

30 November 2016

The Independent Competition and Regulatory Commission
GPO Box 296
CANBERRA CITY ACT

By email: icrc@act.gov.au

Dear Commissioners,

Issues Paper – Standing offer prices for supply of electricity to small electricity customers from 1 July 2017

AGL welcomes the opportunity to comment on the Independent Competition and Regulatory Commission (**ICRC**)’s *Issues Paper: Framework and Approach – Standing offer prices for the supply of electricity to small customers from 1 July 2017, October 2016* (**Issues Paper**’).

AGL is one of Australia’s leading integrated energy companies. AGL is a significant electricity and gas retailer, providing energy solutions to 3.7 million customers throughout eastern Australia and has a diverse power generation portfolio including base, peaking and intermediate generation plants, spread across traditional generation fuel sources as well as renewable sources. Although AGL does not directly retail electricity in the ACT, it is a joint venture partner in ActewAGL Retail, the standard electricity and gas retailer for the ACT.

This Issues Paper is the start of the ICRC’s consultation process for determining retail electricity prices in the ACT from 1 July 2017 to 30 June 2020. It is therefore an important consultation if the ACT electricity market is to have effective retail competition in the next 3 years.

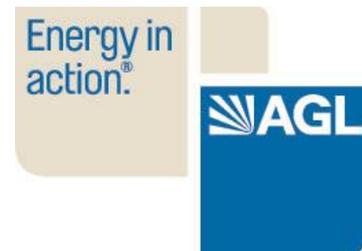
Retail competition

AGL recognises that there are many additional and sometimes conflicting objectives that are relevant to this process, including the overarching efficiency objective of the ICRC Act to *“promote the efficient investment in, and efficient operation and use of regulated services for the long term interests of consumers in relation to the price, quality, safety, reliability and security of the service.”*

However, one of the ICRC primary objectives in making a determination is *“to promote effective competition in the interests of consumers.”*

The AEMC’s retail competition reviews from 2014 to 2016 as well as the 2010 review of the effectiveness of competition in the ACT have consistently reported that the way retail price regulation is implemented in the ACT is one of the key barriers to entry.

The dominance of the incumbent retailer has also been mentioned as a reason to explain why retailers have not entered the ACT retail electricity market as despite the introduction of full retail contestability on 1 July 2003, ActewAGL’s market share has remained above 90 per cent over 13 years later. However, this has not been the experience in in other jurisdictions in the NEM, with the exception of Tasmania, with the market share of the incumbents falling significantly after full retail contestability. For instance, in the South Australian retail electricity market, AGL’s market share is below 50%.



The clear difference between jurisdictions has been the methodology used by the ICRC to regulate retail prices.

Retail price regulation

In a competitive market with regulated prices, the regulated price tends to set a price cap in the market.

AGL notes that the Issues Paper favourably compares the regulated retail price in the ACT with other jurisdictions but these comparisons are flawed and largely highlight the barriers to competition created by the current regulated price, namely:

- Comparing the total bill is misleading as between 40-55 per cent of a retail bill is networks costs. Consequently, variations in total bill between jurisdictions can be largely driven by the efficiency and pricing of regulated networks rather than any competition factor;
- Comparing the ACT regulated price with standing offer retail prices in other jurisdictions is also misleading as it ignores the impact of differential pricing in these competitive markets. Economic theory predicts that the dispersion of prices will increase as competition intensifies and that is true in the other jurisdictions with market offers often 20 to 30 per cent lower than the standing offers. The ACT regulated price should largely be compared with these market offers; and
- The Getup report highlighted in the Issues Paper attempted to provide a more relevant comparison by comparing only the retail segment of the bill and using market offers rather than only Standing Offers. However, the conclusion from this report failed to highlight that the lowest market offers in the other jurisdictions are actually lower than the ACT's regulated retail component.

In AGL's view, the lower retailer participation in the ACT electricity market compared with other jurisdictions in the NEM and subsequent high market share of ActewAGL are very strong indicators that the regulated price cap has been set too low for other retailers to compete. It is likely that some ACT electricity consumers are paying more than they would if there were greater competition.

Competition allowance

In the Issues Paper, the ICRC made the following statements in relation to competition allowances:

- that the rationale for a 'headroom allowance' is to provide some provision for start-up costs for new entrants with the expectation that over time competitive pressure would reduce prices; and
- the introduction of such an allowance in the ACT was not warranted because there is reasonable probability that any benefits will be small or long delayed or non-existent, and therefore of little current value.

The Issues Paper also includes the concept of customer acquisition and retention costs (CARC) within its headroom allowance. The current pricing model does not incorporate a 'headroom' (or competition) allowance.



AGL, as a national energy retailer, believes the ICRC has misconstrued the purposes of both CARC and headroom allowances. They are not linked to start-up costs but are a fundamental component of a competitive retail electricity market. Firstly, to acquire customers, retailers have to incur significant marketing and agency costs such as telemarketing, brokers, door to door sales and aggregators. The CARC allowance recognises these costs which energy retailers legitimately incur in the course of business.

Second, it is a key feature of competition in the retail energy markets to promote on the basis of discounts. Without any headroom, participants cannot effectively compete and procure customers. In the ACT, new entrant retailers are not even in a position to offer discounted products by reducing retail margin to zero as the cost of procuring these customers (CARC) is not included in regulated prices.

In contrast, IPART has explicitly used the CARC allowance as the mechanism for ensuring that regulated prices are set at a level that facilitates the continued development of competition. Accordingly, in the 2013 review, IPART¹ defined the CARC allowance as comprising of two components:

- direct acquisition cost of around \$150 per new customer or approximately \$40 per customer per annum, and
- indirect cost in terms of ongoing market discount of around 8 per cent off regulated prices (usage rate only).

The CARC allowance therefore represents the ongoing costs of a retailer, incumbent or not, operating in a competitive market, not just "start-up costs for new entrants".

ICRC objective

The newly stated objective of the ICRC, when making a price direction in a regulated industry, is in line with the National Electricity Objective (NEO). Both objectives refer to "long-term interests of consumers".

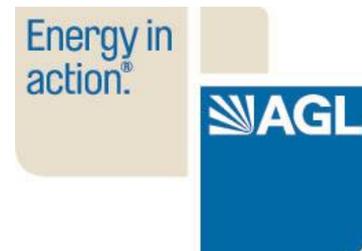
AGL notes that the ICRC has adopted IPART's benchmarks in relation to retail operating costs and retail margin. It is therefore relevant to consider IPART's view on headroom and the long-term interests of consumers:

"In our view the best way to support the long-term interests of consumers is by facilitating increased competition in the market. We consider an effectively functioning competitive market offers customers the best protection from higher than efficient prices in the short term. It can also deliver better customer outcomes in the long term, including better 'value for money' service through reduced costs and/or innovation.

... In our view, the focus for regulators, consumer groups and Governments in this context should be on promoting competitive market conditions rather than determining market outcomes.

However, for such a competitive market to develop while regulation exists, regulated prices must be high enough to create incentives for retailers to enter the market and compete for customers, and for customer to seek out better offers in the competitive

¹ Final Report – Review of Regulated Retail Prices for Electricity – From 1 July 2013 to 30 June 2016, IPART, p 117



market. If regulated prices are set too low – for example, to recover the short-term efficient costs of supply only – the incentives may not be sufficient for retailers to contest customers and for customers to enter into the market.”²

Similarly, the QCA has considered its role in setting notified (regulated) prices:

“... the Authority considers that part of its role in setting notified prices is to provide a transition to effective competition and eventual price deregulation ... Notified prices may provide a level of protection for customers until the Government is satisfied that competition provides a sufficient constraint on prices such that price regulation is no longer required. In the meantime, the Authority considers that notified prices should not act as a constraint on the development of effective competition. In particular, the Authority considers that notified prices should not act as a barrier to retailers entering the market and competing vigorously to acquire and retain customers. Notified prices should also encourage customer to exercise market choice and seek out the best deal in the competitive market. Greater customer engagement should further incentivise retailers to compete vigorously to make the best offers to attract and retain customers.”³

The AEMC is also of the view that a headroom allowance is ultimately in the customers’ long term interests:

“The Commission considers that effective competitive markets are generally the best means of promoting customers’ long-term interests. For competitive prices to develop, regulated retail prices must not create barriers to retailers efficiently entering the market and competing for customers. Accordingly, where jurisdictions consider competition to be feasible, a form of “headroom” should be included to facilitate competition.”⁴

In summary, IPART, QCA and the AEMC have concluded that regulated prices should be set at levels that promote competition which is in the long term interests of consumers. In adopting this view, there is acknowledgement that regulated prices will need to be sufficiently high to provide an incentive for new retailers to develop offers that will encourage customers to switch. Importantly, what is also relevant is not the immediate or short term value, but the long term value, to customers.

The ICRC and NEO also refer to “price, quality, safety, reliability and security of the service”. In AGL’s view, these objectives do not prescribe that the lowest price be determined. Instead, price is only one of a number of factors which are relevant to consumers with the quality of service and innovation in products also important.

Retail operating costs

The current retail operating cost benchmark (2016-17) applied by the ICRC is based on IPART’s 2013 benchmark. This IPART benchmark represents the efficient cost of a benchmark retailer operating in NSW. Two of the three largest energy retailers in Australia are standard electricity retailers in the NSW retail electricity market so this benchmark includes significant economies of scale and scope.

² Review of regulated retail prices and charges for electricity from 1 July 2013 to 30 June 2015, Electricity – Final Report, June 2013, IPART, p 25

³ Final Determination – Regulated Retail Electricity Prices 2013-14, May 2013, QCA, p 56

⁴ Final Report - Advice on best practice retail price methodology, 27 September 2013, AEMC, p iv



The ACT is the smallest market in the NEM. ActewAGL, which is the standard retailer in the ACT, has a customer base of electricity and gas consumers which is around a tenth of the size of any of the top three largest energy retailers in Australia.

Setting the retail operating cost at the efficient cost of the largest retailers in Australia is challenging but doing so with no competition allowance or customer acquisition and retention costs is punitive and has resulted in retail prices which are too low to allow competition to evolve.

If the ICRC does not intend to include CARC or a headroom allowance then, at the minimum, the retail operating cost should reflect the fact that fixed costs will have to be recovered over a significantly smaller customer base compared with the top three largest energy retailers. In addition, it is worth considering whether a cost benchmark established in 2013 is still relevant given the changes in the market such as metering contestability, as well as new products such as residential rooftop solar and battery storage which are impacting on the traditional energy supply chain.

AGL strongly encourages the ICRC to reconsider its position that a competition allowance is not justified so as to encourage retail competition in the ACT over the next 3 years.

Should you have any questions in relation to the information provided, please contact Meng Goh at mgoh@agl.com.au or (02) 9921 2221.

Yours sincerely,

A handwritten signature in blue ink, appearing to read "Beth Griggs". The signature is fluid and cursive, with a small dot at the end.

Beth Griggs
Head of Energy Market Regulation