ICRC
independent competition and regulatory commission

DRAFT REPORT

Review of the Retail Electricity Form of Price Control

Report 3 of 2021, February 2021

The Independent Competition and Regulatory Commission is a Territory Authority established under the *Independent Competition and Regulatory Commission Act 1997* (the ICRC Act). The Commission is constituted under the ICRC Act by one or more standing commissioners and any associated commissioners appointed for particular purposes. Commissioners are statutory appointments. Joe Dimasi is the current Senior Commissioner who constitutes the Commission and takes direct responsibility for delivery of the outcomes of the Commission.

The Commission has responsibilities for a broad range of regulatory and utility administrative matters. The Commission has responsibility under the ICRC Act for regulating and advising government about pricing and other matters for monopoly, near-monopoly and ministerially declared regulated industries, and providing advice on competitive neutrality complaints and government-regulated activities. The Commission also has responsibility for arbitrating infrastructure access disputes under the ICRC Act.

The Commission is responsible for managing the utility licence framework in the ACT, established under the *Utilities Act 2000* (Utilities Act). The Commission is responsible for the licensing determination process, monitoring licensees' compliance with their legislative and licence obligations, and determination of utility industry codes.

The Commission's objectives are set out in section 7 and 19L of the ICRC Act and section 3 of the Utilities Act. In discharging its objectives and functions, the Commission provides independent robust analysis and advice.

Correspondence or other inquiries may be directed to the Commission at the following address:

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The Commission may be contacted at the above address or by telephone on (02) 6205 0799. The Commission's website is at www.icrc.act.gov.au and its email address is icrc@act.gov.au.

How to make a submission

This draft report provides an opportunity for stakeholders to provide feedback and evidence to inform the development of the final report. It will also ensure that relevant information and views are made pubic and brought to the Commission's attention.

Submissions on the draft report close at **5pm Friday 26 March 2021.**

Submissions can be emailed to the Commission at icrc@act.gov.au.

Alternatively, submissions may be made online through the form on the Commission's website: www.icrc.act.gov.au or mailed to the Commission's address below.

Independent Competition and Regulatory Commission
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Please enclose a completed submission cover sheet with your submission. A copy of the submission coversheet is available at the weblink: https://www.icrc. act.gov.au/submissions.

The Commission encourages interested parties to make submissions in either Microsoft Word format or PDF (OCR readable text format – that is, they should be direct conversions from the word-processing program, rather than scanned copies in which the text cannot be searched).

For submissions received from individuals, all personal details (for example, home and email addresses, and telephone numbers) will be removed for privacy reasons before the submissions are published on the website.

The Commission is guided by the principles of openness, transparency, consistency and accountability. Public consultation is a crucial element of the Commission's processes. The Commission's preference is that all submissions it receives be treated as public and be published on the Commission's website unless the author of the submission indicates clearly that all or part of the submission is confidential and not to be made available publicly. Where confidential material is claimed, the Commission prefers that this be under a separate cover and clearly marked 'In Confidence'. The Commission will assess the author's claim and discuss appropriate steps to ensure that confidential material is protected while maintaining the principles of openness, transparency, consistency and accountability.

The Commission secretariat may be contacted at the above address, by telephone on (02) 6205 0799 or via email address: icrc@act.gov.au. The Commission's website is www.icrc.act.gov.au.

Table of Contents

List of Figures

List of Tables

List of Boxes

Executive summary

The Independent Competition and Regulatory Commission decided to review its form of price control during its 2020-24 retail electricity price investigation. The 'form of price control' refers to the approach used by the Commission to regulate retail electricity prices.

During the price investigation, the Commission found that the 2020-21 increase of 5.4 per cent in the network cost pass through for regulated tariffs was significantly higher than the AER approved network price increase of 2.0 per cent for Evoenergy's corresponding regulated tariffs. The difference was caused by a change in the mix of network charges incurred by ActewAGL, which was caused by a change in the mix of consumers on standing offers.

This review has focused on the compositional changes in ActewAGL's customer base—their causes, how they are treated in the Commission's price modelling, and their implications for the ongoing effectiveness of the form of price control.

Draft decisions

The Commission has made a draft decision to amend the methodology for the network cost pass-through so it is consistent with the way the maximum allowed price change is calculated in the Commission's 'tariff basket' formula. This means the calculation will use the same weights—measured using the most recent customer numbers and usage measures—for both years in the network cost calculation.

The Commission has made a second draft decision to implement the change during the current regulatory period (2020-24). The Commission intends to implement its decision on amending the cost estimation method in the annual retail electricity price recalibration for 2021–22.

Reasons for the draft decision

The Commission considers that the current practice of using different weighting methods for calculating the network cost change and the weighted average price change is inconsistent. Currently, changes in the mix of customers on ActewAGL's standing offers affect network costs but are excluded from the Commission's tariff basket approach to the weighted average price change.

The current method of calculating network costs results in compositional effects affecting both the change in average network costs calculated by ActewAGL and the revenue raised by ActewAGL—effectively 'double-counting' the effects of compositional changes. Depending on the nature of the compositional change in any particular year, this can result either in ActewAGL raising more revenue than needed to recover its network costs or not enough revenue to recover its network costs.

The Commission considers that the revised method will allow ActewAGL to recover its efficient costs, based on calculations for the hypothetical efficient retailer.

While the Commission typically does not alter its regulatory methodology between price investigations, the Commission considers that a timely resolution of this issue is necessary.

The distortion caused by the inconsistency between the calculation methods results in inaccurate estimates of network costs, which affects the accuracy of the Commission's determination of the maximum allowed average price increase for ActewAGL's standing offer prices.

The Commission is conscious of the affordability pressures currently being experienced by electricity consumers. It is also conscious that ActewAGL needs certainty that it can consistently recover its prudent and efficient costs over time, without over-recovery in some years and over-recovery in other years. For these reasons, the Commission has concluded that it would be in the best interests of stakeholders if the calculation method were changed as part of the 2021-22 price recalibration.

Next steps

The Commission intends to hold a workshop in March for stakeholders to ask questions and provide feedback on the draft decision.

The final report is planned for release in April 2021, with implementation of the final recommendations expected to take effect on 1 July 2021 when the Commission recalibrates prices to apply from 1 July 2021.

Process for this review

The Commission released an issues paper on 16 October 2020 as the first step in the consultation process for this review. ActewAGL, the ACT Council of Social Services (ACTCOSS) and the ACT Civil and Administrative Tribunal (ACAT) made submissions on the issues. The Commission has considered feedback and information provided in submissions in developing this draft report.

This report is the second milestone in the consultation process for the review.

The Commission welcomes feedback on its draft decision and will consider all feedback in developing its final report.

1. Introduction

The Independent Competition and Regulatory Commission is undertaking a review of the form of price control it uses to regulate retail electricity prices. During the retail electricity price investigation 2020-24, the Commission made a reset principle in the Price Direction to review the form of price control. In this review, the Commission has considered current and potential market developments that may have implications for the effectiveness of the current form of price control.

1.1 Background to the review

The Commission is the Australian Capital Territory's (ACT) independent economic regulator, which regulates prices, access to infrastructure services and other matters in relation to regulated industries in the ACT. The Commission also has functions under the *Utilities Act 2000* (Utilities Act) for licensing electricity, natural gas, water, and sewerage utility services and making industry codes. The Commission undertakes price investigations in accordance with sections 15, 16 and 17 under Part 3 of the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act), and issues Price Directions under Part 4 of the ICRC Act.

Under the Commission's form of electricity price control, the Commission regulates the maximum weighted average price change that ActewAGL can apply across its 'basket' of standing offer tariffs from one year to the next. Under this form of price control, ActewAGL has the flexibility to determine the number of standing offer tariffs and to adjust the prices of those tariffs as long as the weighted average price across all tariffs does not exceed the weighted average price change determined by the Commission.

The Commission calculates the maximum weighted average price change using a pricing model, which estimates the individual cost components that would be incurred by an efficient retailer in a similar position as ActewAGL when providing electricity services to customers on regulated tariffs. The individual cost components in the Commission's pricing model can be grouped into three broad categories: wholesale costs (the costs associated with purchasing electricity from the wholesale market, representing 44 per cent of total costs), network costs (the cost of transmitting and distributing electricity from generators to consumers, representing 43 per cent of total costs), and retail costs (costs faced by retailers in providing services to customers and the retail margin, representing 13 per cent of total costs).

The Commission allows ActewAGL to pass on the network costs that it incurs when providing electricity services to standing offer customers. ActewAGL calculates the network cost pass-through amount and submits it to the Commission for verification. Network charges are regulated by the Australian Energy Regulator (AER), which determines the maximum revenue that a network business (Evoenergy in the ACT) can recover from customers each year. ActewAGL uses network charges approved by the AER when calculating the network cost pass-through amount. After the Commission has verified the network cost pass-through amount, it is included in the Commission's pricing model to calculate the regulated price change. As the network cost component is a significant cost component of the Commission's pricing model, it has a significant effect on the regulated price change determined by the Commission.

In the final report for the 2020-24 retail electricity price investigation, the Commission noted that the increase in the network cost pass-through amount corresponding to regulated tariffs for 2020-21 (5.4 per cent) was significantly higher than the AER approved network price increase for Evoenergy's corresponding

regulated tariffs (2.0 per cent). The Commission reported that the difference reflected a change in the mix of network charges incurred by ActewAGL, which had come about because of a change in the mix of consumers on standing offers.

In its final report, the Commission considered that the way in which network costs are allocated to customers on different tariff types may become increasingly important as the number of standing offer customers continues to change. The Commission therefore made a reset principle in the Price Direction 2020-24 to review the form of price control. Reset principles are principles governing the redetermination of prices in a regulated industry and can provide the opportunity to assess and update, if necessary, aspects of the methodology or approach that will be used by the Commission in future.

1.2 The scope of the review

In this review, the Commission has examined the causes of compositional changes in ActewAGL's customer base, how compositional changes have been dealt with in the Commission's approach, and implications of compositional changes for the ongoing effectiveness of the form of price control.

The Commission has considered whether changes are needed to how the network cost pass-through is calculated to make sure the form of price control remains effective. This report outlines the draft decisions related to the changes of network cost calculation and the proposed implementation timeline.

The Commission reviewed the other cost components of the Commission's pricing model during its 2018-19 Electricity Model and Methodological Review (EMMR).

1.3 The process for the review

The Commission is undertaking a public consultation process for the review. As part of the public consultation, the Commission released an issues paper on 16 October 2020 and invited interested parties to make submissions. The Commission held a workshop on 17 November 2020 to give stakeholders details of the issues for the review and to invite feedback and views.

Written submissions to the issues paper and the views expressed at the workshop by stakeholders were considered when preparing the draft report. Interested parties are invited to submit their comments, and any supporting information, on the draft report by 26 March 2021. The Commission intends to hold a workshop in March 2021 to discuss the Commission's draft decisions with stakeholders.

The final report for the review will be released in April 2021.

The indicative timeline for the review is in Table 1. In developing the indicative timeline, the Commission has considered the timing of other regulatory processes, both in the ACT and in other jurisdictions, and has aimed to allow sufficient time for ActewAGL and other stakeholders to participate fully in the review.

Table 1: Indicative timeline for this review

Task	Date
Release of issues paper	16 October 2020
Workshop I	17 November 2020
Submissions on issues paper close	27 November 2020
Draft report	26 February 2021
Workshop II	March 2021
Submissions on draft report close	26 March 2021
Final report	April 2021

1.4 Commission's role and objectives

In carrying out its functions under the ICRC Act, the Commission has the following objectives as set out in sections 7 and 19L of the ICRC Act (Box 1.1).

Box 1.1: Sections 7 and 19L: Commission objectives

Section 7:

(a) to promote effective competition in the interests of consumers.

(b) to facilitate an appropriate balance between efficiency and environmental and social considerations.

(c) to ensure non-discriminatory access to monopoly and near-monopoly infrastructure.

Section 19L:

To promote the efficient investment in, and efficient operation and use of regulated services for the long-term interests of consumers in relation to

When making a price direction, in addition to the terms of reference and legislative objectives, the Commission is also required to have regard to the provisions set out in section 20(2) of the ICRC Act (Box 1.2).

Box 1.2: Section 20(2): Commission's considerations

(a) the protection of consumers from abuses of monopoly power in terms of prices, pricing policies (including policies relating to the level or structure of prices for services) and standard of regulated services.

(b) standards of quality, reliability, and safety of the regulated services.

(c) the need for greater efficiency in the provision of regulated services to reduce costs to consumers and taxpayers.

(d) an appropriate rate of return on any investment in the regulated industry.

(e) the cost of providing the regulated services.

(f) the principles of ecologically sustainable development mentioned in subsection (5).

(g) the social impacts of the decision.

(h) considerations of demand management and least cost planning.

(i) the borrowing, capital and cash flow requirements of people providing regulated services and the need to renew or increase relevant assets in the regulated industry.

(j) the effect on general price inflation over the medium term.

(k) any arrangements that a person providing regulated services has entered into for the exercise of its functions by some other person.

(l) any arrangements that a person providing regulated services has entered into for the exercise of its functions by some other person.

Section 19L of the ICRC Act (provided in Box 1.1) requires the Commission to make pricing decisions that promote efficient investment in, and efficient operation of, regulated services in the long-term interests of consumers. Following from this, an important consideration for this review is to ensure that the Commission's final decision continues to allow ActewAGL the opportunity to recover the efficient costs of providing electricity services to standing offer customers.

1.5 Structure of the draft report

The remainder of this draft report is structured as follows:

- Chapter 2 summarises recent developments in the Australian electricity market.
- Chapter 3 discusses the form of price control and the Commission's pricing model.
- Chapter 4 discusses the Commission's proposed approach to calculating the network cost pass through amount.
- Appendix 1 presents Evoenergy's network charges associated with ActewAGL's standing offer tariffs.

2. Developments in the Australian electricity market

The Australian electricity market is undergoing a rapid transition. In the wholesale market, the generation mix is undergoing a rapid transition from a centralised system of large fossil fuel generators to smaller scale, dispersed renewable generation. In the ACT retail electricity market, and in retail markets in other jurisdictions, customers are moving from standing offer contracts to market offers reflecting affordability pressures, increased competition and calls by governments and regulators to shop around for cheaper offers. The take-up of smart meters in the ACT is also increasing following the introduction of the Australian Energy Market Operator's (AEMC) Power of Choice reforms and the increasing prevalence of rooftop solar panels. This chapter presents a summary of recent market developments and their implications for this review.

2.1 Developments in the wholesale market

The energy generation mix in the Australian electricity market is changing rapidly. Previously, the Australian electricity generation system was characterised by a centralised system of large fossil fuel (mainly coal) generators. As ageing coal generators exit the market, the generation system is now moving to a decentralised system of widely dispersed, relatively small-scale renewable (mainly wind and solar) generators.

Reflecting the increased supply of renewable energy, wholesale electricity prices in the National Electricity Market (NEM) have been falling over the past few years. Prices averaged $63 per MWh in 2020 compared to around $85 per MWh in 2017 across the NEM.[1] Figure 2.1 shows that electricity spot prices in NSW have decreased from $82 in January 2017 to $35 in February 2021.

Wholesale electricity prices are generally high in summer when demand for air conditioning is highest.[2] In January 2020, wholesale prices in NSW, Victoria and South Australia spiked for a number of reasons including extremely high temperatures on some days which led to very high demand for electricity, lower electricity supply as a result of a plant failure at Victoria's Loy Yang A coal power plant, lower output from wind farms, and a failure at the Heywood transmission infrastructure which links Victoria and South Australia.[3] In February 2017, wholesale prices in NSW spiked due to high temperatures over several consecutive days.[4]

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1 Details at: https://aemo.com.au/en/energy-systems/electricity/national-electricity-market-nem/data-nem/data-dashboard-nem.

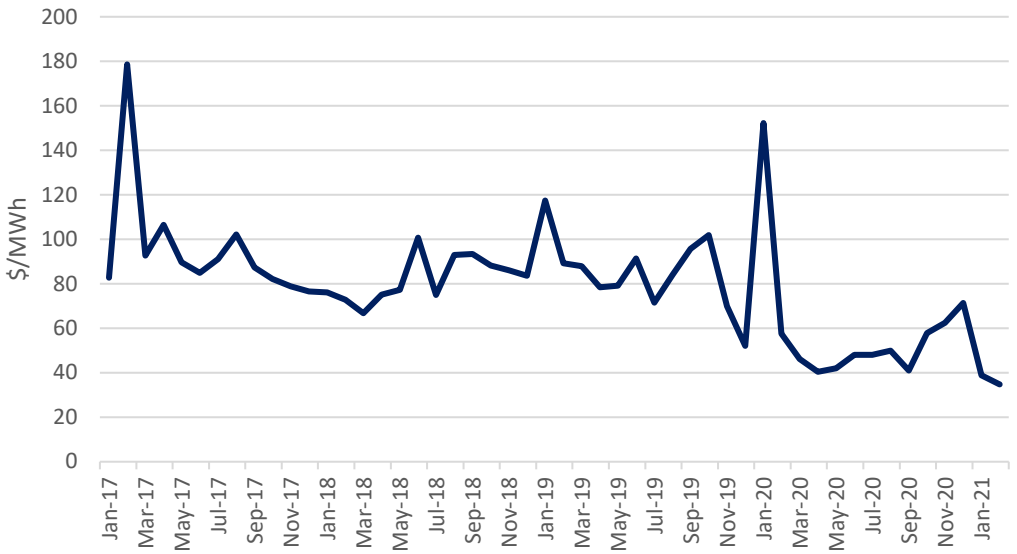
2 AER 2020a, p 41.

3 Details at: https://www.aer.gov.au/communication/aer-reports-on-high-wholesale-electricity-prices-in-january-2020.

4 Details at: https://www.aer.gov.au/wholesale-markets/performance-reporting/prices-above-5000-mwh-6-february-2017-nsw-and-qld.

According to the AER, average electricity prices in the fourth quarter in 2020 were lowest in South Australia and Victoria, with the highest quarterly prices occurring in NSW.[5] The AER stated that prices exceeded $5000/MWh five times in NSW during the fourth quarter mainly due to planned and unplanned outages in the transmission network. The AER further stated that very low levels of demand and high renewable generation led to a record number of negative prices in South Australia and Victoria.

Figure 2.1 Average monthly wholesale electricity prices in NSW ($ per MWh)



Source: Commission's calculation using AEMO data.

Integrating high volumes of renewable energy into the electricity network has been challenging for three main reasons.[6]

First, much of this new generation is in sunny or windy areas far from the main transmission network (also known as the grid). Therefore, this energy is fed into the main grid via long and less efficient transmission lines, resulting in high rates of energy losses during transmission.[7]

Second, the traditional fossil fuel generators provide technical stability services that keep the power system reliable and secure. For example, fossil fuel generators can generate electricity continuously within defined technical limits. The ability of wind and solar generators to provide these services has been limited to date. This is because wind and solar farms use different technologies than the ones used by fossil fuel generators.[8]

Third, because the output of wind and solar generators is dependent on weather conditions, supply gaps have to be filled when the weather is unfavourable for generation. Weather driven volatility requires backup energy that can quickly discharge to the grid when needed, from sources such as gas-fired

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5 https://www.aer.gov.au/wholesale-markets/wholesale-statistics.

6 AER 2020a, p 13.

7 As energy flows through across a network of poles and wires, some of it is lost as heat. The energy loss is higher the further it travels and the weaker the transmission lines.

8 More information on technical stability services can be found in AER 2020a p 48.

generators or increasingly from battery storage, to have an uninterrupted supply of energy and reduce the risk of black-outs in parts of the network.

Government bodies, including the Council of Australian Governments (COAG) Energy Council, Australian Energy Market Operator (AEMO), the Australian Energy Market Commission (AEMC) and the Energy Securities Board (ESB), are taking a range of actions to smooth this market transition.

The AEMC undertakes the coordination of generation and transmission investment (COGATI) review every two years, as requested by the COAG Energy Council, to examine the drivers that could impact future transmission and generation investment.[9] The first COGATI review, completed in December 2018, recommended reforms to the way investment and generation are coordinated. The second COGATI review is expected to conclude in June 2021.

AEMO has prepared a long-term integrated system plan (ISP), which has identified investment choices and made recommendations on essential actions to optimise consumer benefits amid Australia's rapid transition in the energy sector. The investment choices identified in the ISP include new grid projects, improvements to the existing grid infrastructure and establishing Renewable Energy Zones. Establishing Renewable Energy Zones would involve developing new grid infrastructure in renewable energy-rich areas so that several generators can be located in one zone and connected to the grid efficiently.[10]

The ESB is developing a post-2025 market design for the NEM. As part of this market design, the ESB is considering the energy supply chain, all aspects of risks in the energy system and cost recovery arrangements.[11] The ESB released a consultation paper on the market design in September 2020[12] and a Directions paper in January 2021.[13] The Directions paper sets out the reforms to be pursued to the next stage of the ESB's national electricity market redesign project. The ESB is developing detailed designs for each of the reforms for further consultation in March, before final recommendations are made to energy ministers in mid-2021.

These actions are expected to bring long term benefits to electricity consumers. For example, AEMO estimates that if the ISP is properly implemented in that the associated investments and recommended changes to grid infrastructure are made, consumers will gain around $11 billion in net market benefits over the next 20 years.[14]

2.2 Developments in the retail market

Developments in the wholesale markets discussed above have already had effects on the ACT retail electricity market. For example, the Commission's electricity price determination in June 2020 meant that a typical customer on ActewAGL's standing offer contracts was expected to see a 2.56 per cent reduction in retail electricity prices in 2020-21. The price decrease largely reflects falling prices in the wholesale

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9 AEMC 2020, p i.
10 More information on renewable energy zones can be found in AEMC 2019b
11 COAG Energy Council 2019, p 6.
12 COAG Energy Council 2020.
13 COAG Energy Council 2021.
14 AEMO 2020, p 9.

electricity market. A key driver of these lower wholesale prices is the growth in renewable energy generation.[15]

A range of other factors have affected the retail electricity market in the ACT recently. First, there has been a steady increase in the number of customers moving from standing offers to market offers. Standing offers are 'default' contracts that consumers enter into if they do not select a market offer. The prices of these offers are regulated by the Commission, and minimum terms and conditions for these offers are set by government.[16] These offers provide a safety net for those consumers who do not or cannot shop around for better offers.

Market offer rates can sometimes be more price competitive. They generally have terms and conditions that are set by the retailer rather than through regulation. For example, retailers can change market offer prices more frequently than they can change prices for standing offers.

The increased take-up of market offers in the ACT reflects a range of factors, including affordability pressures which have encouraged consumers to shop around for better deals, increased competition among retailers, and government calls to shop around for cheaper electricity offers. In the September quarter 2019, around 54 per cent of ActewAGL's residential electricity customers were on standing offers. However, within a year, this share declined to 40 per cent (in the September quarter 2020; see Figure 2.2). The share of standing offer customers in the ACT is still high relative to that in NSW (11.5 per cent) and Victoria (5 per cent).[17] Therefore, there is still potential for more ACT customers to shift away from standing offers to market offers.

Second, competition in the ACT retail electricity market has increased. ActewAGL is the dominant retailer with a high market share. However, based on AER data,[18] its market share declined from nearly 81 per cent in the September quarter 2019 to around 79 per cent in the September quarter 2020 (see Figure 2.2). Origin Energy appears to be the main competitor to ActewAGL; it increased its market share from around 14 per cent to around 16 per cent between the September quarter 2019 and the September quarter 2020. Energy Australia is the other main retailer with around 4 per cent of the market. Increased competition has potential to put downward pressure on prices of unregulated market offers in the ACT.

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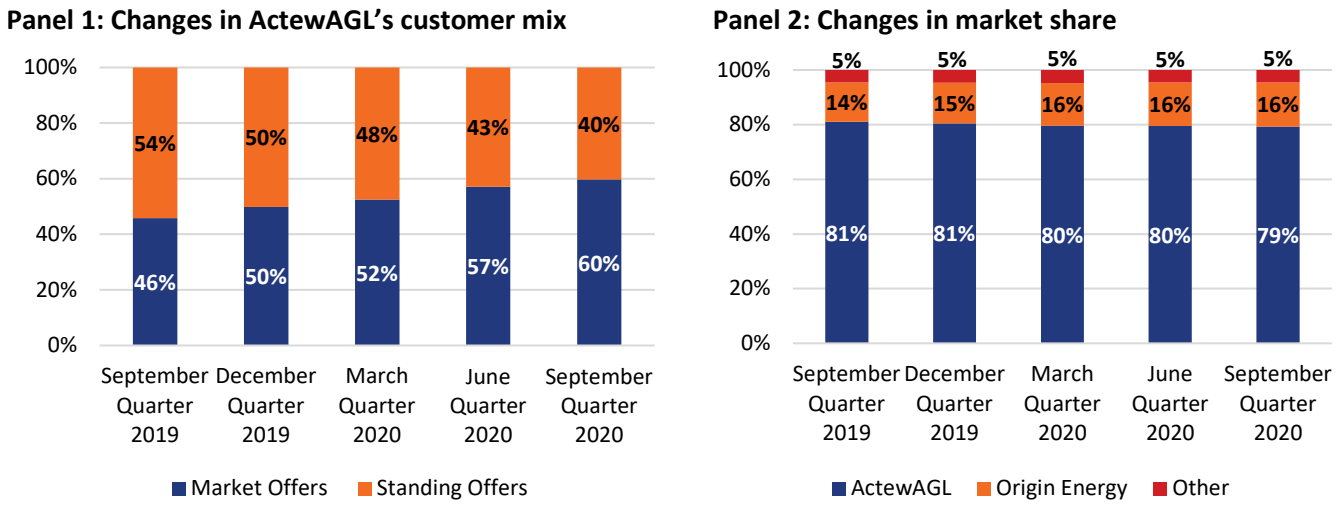
15 AER 2020a, p 14.

16 The minimum terms and conditions are set by the National Energy Customer Framework which was developed by State, Territory and Commonwealth Energy Ministers through the COAG Energy Council.

17 The value for NSW is from AER 2020b and the value for Victoria is from ESC 2020

18 AER 2020b

Figure 2.2 Changes in the ACT retail market



Source: AER 2020

Third, the proportion of consumers on time-of-use tariffs or demand tariffs compared to flat rate tariffs have increased. Flat rate tariffs have a daily supply charge and a single rate for the amount of electricity consumed regardless of when the electricity was used. This means flat rate customers pay the same usage rate whatever time of the day electricity is used. In contrast, customers on time-of-use tariffs pay a fixed supply charge and different usage rates depending on the time of the day when energy is used. Demand tariffs have a fixed supply charge, a usage charge, and a demand charge based on how much electricity is used within the daily peak time period set by the retailer. A customer's demand charge will be higher when many appliances are used at the same time during the daily peak time period. More information about different tariffs is on the Australian Government's Energy Made Easy website.[19]

The trend towards time-of-use and demand tariffs in the ACT reflects increased take-up of smart meters and the 'tariff assignment policies' of some electricity retailers (such as ActewAGL) that require all smart meter customers to be on these tariffs.

The take-up of smart meters in the ACT has increased due to the Power of Choice Reforms introduced by the AEMC in late 2017. The Power of Choice reforms require all new electricity meters for residential and small business customers to be smart meters. The installation of rooftop solar panels has also resulted in an increased take-up of smart meters in the ACT because the installation of solar panels also requires installation of a smart meter.[20]

The type of retail tariff that a customer has access to depends on whether they are a residential or business customer and the type of meter that they have. For example, until recently, ActewAGL customers with a smart meter were automatically placed on a retail demand tariff and had an option to switch to a time-of-use tariff but were not able to access flat rate tariffs. This practice reflected ActewAGL's tariff assignment policy. These policies vary by retailer and are unregulated. ActewAGL changed its tariff assignment policy

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19 https://www.energymadeeasy.gov.au/article/electricity-tariffs

20 https://energysaver.nsw.gov.au/households/understand-your-usage/smart-meters

from 1 July 2020, and customers with smart meters are now automatically placed on time-of-use tariffs and can opt to move to a retail demand tariff.[21] A factor influencing a retailer's tariff assignment policy is the tariff assignment policy of the network operator (discussed below).

2.3 Implications of market developments for network tariffs

As noted in chapter 1, the AER is responsible for regulating prices charged by network businesses such as Evoenergy. The AER undertakes an investigation (usually every five years) to determine the maximum allowable revenue that a network business may recover and the policies that the business uses to assign network charges to consumers.

In determining the maximum allowable revenue, the AER considers the efficient and prudent costs of owning and operating the network. During the regulatory period, the network business proposes prices to the AER. The AER may approve the prices if they are compliant with the revenue allowance, a side constraint and rules set by the AEMC (details below).

Evoenergy and the AER need to follow rules set by the AEMC when setting network prices and network tariff assignment policies. For example, one of the AEMC's rules requires network prices to be cost reflective. This means that the AEMC requires network prices to reflect the efficient cost of providing network services to individual consumers so that consumers can make more informed decisions about their electricity usage.[22]

For Evoenergy, there is a two percent side constraint that applies to revenue recovered at the tariff class level (that is, residential, low voltage commercial and high voltage customers). This means that the increase in revenue from each tariff class cannot exceed two percentage points above the maximum allowable percentage increase in revenue determined by the AER.

As noted in chapter 1, the Commission allows ActewAGL to pass on the network costs that it incurs when providing electricity services to standing offer customers. ActewAGL uses network charges approved by the AER when calculating the network cost pass-through amount. After the Commission has verified the network cost pass-through amount as complying with the AER decision, it is included in the Commission's pricing model to calculate the regulated price change. The network cost approval process is illustrated in Figure 2.3.

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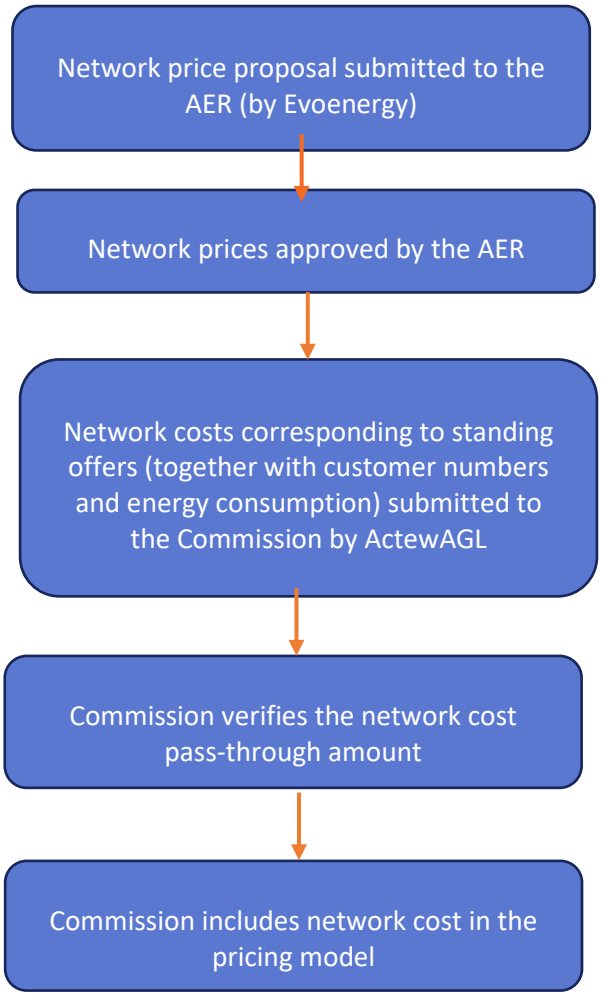
[21] ActewAGL's schedule of charges from 1 July 219 and 1 July 2020 available at https://www.actewagl.com.au/plans-and-connections/pricing-information/act-home-prices

[22] AEMC 2014, p vii.

Figure 2.3 Network cost approval process



Each of ActewAGL's standing offers has a different set of network charges. Network charges differ depending on the type of customer (residential versus business customers) and the type of electricity meter used by the customer (smart meter versus basic meter), because Evoenergy sets network prices to be cost reflective and create an incentive to encourage efficient network use.[23]

Evoenergy has developed its tariff assignment policy to send price signals to retailers about the costs of running the network, particularly during peak periods. For example, a key cost of running the electricity network is network augmentation (expansion) to accommodate growth in peak demand. The demand network tariff and time-of-use network tariff charged by Evoenergy to retailers are higher peak periods to send a signal to the retailer that it should encourage its customers to be mindful of their electricity usage in that period.

Evoenergy automatically assigns consumers to network demand tariffs if they have a smart meter (regardless of their retailer or retail tariff) in order to send a price signal to the retailer.[24] The retailer can choose to pass this price signal onto the consumer (by encouraging the consumer to have a retail demand

[23] Evoenergy 2020, p 4
[24] Evoenergy 2018, p 17

tariff) or not (by allowing them to choose different tariff types). Retailers have some scope to change their consumers' underlying network tariffs within Evoenergy's tariff assignment policy. For example, a retailer can change the network tariff for smart meter customers from the network demand tariff to a time-of-use network tariff. However, retailers cannot assign a flat rate network tariff as an underlying network tariff for smart meter customers.[25]

ActewAGL's tariff assignment policy appears to be strongly influenced by the network tariff assignment policy of Evoenergy. ActewAGL appears to largely pass on the price signals that it receives from Evoenergy to its consumers.[26]

However, retailers are not required to reflect the tariff assignment policies of the network operators in their retail tariffs. Some retailers in the ACT have chosen not to pass on some price signals from Evoenergy. For example, Origin Energy and Energy Australia offer flat rate retail tariffs to smart meter customers despite customers' underlying network tariffs being demand or time-of-use network tariffs.[27]

The market developments described in sections 2.1 and 2.2 have implications for the network cost component of the Commission's pricing model and, therefore, the appropriateness and effectiveness of the form of price control. As described in chapter 1, a change in the mix of standing offer customers led to an increase in the network costs (when expressed in terms of dollars per MWh) incurred by ActewAGL in 2020-21 above the AER approved increase in network prices corresponding to standing offer tariffs.

This is because different network tariffs have different charges. The full list of network tariffs associated with standing offers is available in Appendix 1. Network charges for business customers are generally higher than the network charges for retail customers. Therefore, if ActewAGL's residential customers move away from standing offers, ActewAGL's resulting standing offer customer base will have a higher proportion of business customers, which will result in a higher average network cost per MWh for customers on standing offers. Details on how the network cost component of the Commission's pricing model is calculated are in chapter 3.

The trends discussed in this chapter are likely to continue in the future. For example, as discussed in section 2.2, there is still potential for more ACT customers to shift away from standing offers to market offers. Competition in the ACT market has the potential to increase over time and the smart meter take-up is likely rise as more basic meters are replaced with smart meters.

2.4 Issues paper submissions

ActewAGL noted that the Commission has identified the recent declining trend in wholesale electricity prices. It noted that the reduction in wholesale prices is passed through to customers in the wholesale energy cost component of the Commission's electricity pricing model.

ActewAGL highlighted that the Commission's background paper on the developments in the electricity market recognised the considerable uncertainty about future wholesale market developments. Given the

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25 Evoenergy 2018, p 18.

26 As noted in section 2.2, ActewAGL changed its tariff assignment policy for smart meter customers so that customers with smart meters are automatically placed on time-of-use tariffs rather than the demand tariff.

27 Based on information from retailer websites in October 2020.

ongoing uncertainty, ActewAGL did not provide further comments on potential future trends relevant to wholesale electricity prices.

ActewAGL considers competition to be the main driver of compositional changes in the retail market, in particular the number of consumers on standing offers. It expects competition to continue to drive compositional changes in the retail market as new retailers enter the market and existing retailers continue to evolve their offers. ActewAGL was not aware of any other changes in the Australian energy market that are likely to have implications for the current review.

ACTCOSS noted the information in the Commission's background paper on the recent declining trend in the wholesale electricity prices due to the increased supply of renewable energy. ACTCOSS submitted that, while it hopes this trend continues, there remain significant challenges in transitioning to 100 per cent renewable electricity generation across the NEM. As a member of the National Consumer Roundtable on Energy, ACTCOSS has engaged government consultations on actions to smooth the transition in the electricity market.

ACTCOSS expects to see an increasing number of ACT energy consumers move from standing offers to market offers, and from flat rate tariffs to time-of-use and demand tariffs. ACTCOSS believes this trend will continue and possibly accelerate over coming years. ACTOCOSS expects more customers to move from standing offers to market offers because the ACT Government has committed to implement recommendations made by the Commission to increase the comparability and transparency of electricity offers. ACTCOSS also expects an increasing number of customers to move from flat rate tariffs to time-of-use or demand tariffs due to the ongoing rollout of smart meters under the national Power of Choice reforms as well as the increasing installation of rooftop solar panels and other distributed energy resources like batteries and electric vehicles.

Overall, the submissions largely agreed with the Commission's conclusions on the changes taking place in the electricity market, with some stakeholders highlighting that there is uncertainty about future developments. Therefore, the Commission considers that addressing the implications of these developments on the ACT electricity market is warranted. The Commission intends to address the implications by making changes to its network cost methodology.

Chapters 3 and 4 contains further details about the Commission's form of price control, the pricing model and network costs and sets out the Commission's draft decision on addressing the implications of these market changes. Chapter 5 contains the Commission's proposed implementation timeline.

3. Commission's current form of price control

3.1 Commission's current form of price control

The Commission regulates retail electricity prices faced by small customers on ActewAGL's standing offer tariffs. Small customers are defined as customers who consume less than 100MWh of electricity over any period of 12 consecutive months. Small customers are usually residential customers or small business customers. As described in chapter 2, standing offers are default offers that provide a safety net for those customers who do not shop around for unregulated market offers.

The Commission regulates ActewAGL's standing offer prices by determining the maximum allowable percentage price change that ActewAGL can apply across its 'basket' of standing offer tariffs from one year to the next. This is called a 'tariff basket' form of price control. Section 3.2 below explains how the Commission calculates the maximum allowable percentage price change.

ActewAGL's basket of standing offer tariffs (regulated tariffs) contains different standing offers available to residential and small business customers. As described in chapter 2, there are a variety of standing offers with different characteristics, such as flat rate tariffs, time-of-use tariffs and demand tariffs. In 2020-21, ActewAGL's basket of regulated tariff has 16 such tariffs in total for residential and business customers, each with a different set of charges and/or pricing structure. As discussed in chapter 2, Evoenergy has a range of network tariffs and ActewAGL's standing offer tariff structures and assignment policy often reflect Evoenergy's tariff structures and assignment policy.

The Commission's tariff basket form of price control allows ActewAGL to adjust individual prices for its different standing offers, as long as the average adjustment across the basket of standing offers does not exceed the maximum allowable percentage change determined by the Commission. Under this approach, the Commission does not set the maximum prices that ActewAGL can charge for its standing offers.[28] It only controls the average change across the basket of standing offer tariffs.

In its final decision for the 2020-24 electricity price investigation, the Commission considered that the tariff basket approach is the most appropriate form of price control in the ACT for customers on regulated retail tariffs given the range of tariffs available. The Commission considered that ActewAGL should retain discretion to set individual tariffs in the regulated tariff basket. The current approach gives ActewAGL flexibility in setting tariffs so that ActewAGL can adjust prices to meet market conditions and ensure that tariffs are cost reflective.

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[28] Under an individual price cap form of price control, the regulator sets the maximum level of individual prices.

Verifying ActewAGL's compliance with the Price Direction

Under the Commission's form of price control, the weighted average annual price change in ActewAGL's basket of regulated tariffs must not exceed the maximum allowable percentage change determined by the Commission.[29] Every year, the Commission checks if ActewAGL's standing offer prices meet this criterion.

The weighted average price change for a given year is calculated using ActewAGL's proposed standing offer prices (charges) for a particular year compared to the previous year, and weights for each charge.

The weights in the weighted average price calculation are customer numbers and electricity consumption in the 12 months to 31 March for the latest year available. ActewAGL's electricity offers have a supply charge (a fixed daily rate per customer) and variable rates per unit of energy consumed.[30] Weights are determined by customer numbers for the supply charge and by energy consumption for the variable charge.

The prices used in this calculation differ across the two years, but the weights remain unchanged from one year to the next. For example, when calculating the weighted average price change for 2020-21, the prices used are the charges for 2020-21 and 2019-20, and the weights are the customer numbers and electricity consumption values for the 12 months to 31 March 2020.

The same weights are used in both the year in question and the previous year so that the calculated average across the tariff basket only measures the average change in prices from one year to the next.

The mathematical formula for the Commission's price control is presented in Box 3.1.

Box 3.1: The Commission's price control formula

ActewAGL's regulated retail tariffs should comply with the following formula:

$$1 + \mathrm{Y^t} \geq \frac{\sum_{\mathrm{i=1}}^{\mathrm{n}} \sum_{\mathrm{j=1}}^{\mathrm{m}} \mathrm{P_{ij}^t Q_{ij}^{t-1}}}{\sum_{\mathrm{i=1}}^{\mathrm{n}} \sum_{\mathrm{j=1}}^{\mathrm{m}} \mathrm{P_{ij}^{t-1} Q_{ij}^{t-1}}}, \quad \text{for all i and j,}$$

$$\text{subject to } 1.02 + \mathrm{Y^t} \geq \frac{\sum_{\mathrm{j=1}}^{\mathrm{m}} \mathrm{P_{ij}^t Q_{ij}^{t-1}}}{\sum_{\mathrm{j=1}}^{\mathrm{m}} \mathrm{P_{ij}^{t-1} Q_{ij}^{t-1}}} \text{, for each i.}$$

where:

- ActewAGL has *n* regulated retail tariffs that each have up to *m* components;
- *t* denotes a financial year;
- *i* denotes a regulated tariff and *j* denotes a component of tariff *i*;
- Y^t is the maximum average percentage increase in regulated retail tariffs determined in accordance with the Commission's pricing model;
- P_{ij}^t is the price that ActewAGL proposes to charge for component *j* of regulated tariff *i* for year *t*;
- P_{ij}^{t-1} is the price that ActewAGL charges for component *j* of regulated tariff *i* in the year *t-1*; and

[29] The maximum allowable percentage price change is calculated for each year of the regulatory period in the annual price recalibration (or annual price reset), using the method set out in the Price Direction.

[30] The number of variable rates in each tariff depends on the tariff type. For example, a flat rate tariff has a single rate per energy consumed across the day (and night) and time-of-use tariffs have multiple rates depending on the time of the day. ActewAGL is permitted to change the fixed and variable charges in each tariff type.

- Q_{ij}^{t-1} is the reference quantity for component *j* of the regulated tariff *i* defined as the actual quantity (in both customer numbers and megawatt hours) as reported by ActewAGL for the 12-month period ending 31 March in year *t–1*.

The Commission's form of price control also has a side constraint to ensure that the weighted average price increase of any single tariff does not differ too much from the maximum allowed percentage change (Box 3.2).

Box 3.2: Side Constraint

The form of control includes a 2.0 percentage point upper bound side constraint that ensures that the weighted price increase of any single tariff does not differ significantly from the allowed percentage change. This means that the weighted average price change for any individual standing offer tariff must be within two percentage points above the weighted average price change determined by the Commission. This restriction is an upper bound because the constraint does not limit smaller price increases or price reductions. ActewAGL can choose to increase any individual tariff by less than the maximum allowed price change determined by the Commission plus 2 percentage points.

The Commission introduced the side constraint in the 2020-24 retail price investigation because it considered that there would be benefits to consumers by limiting how much ActewAGL can change prices of individual tariffs in any single year. This is because limiting price increases in any single year will ensure the bill increments for an average electricity customer will be close to the weighted average price change determined by the Commission, and hence provide greater price stability for consumers.[31]

The Commission has examined the form of price control used by the AER, Queensland Competition Authority (QCA), Essential Services Commission in Victoria (ESA), and the Office of the Tasmanian Economic Regulator (OTTER) when regulating retail electricity prices. None of those regulators use a tariff basket approach. Therefore, the methods used by those regulators to regulate prices are not directly comparable to the method used by the Commission. The methods used by other regulators to calculate the network cost component are summarised in Appendix 2 of the Commission's issues paper.

3.2 Commission's pricing model

The Commission uses a pricing model to determine the maximum allowable percentage price change that ActewAGL can apply to its basket of regulated tariffs each year. The pricing model estimates the individual cost components that would be incurred by an efficient retailer in a similar position as ActewAGL when providing electricity services to ACT customers on regulated tariffs.

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[31] ICRC 2020b, p 18

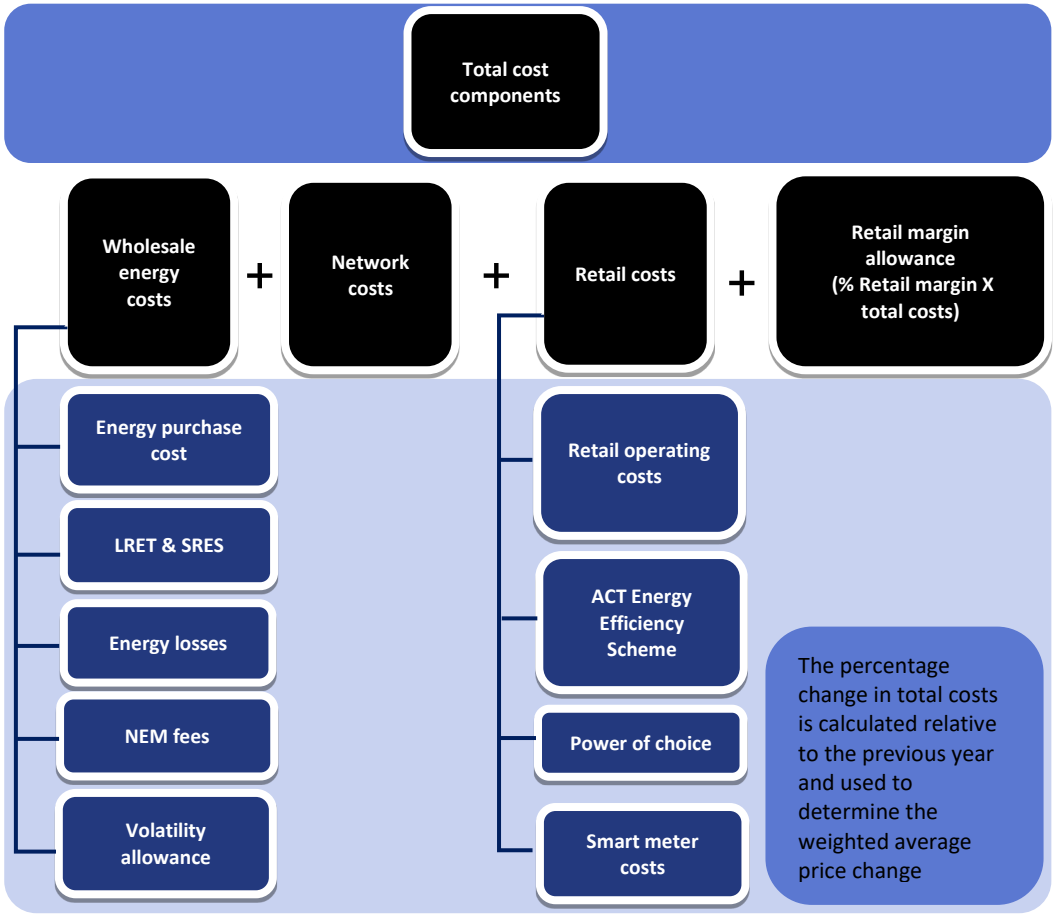
The Commission's pricing model contains three main cost categories:

- wholesale electricity costs, which comprise energy purchase costs, Large-scale Renewable Energy Target (LRET) and Small-scale Renewable Energy Scheme (SRES) costs, energy losses, and National Electricity Market (NEM) fees
- network costs, which include transmission and distribution costs and jurisdictional scheme costs (which include the feed-in-tariff schemes)
- retail costs, which comprise retail operating costs, smart meter costs and Energy Efficiency Incentive Scheme (EEIS) compliance costs.

A large portion of costs are not within the control of the retailer and hence are not regulated by the Commission. These include wholesale costs (except for the hedging strategy used by the retailer) and network costs. The costs that are within the control of the retailer include retail operating costs and the retail margin.

Once the cost categories are estimated, they are added together and multiplied by a retail margin (to provide a profit allowance) to produce total costs to be recovered in dollars per megawatt hour ($/MWh). The total costs are then compared to the total costs calculated for the previous year. This produces a maximum allowable percentage increase that ActewAGL can apply to its basket of regulated retail tariffs. The cost categories are shown in Figure 3.1.

Figure 3.1 The Commission's pricing model



3.3 Network cost pass-through

The network cost pass-through amount for a particular year is calculated as a weighted average network cost (expressed in $/MWh terms) for standing offer customers. A weighted average is used because there are different network charges for different standing offers, as discussed in chapter 2.

In the weighted average network cost calculation, the network prices (or charges) are the regulated charges for each network tariff. The weights are ActewAGL's standing offer customer numbers and their electricity usage for each standing offer in the 12 months to 31 March. As with retail tariffs, network tariffs have a daily supply charge per customer and variable charge per energy consumed. Therefore, both the customer numbers and the energy consumed are needed when calculating the network cost pass-through amount. Data on the weights are provided to the Commission by ActewAGL on a commercial in confidence basis.

When calculating the weighted average annual change in network costs, ActewAGL currently uses different network charges for each year and different weights (customer numbers and energy usage) for each year. That is, the network cost pass-through amount can change year to year for two reasons:

- if there are changes in the AER approved network prices
- if there are changes in the weights.

The weights can change when ActewAGL's mix of standing offer customer changes from year to year (for example, if there is a change in the proportion of customer on different tariff types). To put it another way, the increase in the network cost amount in the Commission's pricing model includes the effect of compositional changes in ActewAGL's customer base in addition to the effect of price changes that are approved by the AER.

In contrast, the Commission's form of price control (outlined above in section 3.1) calculates the weighted average price change by keeping the weights fixed year to year. This means that the weighted average price change in the Commission's form of price control reflects price changes only, whereas the method used to calculate the change in network costs reflects price changes as well as changes in ActewAGL's standing offer customer mix.

4. Network costs

4.1 Issue for this review

In this review, the Commission is considering whether the difference between ActewAGL's network cost calculation method and the Commission's form of control (as outlined above in section 3.3) is appropriate and consistent.

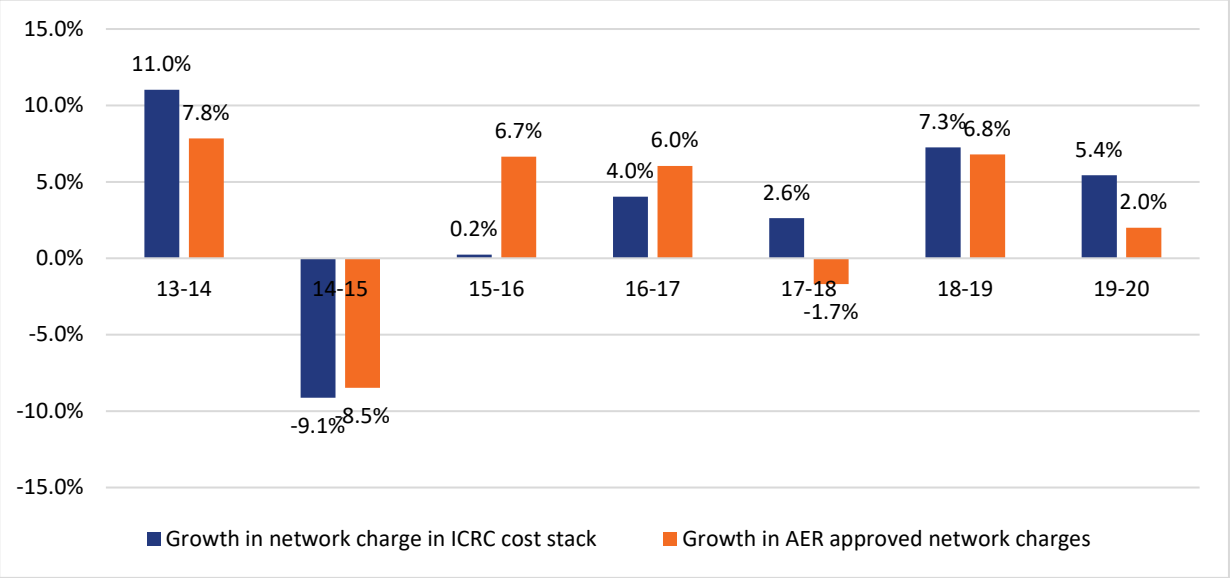
As described in chapter 1, the network cost component in the Commission's pricing model recorded a 5.4 per cent annual increase in 2020-21 compared to the AER approved increase in network prices of 2.0 per cent. The change in the customer mix had resulted from an increase in customers, especially residential customers, changing retailers or moving from a standing offer to a market offer. This caused the proportion of standing offer customers on tariffs with relatively low network costs (residential tariffs) to fall and the proportion of customers with high network costs (business tariffs) to rise.

In addition to the changing residential versus business customer mix, the network cost increase reflected a change in the mix of standing offer business customers. The weighted average network cost (expressed in dollar per MWh terms) for business customers increased by significantly more than the average network price increase of 2.0 per cent. This is because there was a higher proportion of standing offer business customers on more expensive network tariffs. For example, the number of standing offer customers on the business demand tariff (a tariff with a relatively high weighted average network cost) increased due to an increase in businesses with smart meters. At the same time, the number of business customers on other business tariffs decreased.

Figure 4.1 shows that, since 2017-18, ActewAGL's calculation of average network costs for standing offer customers has increased by more than AER approved network prices in each year.

Before 2017-18, the change in the weighted average network costs calculated by ActewAGL (and used in the Commission's pricing model) was sometimes higher and sometimes lower than the average change in the AER approved network charges. For instance, in 2015-16, the average network cost calculated by ActewAGL increased by 0.2 per cent and the AER approved increase in network prices was greater at 6.7 per cent. In 2013-14, the average network cost calculated by ActewAGL increased by more than the AER approved increase in network prices (11.0 per cent compared to 7.8 per cent).

Figure 4.1 Network charge growth comparison



Source: Commission's calculations.

The Commission's analysis in chapter 2 indicates that the forces driving the discrepancy between ActewAGL's network cost change and the AER approved network price change are likely to continue. This discrepancy is caused by differences between the calculation methods used by the Commission in its form of price control and ActewAGL in the network cost pass-through. The inconsistency between the two calculations arises because of the different approaches taken to determining the weights, as explained in chapter 2.

The implication of this inconsistency is that the network cost pass-through amount does not reflect changes in network prices alone. The calculation used by ActewAGL results in both changes in the underlying network prices as well as changes in the mix of its standing offer customers to be incorporated in its network cost pass-through, which ultimately is incorporated in the Commission's overall maximum allowable weighted average price change. This is inconsistent with the Commission's methodology for its form of price control, which is to regulate changes in price only.

The mathematical formula used by ActewAGL to calculate the weighted average network cost change from one year to the next is presented in Box 4.1.

Box 4.1 Weighted Average Price Change

$$1 + Y^{t}_{network} = \frac{\sum_{i=1}^{n}\sum_{j=1}^{m} P^{t}_{ij} Q^{t-1}_{ij}}{\sum_{i=1}^{n}\sum_{j=1}^{m} P^{t-1}_{ij} Q^{t-2}_{ij}} * \frac{[Total\ usage\ in\ year\ t-2]}{[Total\ usage\ in\ year\ t-1]}$$

where:

- ActewAGL pays Evoenergy for *n* network tariffs that each have up to *m* components;
- *t* denotes a financial year;
- *i* denotes a regulated tariff and *j* denotes a component of tariff *i*;
- $Y^{t}_{network}$ is the change in the network cost components (in percent) in the Commission's pricing model;
- P^{t}_{ij} is the network price for component *j* of network tariff *i* for year *t*;
- P^{t-1}_{ij} is the network price for component *j* of network tariff *i* for year *t-1*;
- Q^{t-1}_{ij} is the quantity for component *j* of the regulated tariff *i* defined as the actual quantity (in both customer numbers or megawatt hours) as reported by ActewAGL for the 12-month period ending 31 March in year *t–1*;
- Q^{t-2}_{ij} is the quantity for component *j* of the network tariff *i* defined as the actual quantity (in both customer numbers or megawatt hours) as reported by ActewAGL for the 12-month period ending 31 March in year *t–2*;
- Total usage in year *t-1* is the total actual electricity usage in megawatt hours by ActewAGL's standing offer customers in year *t-1*; and
- Total usage in year *t*-2 is the total actual electricity usage in megawatt hours by ActewAGL's standing offer customers in year *t-2*.

4.2 Issues paper submissions

ActewAGL stated that the formula used to calculate the annual change in the network cost allowance and the price control formula used to demonstrate compliance with the overall price constraint are not consistent.[32]

ActewAGL submitted that compositional changes in customer mix explain the difference between the network cost increase in the Commission's pricing model and the average increase in Evoenergy's network prices. ActewAGL noted that the current method for determining the annual change in the network cost allowance can result in the allowance being less than or greater than the change in Evoenergy network prices, depending on the year-on-year change in the composition of the standing offer customer base.

ActewAGL submitted that the energy industry is evolving at a rapid pace and that it supports the Commission's focus on ensuring the cost-index model remains relevant and fit for purpose.

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[32] ActewAGL 2020, p 2.

ACTCOSS expressed concerns about the way the network cost pass-through amount is calculated because the method may not be equitable, especially across residential and business customers.[33] ACTOCSS noted that the current method used by the Commission could result in residential customers on ActewAGL's standing offer tariffs being made worse off due to the higher network costs of business standing offer tariffs pushing up prices across the tariff basket. ACTCOSS also noted that the current approach reduces the stability and predictability of standing offer prices due to significant variation and difference between the Commission's network cost allowance and the AER's approved network price increase.[34]

ACTCOSS submitted that it is critical to ensure that default offers provide a safety net for all residential and small business customers in the ACT regardless of the retailer. While ACTCOSS acknowledged that ActewAGL's regulated tariffs influence the prices of other market rates due to the dominance of ActewAGL's regulated tariffs in the retail electricity market, it was concerned that this influence would be diminished as ActewAGL's dominance declines.

In this context, ACTOCSS also submitted that it previously recommended that the ACT Government consider the development of a 'Basic Service Offer' that would determine a fair and affordable price for electricity which all retailers would be required to offer to customers as a default. ACTCOSS saw a Basic Service Offer as playing a similar role to that played by the AER's Default Market Offer in NSW, south-east Queensland and South Australia, and the Victorian Government's Victorian Default Offer.

4.3 Commission's analysis

The Commission has considered whether the difference between the network cost calculation method and the form of control is appropriate and consistent. The Commission's conclusion is that the difference in the weighting methods between network costs and the weighted average price change is not appropriate.

By calculating the change in network costs using the change in network prices as well as the change in the composition of customers on Evoenergy's network, the current method of calculating the weighted average annual change in network costs is actually calculating the change in the amount ActewAGL pays to Evoenergy for using the network to supply standing offer customers in the ACT. Put another way, this is the revenue ActewAGL must earn from its standing offer customers to pay Evoenergy for using the network to supply these customers.

The Commission considers that this method of calculating the change in total network costs as the revenue required to recover network costs is not consistent with the Commission's tariff basket form of price control. The tariff basket approach is not used to set a cap on the revenue ActewAGL can raise from its customers to recover its costs. The tariff basket approach is a method to check that ActewAGL has complied with the maximum allowable price change determined by the Commission. The Commission determines a maximum allowable price change that allows ActewAGL to recover its prudent and efficient costs.

The revenue ActewAGL will raise from its standing offer customers each year results from its retail prices and actual supply volumes (customer numbers and usage) for standing offer customers in that year. Each

[33] ACTCOSS 2020, p 14.
[34] ACTCOSS 2020, p 15.

year, its standing offer customer numbers and their total electricity usage will reflect the compositional changes in its standing offer customers that have been discussed in this report.

Achieving consistency between the form of price control and the network cost calculation

The Commission considers that holding the weights constant in the network cost calculation would remove the current inconsistency between the tariff basket formula and the formula for calculating network costs.[35]

Applying the same approach as used in the tariff basket formula—that is, weighting network costs in both years by the most recent usage and customer figures--would achieve consistency and exclude compositional changes from the calculation of the average network cost change.

Ensuring ActewAGL can recover its network costs

The Commission considers that any change to the network cost calculation formula must result in ActewAGL being able to recover its network costs.

The Commission undertook modelling to check that a hypothetical efficient retailer using the proposed weighting method described above would be able to recover its efficient costs. The modelling results confirmed that this is the case. This is because the revenue recovered by the retailer will reflect changes in the composition of its standing offer customers and their electricity usage. It is not necessary to include these compositional changes in calculating network costs because the revenue raised by the retailer will reflect these compositional changes and, depending on the standing offer prices the retailer sets,[36] allow it to raise enough revenue to recover its costs.

In effect, the current method of calculating network costs results in compositional effects affecting both the change in average network costs calculated by ActewAGL and the revenue raised by ActewAGL—effectively 'double-counting' the effects of compositional changes. Depending on the nature of the compositional change in any particular year, this can result either in ActewAGL raising more revenue than needed to recover its network costs or not enough revenue to recover its network costs.

4.4 Commission's draft decision

The Commission's draft decision on the network cost calculation method is to require ActewAGL to amend its calculation methodology so that the network cost pass-through is calculated in a manner consistent with the Commission's weighted average price change formula.

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[35] The Commission's proposed method would see the network cost pass-through amount calculated using the most recent usage and customer figures as the weights to be applied to network prices for the two consecutive years under consideration. This would require re-calculating the earlier years' weighted average network cost with the updated weights. This method is consistent with how the weighted average price change is determined; that is, the weighted average retail price calculated by ActewAGL is re-calculated each year for the new weights.

[36] Within the maximum allowable price change set by the Commission's tariff basket.

The Commission's draft decision would require ActewAGL to use the most recent weights (customer numbers and usage) for both years in the network cost calculation to exclude composition changes in its standing offer customer mix. The revised formula is shown in Box 4.2.

Box 4.2 Proposed Method for Determining Network Cost Pass-Through

$$1 + Y^{t}_{network} = \frac{\sum_{i=1}^{n}\sum_{j=1}^{m} P_{ij}^{t} Q_{ij}^{t-1}}{\sum_{i=1}^{n}\sum_{j=1}^{m} P_{ij}^{t-1} Q_{ij}^{t-1}}$$

where:

- ActewAGL pays Evoenergy for *n* network tariffs that each have up to *m* components;
- *t* denotes a financial year;
- *i* denotes a regulated tariff and *j* denotes a component of tariff *i*;
- $Y^{t}_{network}$ is the change in the network cost components (in percent) in the Commission's pricing model;
- P^{t}_{ij} is the network price for component *j* of network tariff *i* for year *t*;
- P^{t-1}_{ij} is the network price for component *j* of network tariff *i* for year *t-1*; and
- Q^{t-1}_{ij} is the quantity for component *j* of the regulated tariff *i* defined as the actual quantity (in both customer numbers or megawatt hours) as reported by ActewAGL for the 12-month period ending 31 March in year *t–1*.

This equation replaces all references to financial year *t-2* in the current formula (presented in Box 4.1) with financial year *t-1*.

5. Timing and implementation

The Commission's draft decision to amend the calculation method that ActewAGL must use to estimate the network cost pass-through amount is important for ensuring that only efficient and prudent costs are recovered through regulated prices. The Commission has also made a draft decision to implement the decision on the network cost calculation method from the next annual price recalibration in the current regulatory period.

The timely resolution of this issue will benefit all stakeholders

The Commission typically does not alter its regulatory methodology between price investigations because it sees certainty and predictability in the operating environment for regulated entities as important. However, the Commission considers that the timely resolution of this issue is necessary to ensure that the prices set by the Commission allow ActewAGL to recover no more or less than its prudent and efficient costs.

The Commission considers that the distortion caused by the inconsistency between the calculation methods results in inaccurate estimates of network costs, which affects the accuracy of the Commission's determination of the maximum allowed average price increase for ActewAGL's' standing offer prices. In the past, the estimates of network costs were sometimes too high and sometimes too low but recent market developments have caused a trend for estimates that are too high.

The Commission is conscious of the affordability pressures currently being experienced by electricity consumers. It is also conscious that ActewAGL needs certainty that it can consistently recover its prudent and efficient costs over time, without over-recovery in some years and over-recovery in other years. For these reasons, the Commission has concluded that it would be in the best interests of stakeholders if the calculation method were changed as part of the 2021-22 price recalibration.

Price direction can be varied under the ICRC Act

Section 4(b) of the ICRC Act allows for the variation of a price direction in certain circumstances.

In deciding whether to vary the network cost calculation formula before the end of the current price direction, the Commission considered the criteria listed under section 20(2) of the Act and determined that the proposed change is consistent with and appropriate to criteria (a), (c), (e), and (g) as follows:

> (a) the protection of consumers from abuses of monopoly power in terms of prices, pricing policies (including policies relating to the level or structure of prices for services) and standard of regulated services
>
> (c) the need for greater efficiency in the provision of regulated services to reduce costs to consumers and taxpayers
>
> (e) the cost of providing the regulated services
>
> (g) the social impacts of the decision

Without this change, the current method of calculating network costs may lead to ActewAGL recovering more or less than its prudent and efficient costs in any particular year, because of compositional changes in its mix of standing offer customers. This outcome is not consistent with the Commission's legislative objectives to protect consumers, promote efficiency in the delivery of regulated services, and allow ActewAGL to recover its costs in providing regulated electricity services.

In particular, the Commission considers that the current method is not consistent with section 20(2)(e) as it can cause the prices for standing offers to differ from the prices that would allow for the recovery of the cost of providing the regulated services.

ACTCOSS highlighted this concern in its submission, stating that the current method could lead to the retailer recovering more than efficient costs in some situations, resulting in an inequitable form of price control that may also compromise the stability and predictability of standing offers for residential and small business customers.[37] The Commission considers this outcome would be inconsistent with section 20(2)(g) which states that the Commission should have regard to the social impacts of its price decisions.

The Commission has considered whether it would need to vary the 2020-24 price direction under section 4(b) of the ICRC Act to give effect to its draft decision to amend the network cost calculation method. While the calculation of network costs informs the determination of the maximum allowable average price change that is included in the price direction, it is not a calculation that is described in the price direction. The Commission considers that the calculation formula can be varied without varying the price direction and this change can be made during the 2021-22 electricity price reset.

Nevertheless, the Commission intends to follow the same process in this review as if it were varying the price direction under Section 4(b) of the ICRC Act. Doing this will ensure that stakeholders have enough opportunity to give their input into the Commission's decision.

Under section 4(b), the Commission would be required to release a draft report, allow not less than 20 business days for submissions, and release a final report. The Commission will follow this process for the rest of this review. The indicative timeline for the review shown in table 1 of this report follows this process. This report is the draft report that would be required under section 4(b) if the Commission was varying the prices direction.

Commission's draft decision

The Commission's draft decision is to implement its implement its draft decision on amending the network cost calculation method during the annual retail electricity price recalibration for 2021–22.

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[37] ACTCOSS 2020, p 14.

Appendix 1 – Network charges associated with ActewAGL's standing offer tariffs

This appendix presents Evoenergy's network charges associated with ActewAGL's standing offer tariffs.

Table A.2: 2020-21 Network prices for residential customers*

Customer class	Network price
Residential Demand Network	
Supply charge (c/day)	36.91
Direct debit supply charge (c/day)	36.91
Energy (c/kWh)	3.22
Maximum demand (c/kW/day)	15.55
Basic Residential Network	
Supply charge (c/day)	41.44
Direct debit supply charge (c/day)	41.44
Energy (c/kWh)	8.04
Residential 5000 Network	
Supply charge (c/day)	63.82
Direct debit supply charge (c/day)	63.82
Energy (<60 kWh/day) (c/kWh)	6.66
Energy (>60 kWh/day) (c/kWh)	8.04
Residential Heat Pump Network	
Supply charge (c/day)	108.90
Direct debit supply charge (c/day)	108.90
Energy (<165 kWh/day) (c/kWh)	5.08
Energy (>165 kWh/day) (c/kWh)	8.04
Residential TOU Network	
Supply charge (c/day)	41.44
Direct debit supply charge (c/day)	41.44
Peak Energy (c/kWh)	14.43
Shoulder Energy (c/kWh)	6.54
Off-peak Energy (c/kWh)	3.20
Off-Peak Night Network	
Energy (c/kWh)	2.21
Off-Peak Day & Night Network	
Energy (c/kWh)	3.40

Notes: * Network prices presented in this table are provided to the Commission by ActewAGL and are based on Evoenergy's network prices approved by the AER. The Commission applies standing offer customer numbers and energy consumptions to these prices to estimate network costs on $/MWh basis.

Table A.3: 2020-21 Network prices for business customers*

Customer class	Network price
LV demand network	
Supply charge (c/day)	66.76
Energy (c/kWh)	4.76
Maximum demand (c/kW/day)	45.77
General Network	
Supply (c/day)	74.67
Energy (<330 kWh/day) (c/kWh)	12.27
Energy (>330 kWh/day) (c/kWh)	15.94
General TOU Network	
Supply (c/day)	74.67
Business (c/kWh)	19.34
Evening (c/kWh)	8.76
Biz Off-Peak (c/kWh)	3.96
LV TOU kVA Demand Network	
Supply ($/day)	250.61
Business (c/kWh)	7.28
Evening (c/kWh)	4.02
Biz Off-Peak (c/kWh)	2.19
Maximum Demand (c/kVA/day)	46.06
Streetlighting	
Supply (c/day)	74.99
Energy (c/kWh)	8.52
Small Unmetered Loads	
Supply (c/day)	41.23
Energy (c/kWh)	12.48

Notes: * Network prices presented in this table are provided to the Commission by ActewAGL and are based on Evoenergy's network prices approved by the AER. The Commission applies standing offer customer numbers and energy consumptions to these prices to estimate

Abbreviations and acronyms

ACT	Australian Capital Territory
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
COAG	Council of Australian Governments
Commission	Independent Competition and Regulatory Commission
EMMR	Electricity Model and Methodology Review
ESB	Energy Securities Board
ESC	Essential Services Commission
MWh	Megawatt hour
NEM	National Electricity Market
OTTER	Office of the Tasmanian Economic Regulator
QCA	Queensland Competition Authority

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