

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

ActewAGL Retail Issues Paper response to the Independent Competition and Regulatory Commission

15 November 2013

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## 1. Introduction

In September 2013, the Australian Capital Territory (ACT) Government issued Terms of Reference (ToR) requiring the Independent Competition and Regulatory Commission (the Commission) to provide a price direction for the supply of electricity to franchise customers for the period from 1 July 2014. On 4 October 2013, the Commission released its Issues Paper for its review of retail prices for franchise electricity customers from 1 July 2014 (the Issues Paper).

ActewAGL Retail (ActewAGL) considers that the regulated retail tariff should be removed, allowing customers to capture the benefits that can arise from a market free of regulatory constraints. The maintenance of a regulated price in a competitive environment stifles competition, product innovation and delivers less than optimal outcomes to consumers. The benefits from removing price regulation have been recognised in other jurisdictions.

Given that regulation is to be maintained in the ACT in the short term, ActewAGL endorses the Australian Energy Market Commission's (AEMC) recommendation in its 2013 report on a best practice retail regulation methodology that a stable and predictable regulatory framework needs to be applied for the effective operation of retail markets.<sup>1</sup> In making its recommendation, the AEMC considers a consistent approach reduces regulatory risk for retailers and promotes competition for the long term benefit of customers.

ActewAGL notes that consistency and predictability are vital elements of any continued price regulation regime in the ACT. If the regulatory environment is uncertain, the risks to retailers are considerably increased, particularly in terms of wholesale energy purchasing decisions that must be made well before the release of the Commission's final decision.

ActewAGL provides this submission in response to the Issues Paper and highlights that:

- ActewAGL broadly supports the continuation of the Commission's energy purchase cost (EPC) model developed in 2010. Within that model, market developments over recent years have resulted in the need for one update - an increase to the parameter value of the forward price margin uplift (FPMU) in the hedge cost (HC) component.
- The allowance for retail operating cost (ROC) has only been increased by the consumer price index (CPI) since it was set in 2003 despite a consistent increase of greater than CPI in employment costs, which make up a significant part of the ROC. Other jurisdictions have increased the ROC by more than CPI in line with cost movements, making the ACT ROC the lowest of benchmarked jurisdictions. As a result the allowance is insufficient and falls below the bottom level of an estimated commercial range. The gap becomes even greater when consideration is given to economies of scale.

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<sup>1</sup> AEMC 2013, *Advice on best practice retail price methodology, Final Report*, 27 September

- ActewAGL notes the uncertainty regarding repeal of the carbon pricing mechanism legislation. ActewAGL supports the use of over-the-counter contract prices as the most practical way of incorporating price impacts. Where a position has not been clearly established at the time of the Commission's decision, ActewAGL urges the Commission to consider a flexible and transparent pass through mechanism. This is necessary to ensure impacts flow through to the regulated price and ensure that neither ActewAGL nor its customers are disadvantaged.
- ActewAGL's position on Large-scale Renewable Energy Target (LRET) and Small-scale Renewable Energy Scheme (SRES) costs is unchanged from that stated during the 2012 review.
- ActewAGL contends that the retail margin should be increased in line with commercial benchmarks in other jurisdictions to at least six per cent.
- ActewAGL suggests a regulatory period length of maximum two years, provided that the Commission allows full and sufficient flexibility in pass throughs and predictability in relation to the year two price reset.
- ActewAGL considers the approach for determining allowances for other costs should be consistent with previous determinations.

ActewAGL appreciates the opportunity to comment on the Issues Paper and is available to discuss in more detail the important matters raised in this submission.

## 2. Competition in the electricity market

ActewAGL remains committed to its long held opinion that electricity retail price control regulation should be removed in the ACT, as it was with retail gas pricing in 2004. Further, ActewAGL remains concerned about the asymmetric risks inherent in continued price regulation.

Price regulation has already been removed in Victoria and South Australia.<sup>2</sup> The Queensland Government has announced its intention to deregulate south-east Queensland from 1 July 2015,<sup>3</sup> and there is a prospect that the NSW Government may deregulate before the end of the 2013-16 determination set by the Independent Pricing and Regulatory Tribunal of NSW (IPART), in light of the AEMC's recommendations from the review of competition in NSW.<sup>4</sup> Table 1 below provides a summary of retail electricity price regulation in Australian jurisdictions.

**Table 1 Overview of retail electricity price regulation in Australian states and territories**

| Key                          | No price regulation  | Potential for price deregulation | Price regulation remains |
|------------------------------|--|----------------------------------|--------------------------|
| <b>NEM jurisdictions</b>     |  |                                  |                          |
| Victoria                     | Retail price regulation removed 2009   |                                  |                          |
| South Australia              | Retail price regulation removed February 2013  |                                  |                          |
| Queensland                   | Regulated retail prices currently set by the Queensland Competition Authority, which is currently undertaking the 2013-2016 review, however the Queensland Government intends to remove price regulation in south-east Queensland by 1 July 2015 to be replaced with a price monitoring scheme |                                  |                          |
| New South Wales              | Regulated retail prices set by IPART until June 2016, however this may be impacted by release of the AEMC's final report of its review of competition in the NSW retail electricity and natural gas markets which recommends the removal of price regulation (see section below)               |                                  |                          |
| Tasmania                     | Regulated retail prices set by the Office of the Tasmanian Economic Regulator  |                                  |                          |
| ACT                          | Regulated retail prices set by the ICRC  |                                  |                          |
| <b>Non-NEM jurisdictions</b> |  |                                  |                          |
| Western Australia            | Regulated retail prices set by the WA Government for non-contestable customers (small customers)   |                                  |                          |
| Northern Territory           | Regulated retail prices set by the NT Government   |                                  |                          |

IPART supports the removal of price regulation in NSW, having earlier responded to the AEMC's draft report into competition in the NSW retail electricity and natural gas markets that:

<sup>2</sup> AGL 2012, *Lower electricity prices for South Australian Families*, media release, 18 December

<sup>3</sup> Queensland Government 2013, *End of electricity price regulation to improve competition*, media release, June 17

<sup>4</sup> AEMC 2013, *Review of competition in the retail electricity and natural gas markets in New South Wales – Final report*, 3 October

"We consider that electricity and gas retail price regulation is no longer necessary in NSW given that the retail electricity and gas markets now protect customers against market power by offering more choices and better price and service outcomes."<sup>5</sup>

In 2006 the Commission similarly recommended that the regulated transitional franchise tariff be discontinued<sup>6</sup> and in 2010 noted that the most appropriate manner to address the increasing complexity of factors relating to the Commission's decisions is through the complete removal of a regulated retail price for electricity.<sup>7</sup>

ActewAGL notes the ACT Government recently advised that it "retains the view that deregulating pricing at this stage of market development would neither be appropriate and nor in the long term interest of consumers."<sup>8</sup> The Government has indicated it will rely on the identification of "positive and sustained development in the level of competition"<sup>9</sup> before considering deregulation.

ActewAGL remains concerned about the risks it continues to face from price regulation. For example, that adjustments to regulated prices from a repeal of the carbon price legislation can potentially be a more complex process for ActewAGL's standing offer tariffs than its market tariffs. It is essential for the Commission to consider a mechanism to ensure that neither ActewAGL nor its standing offer customers are disadvantaged in this process. ActewAGL discusses these complexities further in section 3.2.

In relation to the removal of retail price control regulation, ActewAGL notes the Commission has highlighted in its Issues Paper the Essential Services Commission of Victoria's (ESCV) discussion paper *Retail Margins in Victoria's Electricity Market* and the ESCV's conclusion that retailer margins were decreasing in the last few years prior to full deregulation and have increased since then.<sup>10</sup> ActewAGL considers that this discussion paper provides limited insight and usefulness for assessing the outcomes from removing price regulation. The ESCV discussion paper itself noted the inherent difficulties in estimating retailer costs for its review.<sup>11</sup> The Energy Retailer Association of Australia (ERAA) and the Energy Supply Association of Australia (ESAA) have expressed serious concerns with the paper. The ERAA commissioned Deloitte to conduct a high level independent review of the analysis contained within the supporting report from SKM-MM, concluding that the ESCV paper:

- utilised a methodology which was not transparent and is not used by any regulator in Australia;

<sup>5</sup> IPART 2013, Peter Boxall letter to John Pierce, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales – Draft Report*, 26 June.

<sup>6</sup> ICRC 2006, *Retail Prices for Non-contestable Electricity Customers*, Final Report, p.3

<sup>7</sup> ICRC 2010, *Retail Prices for Non-contestable Electricity Customers 2010-2012, Final Decision*, p.55

<sup>8</sup> ACT Government 2013, *Submission to SCER Response to items 8.2 and 8.3 of the COAG National Energy Market Reform*, July, p. 1

<sup>9</sup> ACT Government 2013, *Submission to SCER Response to items 8.2 and 8.3 of the COAG National Energy Market Reform, Attachment 1*, July, p. 5

<sup>10</sup> ICRC 2013, *Issues paper - Retail prices for franchise electricity customers from 1 July 2014*, October, p.11

<sup>11</sup> ESCV 2013, *Retail Margins in Victoria's Electricity Market*, Discussion Paper, p.16

- does not reflect recent determinations by other state regulators which have concluded that retailers' operational costs have not been accurately reflected in the past;
- understates retail discounts and therefore overstates retail margins;
- conveys an inaccurate picture of retail operations and the market; and
- does not look at the full impact of smart meter or green costs.

The ESAA noted that the analysis is a hypothetical exercise and not based on the actual costs of any specific retailer.

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

#### 3.1 Regulatory approach

##### 3.1.1 Weighted average price cap

As noted in its submission to the AEMC best practice retail regulation review,<sup>12</sup> ActewAGL continues to support the application of the weighted average price cap, consistent with previous determinations. This has the advantage of providing the incentive and flexibility to develop cost reflective tariffs, as the AEMC noted in the Power of Choice Final Report.<sup>13</sup>

##### 3.1.2 Length of the regulatory period

In its Issues Paper, the Commission notes that it must balance the trade-offs between regulatory certainty, flexibility, incentives and cost burden when making a decision on the length of the regulatory period.<sup>14</sup>

ActewAGL agrees that if price regulation is to be maintained, shorter regulatory periods can provide greater flexibility, but considers that they provide less certainty for retailers and consumers alike, and come at increased cost as they require more frequent price reviews.

Conversely, longer regulatory periods provide greater certainty in approach and generally lower review costs, but could provide less flexibility and leave retailers exposed to the very high risk and unavoidably dire consequences of inappropriate regulatory settings.

With the application of a consistent approach across financial years by the Commission, ActewAGL considers a length of two years to be an appropriate term for any forthcoming regulatory period, subject to the ACT Government making an earlier decision to deregulate during the period. In the meantime, cost pass through arrangements must be maintained with an annual price adjustment mechanism in place, as discussed in sections 3.1.3 and 4. This balances the advantages and disadvantages of shorter and longer regulatory periods.

##### 3.1.3 Cost pass through arrangements

The Commission has stated in its Issues Paper that it will “consider the necessity of maintaining pass-through arrangements, the set of allowable pass-through events and the level of the materiality threshold.”<sup>15</sup>

<sup>12</sup> ActewAGL 2013, *Advice on best practice retail electricity pricing methodology – response to issues paper*, July

<sup>13</sup> AEMC 2012, *Power of choice review – giving consumers options in the way they use electricity, Final Report*, p. viii

<sup>14</sup> ICRC 2013, *Issues paper - Retail prices for franchise electricity customers from 1 July 2014*, October, p.14

<sup>15</sup> ICRC 2013, *Issues paper - Retail prices for franchise electricity customers from 1 July 2014*, October, p. 15.

ActewAGL strongly believes that the full pass-through of costs that are beyond a retailer's control is a critical and mandatory component of retail price regulation in a competitive operating environment. The pass through arrangements that applied from 2012-2014 should remain in place to ensure that retailers do not bear the risk of unforeseeable or uncontrollable costs during the regulatory period with the addition of a flexible carbon policy pass through.

The 2012-2014 regulatory decision provides for a within-year pass-through adjustment. ActewAGL supports the continued allowance for a within-year pass-through adjustment as this would minimise the impact of cost changes on prices by distributing them in a timely manner and over a longer term. ActewAGL must be immediately and fully compensated for uncontrollable costs beyond its control.

It is understood for example, that the cost of Network Support and Control Ancillary Service charged to retailers will materially increase over the period 1 July 2013 to 31 December 2014. ActewAGL is assessing the financial impact, on the basis it may need to lodge a pass through application for a regulatory change event so these costs can properly be recovered in regulated tariffs.

Furthermore, ActewAGL encourages the Commission to provide assurance that the pass through formula used by the Commission in its 2012 Price Direction can be applied in a neutral way for within-year pass throughs. ActewAGL notes that the current formula requires that the annualised value of a pass through event (labelled APT by the Commission), to be added (or subtracted) to the annual projected revenue target, must be adjusted to ensure that the tariffs reflect the full pass through value (positive or negative). ActewAGL is available to discuss this technical matter in more detail.

### 3.1.3.1 Materiality

For the 2012-2014 regulatory period, the Commission adopted a materiality threshold for pass-through claims such that the impact of the pass-through event or events on costs must be greater than 0.25 per cent of ActewAGL's revenue from regulated retail tariffs in the 12 months to March of the most recent year.<sup>16</sup>

ActewAGL maintains its position that a materiality threshold is unnecessary and unwarranted. The administrative cost burden of applying to the Commission for recovery of a pass through amount provides sufficient incentive against ActewAGL seeking pass through unless costs are material. As all of the proposed pass-through events are related to events outside of ActewAGL's control, it would be unreasonable for a materiality threshold to apply such that ActewAGL is required to bear the risk and face a cost burden for material pass through events occurring in an open market environment.

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<sup>16</sup> ICRC 2012, *Final report retail prices for franchise electricity customers 2012-14*, June, p 60

## 3.2 Carbon policy

It is necessary that any price direction for the period from 1 July 2014 allows for the implementation of changes arising from Federal Government policy in relation to the carbon pricing mechanism. The Commission seeks stakeholder views in its Issues Paper on whether “using over-the-counter contract prices and allowing for pass through arrangements if the uncertainty is not resolved before the price direction is finalised is sufficient to deal with potential carbon pricing outcomes.”<sup>17</sup> ActewAGL supports the continued use of over-the-counter carbon-exclusive contract prices as the most practical way of incorporating price impacts of the repeal of the carbon price.

Much uncertainty surrounds the carbon price mechanism. It is ActewAGL’s view that the Commission must include flexible provisions in the final price direction to accommodate the impact of changes to legislation that are made after the final price direction or that are to come into effect after 1 July 2014 but before 1 July 2015.

ActewAGL is cognisant of public interest and expectations and the position of the Australian Competition and Consumer Commission in its proposed role of price monitoring and price exploitation prosecutor, that prices should decrease “fairly immediately”.<sup>18</sup> In light of this, ActewAGL considers it important for the Commission to be aware of a requirement under NECF to not vary standing offer tariffs more often than once every 6 months.<sup>19</sup> This would impact the ability of standing offer tariffs to be adjusted “fairly immediately” after repeal of the carbon price if it is to come into effect after 1 July 2014, as may occur for mass market offers.<sup>20</sup>

As a minimum, ActewAGL recommends that a change in the Government’s carbon pricing mechanism, included in the ToR for consideration by the Commission, should be specifically included in the definition of a regulatory change event for the period from 1 July 2014. Beyond this, ActewAGL considers it necessary for the Commission to give consideration to flexible and transparent mechanisms that could be employed in the case that changes to legislation made after the final price direction or which come into effect after 1 July 2014 but before 1 July 2015. By developing a flexible and transparent mechanism the Commission will ensure both ActewAGL and its standing offer customers are not disadvantaged and the impacts flow through as soon as practicable.

<sup>17</sup> ICRC 2013, *Issues paper - Retail prices for franchise electricity customers from 1 July 2014*, October, p. 21

<sup>18</sup> Sydney Morning Herald, 8 November 2013, *Power bills must fall as soon as tax goes, ACCC warns business*, p. 10

<sup>19</sup> National Energy Retail Law clause 23 (5) (a) and ActewAGL Standard retail contract terms for small customers in the ACT and NSW Effective from 1 July 2013, clause 8.2 (b)

<sup>20</sup> ESAA, ERAA, ENA, APIA, NGF 2013, *Submission to Department of the Environment Carbon tax repeal exposure draft legislation and consultation paper*, November, p. 5

### 3.3 Pricing model

The Commission uses a pricing model based on cost benchmarks.<sup>21</sup> The annual change in the cost benchmark is then used to adjust prices. ActewAGL supports the continuation of the Commission's CPI plus X formula consistent with previous determinations. The continuation of the Commission's approach provides a consistent and predictable price regulation in line with the AEMC's recommendation.

ActewAGL also considers the Commission's pricing model, including the model for determining the electricity purchase cost, to be relatively transparent compared with other jurisdictions.

#### 3.3.1 Energy purchase cost

Although the level of spot price volatility has fallen in the past two years, setting a regulated tariff in volatile commodities markets remains a complex task, as has previously been acknowledged by the Commission.<sup>22</sup> In the detailed discussion of the EPC model within the Issues Paper, the Commission seeks comment from stakeholders on three specific issues<sup>23</sup> relating to its energy purchase cost model:

1. Whether the Commission should have regard to the long-run marginal cost (LRMC) in determining the EPC.
2. A revisit of the switch from using futures prices to forward contract prices determined in the Commission's 2012 review.
3. Whether the Commission's current approach for determining hedging costs in the EPC is still relevant.

In addition to the above issues, ActewAGL will address some further aspects of the EPC that are important for the upcoming review.

During the Commission's 2010 consultation for determining the EPC model, the Commission set down three high level requirements that the Commission considered "to be appropriate when deriving the energy purchase cost component":<sup>24</sup>

- The model should be simple, transparent and predictable.
- The model should provide an unbiased estimate of electricity purchase costs.
- Outputs from the model should be replicable.

<sup>21</sup> ICRC 2013, *Issues paper - Retail prices for franchise electricity customers from 1 July 2014*, October, p. 15

<sup>22</sup> ICRC, *Final Decision - Retail prices for non-contestable electricity customers 2010-12*, June 2010, p 7

<sup>23</sup> ICRC 2013, *Issues paper - Retail prices for franchise electricity customers from 1 July 2014*, October, p. 18

<sup>24</sup> ICRC 2010, *Final technical paper - model for determining the energy purchase cost component of the transitional franchise tariff, report 3 of 2010*, p9

ActewAGL continues to support a transparent and predictable methodology and encourages the Commission to retain these key principles in the current review. This is key to a credible price determination process which delivers confidence to industry and consumers.

#### *Long-run marginal cost*

With the continuation of price regulation, ActewAGL would like to re-affirm its position of using the LRMC<sup>25</sup> of generation as a reference point in establishing a deemed purchase cost for electricity. In NSW, IPART continues to reference LRMC in its determinations for regulated tariffs.<sup>26</sup> However, given the detailed discussion and conclusion drawn by the Commission on this matter in its 2010 and 2012 determinations and noting ActewAGL's preference for a transparent, stable and open regulatory process that minimises the administrative burden, ActewAGL acknowledges the Commission's previous preference to maintain, where possible, the current approach to the derivation of EPC for the retail prices for franchise electricity customers.

#### *Concerning trend with the EPC model total uplift factor*

ActewAGL broadly supports the continuation of the Commission's energy purchase cost (EPC) model developed in 2010. Within that model, market developments over recent years have resulted in the need for one update - an increase to the parameter value of the forward price margin uplift (FPMU) in the hedge cost (HC) component.

The Commission's EPC model is calculated as set out in the formula below:

$$\text{Energy purchase cost} = FP * (LS + HC)$$

Where:

$FP$  = Forward Price (average)

$$LS = \text{Load Shape} = \frac{L - W \text{ Price}}{T - W \text{ Price}}$$

$HC$  = Hedging Cost =  $(LR - LS) * FPMU$

$$LR = \text{Load Ratio} = \frac{\text{Max. Load}}{\text{Ave. Load}} + 0.1$$

$$FPMU = \text{Forward price market uplift} = \frac{(\text{Forward Price} - \text{Ave. Spot Price})}{\text{Forward Price}}$$

<sup>25</sup> ActewAGL 2009, *Model for determining the energy purchase cost component of the transitional franchise tariff – response to ICRC issues paper*, 23 October, pp 4-5

<sup>26</sup> IPART 2013, *Review of regulated retail prices and charges for electricity from 1 July 2013 to 30 June 2016 – Final report*, June, pp. 57-58

Table 2 below illustrates ActewAGL's forecast for the total uplift factor based on continued lower spot price volatility, coupled with further reductions in average loads.<sup>27</sup> These assumptions reflect sustained low spot volatility associated with falling demand across the NEM combined with increased peakiness of the ACT load shape due to further reductions in average demand associated with energy efficiency and solar generation together with increasing penetration of reverse cycle air-conditioning.

**Table 2 LS, HC and total uplift factor**

| Year      | LS, % | HC, % | Total uplift factor, % |
|-----------|-------|-------|------------------------|
| A 2009-10 | 16.6  | 5.5   | 22.0                   |
| A 2010-11 | 16.1  | 5.9   | 22.0                   |
| A 2011-12 | 15.5  | 6.0   | 21.5                   |
| A 2012-13 | 15.3  | 5.5   | 20.8                   |
| A 2013-14 | 14.1  | 5.9   | 20.0                   |
| F 2014-15 | 13.2  | 6.1   | 19.3                   |
| F 2015-16 | 12.5  | 6.4   | 18.9                   |
| F 2016-17 | 11.9  | 6.7   | 18.5                   |

ActewAGL is concerned that the total uplift factor produced by the EPC model has decreased each year since the EPC model was introduced and, that this trend is forecast to continue. This outcome contradicts the trend in ActewAGL's actual hedging costs which have been rising due to the increasing peakiness of the ACT load profile. Whilst energy saving initiatives have reduced average load in recent years (all quarters since Q211) the number of households with energy intensive reverse cycle air-conditioners is increasing. Despite average load falling in each quarter since Q211 the trend for peak load has been continued growth, particularly in the summer quarters.

ActewAGL notes the Commission's consideration of the present hedge strategy as conservative, in allowing for contracts to be purchased in excess of the historic maximum load. However, ActewAGL does not consider that the outcome of the Commission's EPC model to be conservative.

ActewAGL considers that anything less than a conservative hedge, when defined this way, is not within the acceptable function of a prudent and efficient retailer. The Commission established its precautionary approach to setting the EPC following extensive consideration

<sup>27</sup> Forecast assumptions:

- Maximum loads observed in quarters Q412 - Q413 rolled forward to Q415.
- Average loads observed in quarters Q412 - Q413 reduced annually by 2% (Q2 & Q3) and 3% (Q1 & Q4) out to Q415.
- LS ratios observed in quarters Q312 - Q313 rolled forward to Q415.

and consultation at the time of its 2010 decision.<sup>28</sup> This, in part, addresses the asymmetric risk in setting regulated tariffs in a competitive environment.<sup>29</sup> The nature of an effective hedge must allow for headroom above historic maximums to avoid potential exposure to the spot market.

### *Approach for determining the cost of hedging of the HC component*

The FPMU factor is what the Commission referred to as the forward price margin in its Issues Paper.

In relation to the FPMU parameter of the HC component in the EPC model, ActewAGL would like to draw the Commission's attention to the 2010 Final Technical Paper of the EPC model:

"Four-year and five-year averages for both the forward and spot price can be calculated. Four-year averages are calculated as the forward data for the 2004–05 year only begins in September 2002. The striking observation is that the average realised spot price is higher than the average forward price for the same financial year. Indeed, the realised spot price exceeds the forward price in three out of five years. There is considerable variability in the available data. In 2006–07, the spot price was 55% above the forward price, while in 2008–09 the spot price was 22% below the forward price. This appears to conflict with the market perception that swap contracts trade at a margin to the expected spot prices. However, four or five year's worth of data is not enough data for the Commission to make a definitive decision on the magnitude of the relationship between the forward price and the spot price.

Thus in this context, the Commission has to seek other information. Consistent with the Commission's decision to take a precautionary view when setting the purchase cost of electricity, the Commission has decided to set the forward price premium in the equation given above to 5%. This is the view taken by Frontier Economics in their modelling for IPART and appears to be an accepted industry standard. The Commission notes, however, that at some future period the Commission may want to revise this allowance once more data are available should the Government continue to require a TFT to be determined."<sup>30</sup>

Four more years of forward and spot price data is now available. ActewAGL reproduces the Commission's Table 1 from the Final Technical Paper of the EPC model below with the additional data now available. The values of the forward price for the additional years have been based on the sample periods used in the Commission's final decisions.

<sup>28</sup> ICRC 2010, *Final decision – Retail prices for non-contestable electricity customers 2010-2012*, June, p. 32

<sup>29</sup> ESAA 2012, *Retail Prices for Non-contestable Electricity Customers – 2012-14 – submission to the Issues Paper*, February, p. 2

<sup>30</sup> ICRC 2010, *Final Technical Paper – The Energy Purchase Cost Component of the TFT 2010–12*, March, p 30

**Table 3 Forward and spot price comparison**

| Year    | Forward price | Time weighted spot price | FPMU | Sample period            |
|---------|---------------|--------------------------|------|--------------------------|
| 2004-05 | 35.68         | 39.33                    | -9%  | Data from September 2002 |
| 2005-06 | 36.28         | 37.25                    | -3%  | 2 year average           |
| 2006-07 | 37.88         | 58.72                    | -35% | 2 year average           |
| 2007-08 | 44.57         | 41.66                    | 7%   | 2 year average           |
| 2008-09 | 49.52         | 38.85                    | 27%  | 2 year average           |
| 2009-10 | 49.74         | 44.19                    | 13%  | 23 months                |
| 2010-11 | 47.99         | 36.74                    | 31%  | 23 months                |
| 2011-12 | 41.15         | 29.67                    | 39%  | 23 months                |
| 2012-13 | 61.87         | 55.10                    | 12%  | 14 months                |

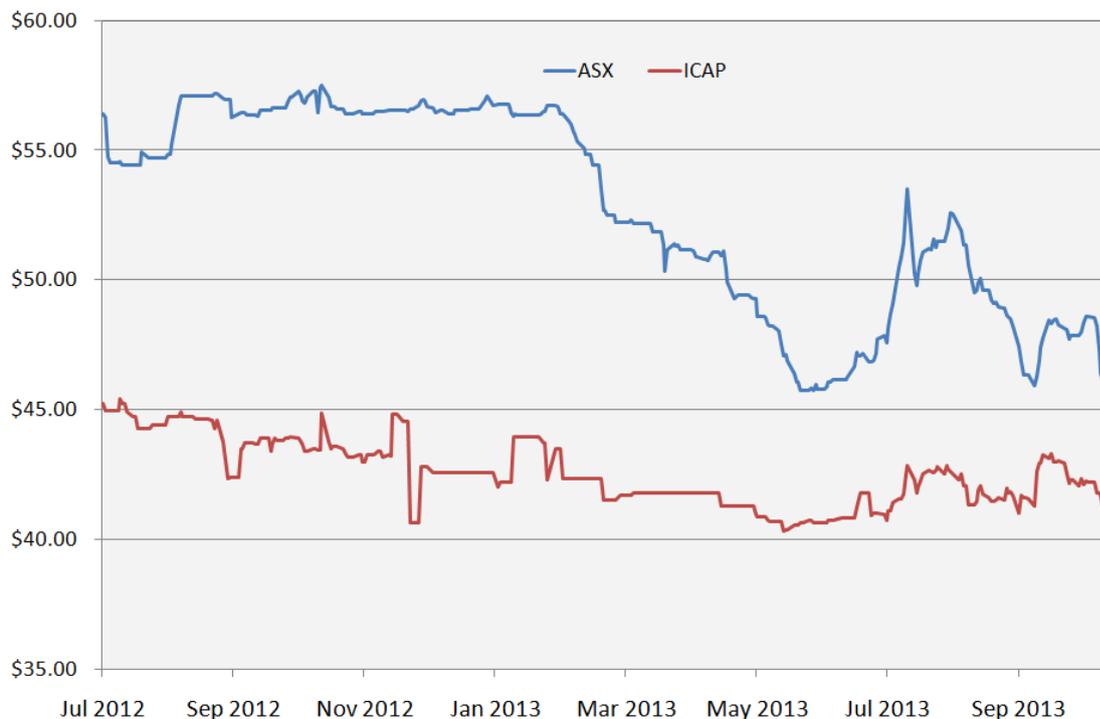
The average difference between the forward price and the time weighted spot price (FPMU) in the last four years has been 21 per cent. However, the Commission's EPC model assumes the FPMU to be 5 per cent.

ActewAGL encourages the Commission to reconsider its 5 per cent assumption by increasing the FPMU to a level that more closely reflects the relationship in the observed data.

*Revisiting the switch from using futures prices to forward contract prices*

In the 2012/13 final retail price direction, the Commission recognised that the introduction of a carbon price required a deviation to the existing model, moving from exchange traded futures (ASX) towards over-the-counter carbon exclusive contracts (ICAP), effectively isolating forward pricing from ongoing carbon price uncertainty. ActewAGL upholds that the carbon price uncertainty persists in the current forward price reference period. The question and timing of a possible repeal contributes to this uncertainty, not dissimilar to what was observed before and during the carbon legislation's introduction. This is demonstrated by Figure 1 which shows that in effect futures have already partially discounted the carbon price for a potential repeal.

**Figure 1 Spread analysis between ICAP NSW Base FY15 versus ASX NSW Base FY15 strip futures**



It is ActewAGL's view that a return to referencing carbon inclusive futures would be problematic, and raises the question of whether a prudent and efficient retailer would take an implied position on the future value of carbon, valued presently at a mid point that is neither reflective of its continuation, nor its repeal. This would represent a risky hedge strategy and contrary to the behaviour of a prudent retailer. ActewAGL therefore supports the continuation of using ICAP, carbon exclusive forward contract prices.

Due to the uncertainty around the repeal of the carbon price, as discussed above, ActewAGL supports the introduction of full pass-through arrangements to address associated risks until this uncertainty is resolved.

#### *Additional important EPC issues*

ActewAGL also notes that in the Commission's final decision on the retail price adjustment for franchise electricity customers for 2013/14, the forward price time horizon was reduced from 23 months to 14 months, which was inconsistent with the actual determination which specified 23 months.<sup>31</sup> ActewAGL appreciates this shortening of the sample period was required to keep inter-temporal consistency with the 2012/13 forward price, which was shortened due to

<sup>31</sup> ICRC 2012, *Final report retail prices for franchise electricity customers 2012-14*, June, p 45

uncertainty present within the carbon inclusive curve and data availability. However, such constraints are no longer present within the applied forward prices, and therefore ActewAGL anticipates a return to the full 23 month time horizon as reflective of the actual purchasing window of a prudent retailer. This would be consistent with the model established in 2010.<sup>32</sup>

Furthermore, in the 2013/14 price decision, for the calculation of EPC the Commission calculated carbon intensity by using the same averaging period (14 months) as was applied to the forward price of electricity. ActewAGL supports the continuation of this method, valuing carbon within the same period as the forward price is valued.

To value carbon within a different timeframe from energy, is to de-couple carbon pricing from standard electricity pricing, presenting an asymmetric contribution of each towards the total energy purchase cost. Therefore, for 2014/15 ActewAGL considers that the average carbon intensity factor should, for consistency purposes, reference a 23 month sample period aligned with the forward prices.

### 3.3.2 LRET and SRES costs

The Commission currently applies a market-based approach to determine efficient Large-scale Renewable Energy Target (LRET) and Small-scale Renewable Energy Scheme (SRES) costs and is seeking comments from stakeholders in relation to its current approach.

The obligation under LRET is underpinned by the Renewable Power Percentage (RPP) which specifies the proportion of electricity that must be supplied from large-scale renewable generators. Under SRES, the Small-scale Technology Percentage (STP) specifies the proportion of electricity that must be supplied from small-scale renewable generators.

The LRET and SRES schemes operate across calendar years and the Clean Energy Regulator (CER) sets the RPP and STP for a given compliance year. The Government has announced its intention to bring forward the setting of these percentages from 31 March of the current compliance year to 1 December of the preceding year.<sup>33</sup>

The CER publishes *non-binding* estimates for the next two compliance years, which the Commission has used in its recent decisions. To determine costs, the Commission's model multiplies non-binding estimates of the RPP and STP with the market sourced purchase data for the large-scale generation certificates (LGCs) and small-scale technology certificates (STCs). The LGCs and STCs have been based on 11 months data until 31 May and takes into account holding costs incurred by ActewAGL. In the following year, the Commission has

<sup>32</sup> ICRC 2010, *Final technical paper – model for determining the energy purchase cost component of the transitional franchise tariff*, report 3 of 2010, March, p.38

<sup>33</sup> From 2013, the STP and RPP will be released by 1 December. See recommendation 15 at: <http://www.climatechange.gov.au/reducing-carbon/renewable-energy/renewable-energy-target/ret-scheme-updates/australian-government>

adjusted for differences between the non-binding estimates and set RPP and STP. This element of the model has been essential as the CER's non-binding estimate for the STP has been consistently and significantly below the set percentage. ActewAGL expects that another adjustment for 2012/13 will be necessary.

The last two years' allowance for recovery of the LRET and SRES cost obligations imposed by governments has been lower than required. The Commission's allowance is based on publicly available information on spot prices for STCs. This is of concern to ActewAGL. In fact, the purchase of STCs has been set below the CER's \$40 clearing house price that forms the basis for SRES allowances by regulators in other jurisdictions.

### **STC prices**

ActewAGL maintains that the present market based approach does not fully address the volume, liquidity and regulatory risks presently observed in the STC market. Furthermore, it is anticipated that over the longer term, market pricing of STCs will be restored to levels consistent with the CER's fixed clearing house price.

ActewAGL considers that the previously observed conditions of an over supplied and discounted STC market no longer exist, due largely to the effects of state based reforms on solar multipliers and withdrawn feed-in tariffs.

As such it is ActewAGL's view that SRES cost recovery should be calculated on the basis of the CER's<sup>34</sup> clearing house price of \$40 per STC, and the CER's binding and non-binding STPs as the most appropriate and cost reflective method for estimating future certificate pricing.

### **LGC prices**

With consideration of the rising wholesale obligations under the LRET scheme, the certificates required for surrender by retailers are more often than not sourced through Power Purchase Agreements and/or long term committed equity in renewable generation. As such ActewAGL holds the view that a LRMC approach remains the most cost-reflective and therefore appropriate for regulators to assess LRET compliance costs.

By contrast, the closing price of the ICAP spot LGC market does not reflect actual liquidity, or the required market depth for a retailer to secure minimum volumes without significant movements in price. This market condition deteriorates further with regard to longer dated futures, which an efficient retailer with cash flow constraints would need to consider over buying primarily from spot.

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<sup>34</sup> ORER amalgamated into the Clean Energy Regulator on Monday 2 April 2012.

In addition, the speculative nature of financial markets has seen increased volatility observed in offer prices, particularly in response to events surrounding the federal election and the implied uncertainty on the future the LRET scheme. Whilst volatility is welcomed by trading participants in these markets, ActewAGL is concerned that as a retailer, market and regulatory risks are not being fully addressed within the commission's current market based approach.

ActewAGL remains of the view that the Commission should consider the LRMC of large-scale renewable generation as the basis for estimating LGC costs for LRET. However, should the Commission be predisposed towards a "market-based" model (rather than an LRMC based approach), it should continue to:

1. Reference publicly available closing prices of LGCs traded in a liquid market;
2. Incorporate retailer holding costs (of at least 10 per cent);
3. Make appropriate allowances to recover costs associated with volume risk, liquidity risk, delivery risk and regulatory risk, and operational administration costs.

The Commission's current model for LRET broadly reflects most of these features. ActewAGL encourages the Commission to consult with the industry in estimating LGC cost.

### 3.3.3 Energy losses

ActewAGL supports the continued use of the methodology used during the 2012-2014 period to calculate the energy losses for the transportation of electricity through transmission and distribution networks. This method is based on the distribution loss factor and transmission loss factor published by AEMO for the relevant financial year.

The loss factors cannot be finalised until they are published by AEMO by 1 April each year.

### 3.3.4 Energy contracting costs

ActewAGL confirms that the existing method of adjusting this cost component to reflect the change in the CPI is sufficient.

### 3.3.5 National Electricity Market fees

ActewAGL considers that the Commission's approach to determining NEM fees, by way of an annual CPI adjustment, should remain unchanged for the next regulatory period.

### 3.3.6 Retail operating costs and customer acquisition and retention costs

The ROC component was calculated in 2003 when the first transitional franchise tariff determination was handed down. Since then, increases in the allowed ROC component have moved in line with the rate of inflation, with no additional allowance for customer acquisition and retention costs (CARC), nor adjustments for consistent real cost increases in wages.

ActewAGL has repeatedly expressed a clear preference for benchmark costs to be based on a mass market new entrant rather than an incumbent retailer. Retail tariffs should reflect the cost of supplying electricity, including an appropriate margin.

The Commission's Issues Paper raises two key issues relating to the determination of the efficient level of retail operating costs in this investigation:

1. The fundamental objective of regulation and whether a headroom allowance is required over and above efficient retail operating costs to promote competition in a regulated market.
2. Whether there is evidence of diseconomies of scale due to the small size of the ACT market that should be accounted for in determining efficient retail costs.

ActewAGL discusses these two key issues below as well as a third issue; increasing relative costs.

#### *Headroom allowance (or CARC)*

ActewAGL has maintained over several retail price reviews that customer acquisition and retention activities impose legitimate costs of a competitive and commercially driven electricity market which should be incorporated in the benchmark market assessment determined by the Commission. ActewAGL considers that the small allowance that was included in the 2003 determination is insufficient. This cost was determined when the market had only just opened to competition and thus before ActewAGL started to incur costs for holding and acquiring customers. ActewAGL considers:

- that ActewAGL and other retailers in the ACT incur CARC in the ACT market as retailers compete to acquire new customers and retain existing customers;
- that as a result of no CARC allowance in the ACT regulated price, the total ROC allowance in the regulated tariff is not cost reflective; and
- when coupled with economies of scale differentials in other markets, the total ROC allowance is clearly insufficient and below a commercial level in the ACT.

CARC is a legitimate market based cost that should be explicitly included in the cost build-up in order to properly, fully, and justly reflect the costs of a prudent and efficient mass market electricity retailer, many costs of which are incurred by an incumbent retailer. This view was also supported by the AEMC in its 2010-2011 review of the effectiveness of the competition in the ACT.<sup>35</sup>

In 2012 ActewAGL engaged Allen Consulting Group to review the CARC for an efficient electricity operating in the ACT who concluded:

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<sup>35</sup> AEMC 2011, *Stage 2 Final Report, Review of the effectiveness of competition in the electricity retail market in the ACT*, 3 March, p 53

Given the ICRC's Terms of Reference requires the ICRC to take into account the efficient and prudent cost of managing risk in the cost of purchasing electricity and this is not limited to the costs of an incumbent retailer, we recommend that the ICRC incorporate CARC in its current pricing decision. Our research suggests a value of \$37.70 per customer would be appropriate.<sup>36</sup>

### *Increasing relative costs*

Since the introduction of the transitional franchise tariff in 2003, and as noted above, the Commission has only increased the ROC allowance annually by CPI. Other jurisdictions have increased the effective allowance by more than CPI<sup>37</sup> during that time and the ACT ROC allowance is now the lowest of benchmarked jurisdictions, even before taking into account the diseconomies of scale and no CARC compensation.

ActewAGL notes that a majority of the ROC relates to employment costs. It has been well documented that wages have increased by more than CPI. In fact, ABS data shows that the annualised nominal growth rate for general wages in the ACT from May 2003 to May 2013 has been 5.65 per cent. The average inflation in the ACT has been 2.7 per cent,<sup>38</sup> resulting in a real wage increase of almost 2.9 per cent annually since 2003. This cost pressure over such a long time is another indication that it is necessary for the Commission to increase the ROC allowance to allow prudent retailers to recover prudent and efficient costs for providing retail electricity services in the ACT.

### *Economies of scale*

In addition to considering the appropriate level of the ROC, consideration should be given to the feasibility for a mass market new entrant electricity retailer to achieve economies of scale in the ACT market. Given the size of the ACT market, it is important for the regulator to consider economies of scale when determining an appropriate ROC allowance. The Commission has itself noted this:

"While the Commission is not persuaded that it needs to depart substantially from the operating cost benchmark of \$80 per customer, inclusive of FRC costs, as used in its FRC Report, it recognises that there are likely to be diseconomies of scale in relation to the ACT market relative to the Victorian and South Australian markets from which this upper limit cost benchmark amount of \$80 per customer has been derived."<sup>39</sup>

In order to guide the assessment of the benefits that accrue from economies of scale, in 2010 ActewAGL undertook a sensitivity analysis to illustrate the effect of an expanding customer base on total ROC per customer (which included CARC in other jurisdictions). ActewAGL

<sup>36</sup> The Allen Consulting Group, *Calculating the CARC for an efficient full-market electricity retailer in the ACT*, April 2012, p 14

<sup>37</sup> IPART 2013, *Review of regulated retail prices and charges for electricity from 1 July 2013 to 30 June 2016*, June, p. 100

<sup>38</sup> ActewAGL notes that the CPI inflation is measured from June 2003 to March 2013.

<sup>39</sup> ICRC 2010, *Final Determination: Investigation into retail prices for non-contestable electricity customers in the ACT*, May, p 39

modelled this in relation to the total ROC allowed in the ACT, NSW, Queensland and South Australia and illustrated that at the time a plausible range of \$113 - \$210 per customer should be considered as an appropriate total ROC allowance in the ACT, when economies of scale are taken into consideration.

Four years have passed since the above analysis was undertaken. During that time, the Commission has increased the ROC allowance by CPI in the ACT. Other jurisdictions have also adjusted their ROC and CARC allowances. Table 4 below provides a summary of current allowances across different jurisdictions and this is depicted in Figure 2.

**Table 4 Comparison of ROC allowance in different jurisdictions and customer numbers, 2013/14**

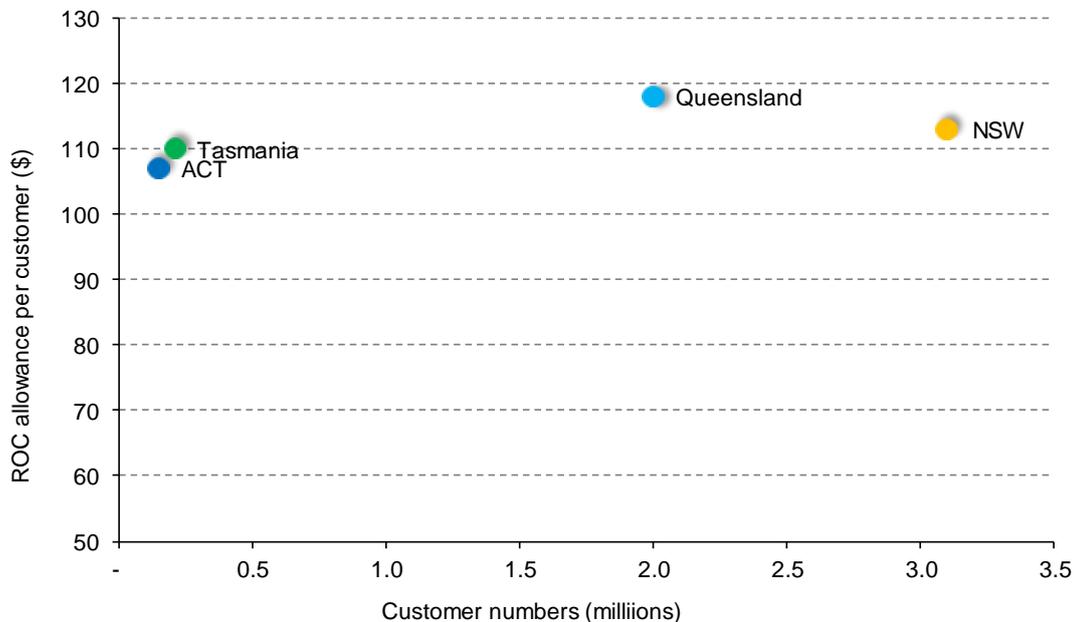
| Regulator                     | IPART   | QCA  | ICRC         | OTTER                      |
|-------------------------------|---|--|--------------|----------------------------|
| ROC (\$ per customer)         | 113   | 118  | 107          | 110                        |
| CARC/ headroom (per customer) | CARC allowance: 69.3-107.8<br>Total incentive: 169.4  | 44.25<br>5% on all costs   | N/A          | 11.60                      |
| Customer numbers              | 1.35 million (Origin)<br>1.09 million (EnergyAustralia)<br>3.22 million (total NSW small customers) <sup>40</sup> | 1.10 million (small non-market customers) 0.96 million (small market customers) 2.05 million (total small customers) <sup>41</sup> 0.70 million (Ergon Energy) | 0.15 million | 0.21 million <sup>42</sup> |

<sup>40</sup> IPART 2012, *Customer service performance of electricity retail suppliers 1 July 2007 – 30 June 2012*, December, p.29

<sup>41</sup> QCA, 2013, *Market and non-market customers – June quarter 2013*, p.2

<sup>42</sup> Office of the Tasmanian Economic Regulator, 2013, *Retail pricing proposal for period 1 of the 2013 interim price-regulated retail service price determination*, August, p. 2

**Figure 2 ROC allowance per customer (excluding CARC where allowed) based on customer base in the ACT, Tasmania, Queensland and NSW market, 2013/14**



ActewAGL has updated its modelling from 2010 with the 2013/14 allowance set out in Table 4. In comparison with 2010, ActewAGL has this time only included the ROC allowances from the other jurisdictions to ensure a direct comparison of ROC costs.

The economies of scale model assumes, as a starting point, that a retailer has a customer base of 150,000 customers (as in the ACT) with an assumed initial ROC structure of 65 per cent fixed and 35 per cent variable. For each additional customer added to the customer base, there are extra costs associated with servicing the customer. Some costs will have a one-to-one relationship with each customer, most obviously billing. Many costs will, however, increase at less than a one-to-one relationship with the addition of a number of customers.

If it is assumed that every new customer has a ratio of 50 per cent fixed and variable costs, this ratio can be used to illustrate the difference between current regulatory allowances in other jurisdictions and what this implies for the ACT market. Using a 50 per cent fixed/variable costs ratio assumption for additional customers above 150,000, the modelling reveals:

- A customer base of 210,000 with a ROC of \$110 per customer (in line with Tasmania) is equivalent to a ROC in the ACT of \$120 per customer with an assumed customer base of 150,000.
- A customer base of 700,000 with a ROC of \$118 per customer (in line with the average of incumbent retailers in Queensland), is equivalent to a ROC of \$154 per customer in the ACT with an assumed customer base of 150,000.

- A customer base of 1.2 million with a ROC \$113 per customer (in line with the average of incumbent retailers in NSW), is equivalent to a total ROC of \$154 per customer in the ACT with an assumed customer base of 150,000.

By adjusting the assumption regarding the fixed/variable cost ratio for additional customers it is possible to explore the range of plausible comparative ROC allowances. If the fixed/variable ratio is decreased to 40 per cent fixed costs (for additional customers above 150,000), the equivalent ROC allowances for a customer base of 150,000 increases even further as set out in Table 5. This is because the economies of scale are assumed to be greater. However, if the fixed/variable ratio is increased to 60 per cent fixed costs (assuming there are lower economies of scale) the equivalent ROC allowances for a customer base of 150,000 are as set out in Table 5.

**Table 5 - Equivalent total ROC allowance per customer in other jurisdictions, adjusted for customer bases of 150,000, 2013/14**

| Fixed/variable ratio (%) | NSW | QCA | TAS |
|--------------------------|-----|-----|-----|
| 60/40                    | 127 | 131 | 114 |
| 50/50                    | 154 | 154 | 120 |
| 40/60                    | 178 | 176 | 125 |

The conclusion is an indicative range of \$114 - \$178 per customer to be considered as appropriate total ROC allowance in the ACT when economies of scale are taken into consideration against relevant industry and regulatory benchmarking provided from other jurisdictions. The Commission's allowance of \$107 per customer in the 2013 final decision for 2013-14 is therefore considered to be set approximately four per cent lower than the minimum appropriate ROC allowance, adjusted for economies of scale in other jurisdictions. This reinforces the compelling need for the ROC allowance in the ACT to be increased to properly reflect efficient and commercial costs in regulated retail prices.

#### *Summary of findings on retail operating costs*

In the sections above, ActewAGL has shown:

- There are legitimate reasons to include a CARC in the ACT;
- The ROC allowance in the ACT is the lowest when benchmarked against NSW, Queensland and Tasmania, even when excluding the CARC allowance in these jurisdictions. This is exacerbated when taking into account diseconomies of scale, with a ROC allowance four per cent lower than the minimum appropriate ROC allowance; and
- Other jurisdictions have increased the effective ROC allowance by more than CPI. A majority of the ROC relates to employment costs that in the ACT have increased by 2.9 per cent annually since 2003 (in real terms).

ActewAGL believes the evidence above strongly indicates a need for an increase in the ROC allowance by more than CPI in 2014/15.

### 3.3.7 Energy Efficiency Improvement Scheme costs

In June 2012 the Commission supported ActewAGL's proposal to commence recovery of ACT Energy Efficiency Improvement Scheme (EEIS) costs with an adjustment mechanism to account for differences between forecast and actual costs. The Commission noted that the "...recovery of costs should be aligned with when they are incurred, and therefore considers it appropriate that costs incurred during 2012-13 are recovered through 2012-13 prices." An adjustment methodology for 2013-14 prices was determined in the Commission's 2012 Final Report:

"The Commission will assess the proposal as part of any adjustment and as an input into forecasting costs for future years.

In Developing costs for 2013-14 and making any adjustment and the Commission notes that there may be insufficient data available to accurately assess costs. In this case, the adjustment process will take place as part of the process for setting prices for 2014-15, should the Commission be involved in setting a regulated tariff at that time."<sup>43</sup>

As part of the retail price reset for 2013/14, in May 2013 ActewAGL provided the 2013 costs of the EEIS, calculated consistent with the Commission's determined methodology. Included were details on the make-up of these costs and their prudence and efficiency. ActewAGL received no request from the Commission for further information.

Although ActewAGL provided substantive material to allow the assessment of costs, the Commission's Final Decision for 2013-14 noted that:

"At this time, the Commission is not in a position to adequately assess ActewAGL Retail's costs. ... Should the Commission be involved in setting a regulated tariff for 2014/15 and beyond, it will assess the prudence and efficiency of the costs of implementing the Energy Efficiency Scheme."

ActewAGL understands the Commission will assess the prudence and efficiency of the costs of implementing the Energy Efficiency Scheme for 2014/15 and beyond, and report on the efficient costs of complying with the Energy Efficiency (Cost of Living) Improvement Act 2012 in accord with the Terms of Reference.

However, ActewAGL would be concerned at the risk of any ex post assessment and adjustment having made commitments and supported this with substantial evidentiary material in relation to prudence and efficiency to the Commission at the time of the reset for 2013-14 prices. This would add further and unexpected regulatory risk, particularly as ActewAGL was required to implement the Energy Efficiency Scheme from 1 January 2013.

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<sup>43</sup> ICRC 2012, *Final report retail prices for franchise electricity customers 2012-14*, June, p 29

## Issues Paper

In its Issues Paper the Commission seeks stakeholder views on how best to determine the prudent and efficient costs of complying with the scheme.

For the 2013/14 regulatory year, the Commission used the following formula to calculate an electricity retailer's obligation for the EEIS:<sup>44</sup>

$$\text{SESO} = \text{EST} \times (\text{Electricity Sales} \times \text{Emissions Factor})$$

Where

- SESO is the supplier energy savings obligation;
- EST is the energy savings target;
- electricity sales are the sales by the relevant retailer and;
- the emissions factor is the tonnes of carbon dioxide equivalent greenhouse gas emissions attributed to the consumption in the ACT of 1 MWh of electricity (to be set by disallowable instrument).

ActewAGL considers that the above formula should continue to be used when estimating the EEIS costs.

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

The 2014 Compliance Plan will be provided to the EEIS Administrator in late 2013. This document will outline the resources, systems, processes and eligible activities to be implemented by ActewAGL during the year to ensure that all obligations and responsibilities required by the Energy Efficiency (Cost of Living) Improvement Act and the Record Keeping and Reporting Code of Practice (Part 4) are met. ActewAGL believes that this document will provide the Commission with useful information to assess the costs to be incurred in relation to the EEIS.

In relation to the prudence aspect, ActewAGL notes that for the 2013-14 annual reset, the Commission was provided with detailed information as to why the costs for the entire EEIS are prudent. ActewAGL considers that this information also is relevant for future assessment of the EEIS from a prudence and efficiency perspective. In summary:

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<sup>44</sup> ICRC 2012, *Final report retail prices for franchise electricity customers 2012-14*, June, pp. 28-29

- the prudence of the EEIS has been satisfied via the government mandated nature of the program.
- ActewAGL undertook a rigorous competitive tender process, receiving 17 tenders, to find a contractor to conduct field activities, which represent approximately 80 per cent of the EEIS costs that ActewAGL incurs.

Further, the Government approved the 2013 Compliance Plan, supporting the level of activity planned for the 2013 calendar year.

### **Development of the EEIS**

In 2013 ActewAGL expects to install energy saving equipment in approximately 17,000 residential households in order to achieve its SESO. ActewAGL understands that the Commission will put forward an information request for additional information to report on the efficient costs associated with compliance with this scheme as required by the Terms of Reference.

In this regard, ActewAGL notes that there is currently substantial uncertainty in relation to the future cost of the EEIS. Under the ACT EEIS, the abatement factor is based on the abatement factor assigned by the ESCV. The ESCV has issued a notice informing stakeholders that the abatement factors for AV and IT standby power controllers will be reduced by 55 per cent and 62 per cent respectively from October 2013.

The EEIS Administrator has sought comments from ActewAGL in relation to this change, which ActewAGL provided on 1 November 2013. The impact of the change for the period January 2014 to June 2014 will be approximately \$1 million. ActewAGL is now waiting for the EEIS Administrator to determine abatement factors for calendar year 2014 and will provide its 2014 Compliance report to the Commission once it has been finalised.

### **3.3.8 Network costs**

ActewAGL Retail notes that distribution network costs are subject to a review and determination by the AER, which will be released in April 2014 for the 2014/15 transitional period, and April 2015 for the 2015-19 subsequent regulatory period.

ActewAGL Retail notes that these costs are unavoidable for retail electricity businesses and are determined by the AER, and as such, these costs should continue to be passed through to customers in the Commission's price decision. This should include costs associated with complying with the ACT feed-in tariff scheme.

ActewAGL notes the requirement for the Commission to "identify and report on the cost allowance of the ACT Feed-in Tariffs (small and large scale) for the year(s) or period for which

its determination is being made.”<sup>45</sup> The cost of the allowance for the Feed-in Tariffs are included in network prices.

### 3.3.9 Retail margin

The retail margin represents the return that a retailer requires to compensate it for the systematic risks associated with supplying electricity to franchise customers.

The retail margin of 5.4 per cent granted by the Commission for the current regulatory period was based on extensive analysis undertaken at the time by IPART and its expert consultants, SFG Consulting. For the review of regulated retail prices and charges for electricity in NSW to apply from 1 July 2013 to 30 June 2016, IPART once again engaged SFG to update the estimate of the retail margin. ActewAGL notes that IPART’s final decision was for a retail margin of 5.7 per cent of earnings before interest, tax, depreciation and amortisation (EBITDA), to be expressed as a fixed percentage of total costs.

In Queensland for the final determination of regulated retail electricity prices for 2013-14, the Queensland Competition Authority (QCA) adopted IPART’s updated estimate and set the retail margin at 5.7 per cent of total costs, inclusive of the margin,<sup>46</sup> or six per cent on top of total costs, excluding the margin.<sup>47</sup>

ActewAGL considers it appropriate for the Commission to reflect a commercial level of retail margin for the next regulatory period, as assessed and determined in recent decisions by regulators in NSW and Queensland. ActewAGL considers the most appropriate approach to assessing its retail margin to be a market based one. Based on SFG’s analysis for IPART, this would allow for a margin between 6.3 per cent and 6.9 per cent.

ActewAGL notes that for the 2012-14 price decision, the Commission has applied the retail margin on total costs, and therefore considers it essential for the Commission to ensure it is comparing ‘like for like’ applications of the retail margin when making a decision on this allowance.

It is also important that the Commission considers the retail margin and the decisions of other regulators in the context of decisions made for other regulatory parameters. For example, both the QCA and IPART provide for a headroom allowance.

Based on the evidence provided above, ActewAGL believes that a retail margin of at least six per cent should apply in the ACT market, and be applied in a manner consistent with previous determinations.

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<sup>45</sup> Barr 2013, *Independent Competition and Regulatory Commission (Price Direction for the Supply of Electricity to Franchise Customers) Terms of Reference Determination 2013*, September.

<sup>46</sup> QCA 2013, *Final determination – Regulated retail electricity prices 2013-14*, May, p. 55

<sup>47</sup> QCA 2013, *Final determination – Regulated retail electricity prices 2013-14*, May, p. 110

## 4. Mechanisms to apply for mid-period price adjustment

ActewAGL preference is for a mid-period price adjustment mechanism that mirrors the approach adopted by the Commission applied in its 2010-12 decision. ActewAGL considers this approach to provide a reasonable level of stability and predictability.

Following the proposed changes as described for 2014-15 as discussed in section 3.3 and on the basis that the next retail price period extends beyond one year, ActewAGL believes that the mid-period price adjustment should calculate an x-factor to be applied in the weighted average price cap formula. The elements of the mid-period adjustment should be applied as follows:

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

## Abbreviations and acronyms

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