas access regime is similar to the electricity access regime in that it does not specify when pass through events should be reflected in prices. Some guidance on the AER's expected approach is therefore available from the AER's Access Arrangement Guideline which states:

> Consideration of more frequent variations to reference tariffs will need to factor in any additional administrative costs for the service provider and the AER.[64]

This shows that in certain circumstances, the AER will consider tariff variations outside of the annual tariff variation mechanism. In the absence of any restrictions to this approach applying in the electricity sector, ActewAGL considers it reasonable to assume that the AER will also consider the recovery of costs resulting in a mid-year tariff variation. In this event, ActewAGL should be able to pass through the additional network charges.

Feed-in tariff

The Commission was not inclined to accept a pass through provision for the feed-in-tariff in its Draft Decision stating it, "expects to be guided by the AER's final decision for ACT distribution services."[65]

In its Final Decision, the AER considered that, "passing through any discrepancy between the forecast and actual direct tariff payments arising under the FiT scheme be nominated as a specific nominated pass through event." [66]

As previously highlighted, ActewAGL is concerned that this scheme could have large and unknown financial and administrative implications. This is because of the ACT government's expectation to announce Stage 2 of this scheme in June 2009 to apply to larger generating units. No details of the scope and application of Stage 2 of the scheme, and how it will apply to ActewAGL, are yet available. Stage 2 of the scheme could include different administrative arrangements to Stage 1, and the scope of projects allowed by Stage 2 could have significant effects on ActewAGL's load profile and purchasing in the NEM. Therefore, ActewAGL considers it is reasonable to request the pass through of any additional Feed-in-Tariff costs to ensure the business is no worse off as a consequence of this policy.

Environmental initiatives

The Commission expressed concerns, in the Draft Decision, about the lack of clarity of this proposed pass-through event for Environmental Initiatives. ActewAGL notes the difficulty in providing clarification of events which are by their nature, "unforeseen, or whose extent is uncertain, and which are beyond the ability of the regulated entity to control."[67]

The Commission invited additional details on this pass through event in the response to the Draft Decision. Firstly, ActewAGL would like to advise of the AER's Final Decision, which

[64] AER 2009b, p. 75
[65] ICRC 2009a, p. 65
[66] AER 2009a, p. 131
[67] ICRC 2009a, p. 61

considered that an emissions trading event was a foreseeable and uncontrollable event and therefore allowed it as a pass through event for NSW and ACT Distribution Network Service Providers (DNSPs).[68]

Secondly, the validity of ActewAGL's proposed environmental initiative event is supported by current government agendas. Both the Federal and ACT Government have indicated a clear direction towards carbon pollution reduction. The ACT has its own Climate Change Strategy[69] which contains a number of obligations on business and community. In addition, the Standing Committee on Climate Change, Environment and Water has been given a Terms of Reference which requires them to report on appropriate dates and targets for the reduction of greenhouse gas emissions in the ACT. The Committee will present their report on July 30 2009 which will potentially contain changes for the 2009-10 regulatory period. The Committee will also be reporting on, "the efficacy of existing programs within the current ACT Climate Change Strategy Weathering the Change, and the need for additional programs in the Strategy."[70] ActewAGL believes that, given current government priorities, there is the potential for an environmental initiative to be introduced during the coming regulatory period that would impose costs on the business. For this reason, ActewAGL believes that a pass through arrangement for this eventuality is warranted.

[68] AER 2009a, p. 133
[69] TAMS 2009
[70] ACT Legislative Assembly, 2008

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