

ELECTRICITY MODEL AND METHODOLOGY REVIEW 2018-19

ACTEWAGL RETAIL SUBMISSION TO THE
INDEPENDENT COMPETITION AND REGULATORY
COMMISSION ISSUES PAPER

16 November 2018

ActewAGL

for you

Table of contents

- Table of contents..... 3
- 1. Introduction 4
- 2. National Green Scheme Costs..... 6
- 3. NEM Fees 7
- 4. Retail Operating Costs 8
- 5. Retail Margin 9

1. Introduction

ActewAGL Retail (AAR) welcomes the opportunity to provide a submission on the Independent Competition and Regulatory Commission's (ICRC's) Issues Paper in relation to the electricity model and methodology used for setting regulated electricity retail prices¹. The Issues Paper is the start of the consultation process for the ICRC's Electricity Model and Methodological Review required by the Price Direction. The Issues Paper is accompanied by a Technical Appendix that sets out the mathematical description of the current cost-index model used by the ICRC to determine the maximum average percentage change that AAR can apply to the suite of regulated tariffs on an annual basis.²

The Reset Principle in the 2017 Price Direction (Price Direction) directs the ICRC to:

“conduct a review of the model and methodology to be used to regulate standing offer prices for the supply of electricity to small customers for the regulatory period from 1 July 2020. At the conclusion of the review, the ICRC must set out in a report its decision on whether amendments should be made to the model or methodology. The ICRC may also recommend that no changes be made to the model or methodology used by the ICRC.”³

The ICRC states that the purpose of the review is to ensure that the ICRC pricing model is accurate, reflects current market conditions and retailer practices and is consistent with legislative obligations⁴.

AAR supports the ICRC's review and considers it good regulatory practice to periodically review the cost model methodology to ensure that it continues to meet its required objectives. AAR also agrees with the ICRC's broad approach to the review, which involves limiting the review to cost elements that are within the ICRC's regulatory control. The ICRC proposes that the scope of the review excludes network costs (determined by the Australian Energy Regulator)⁵, the Energy Efficiency Improvement Scheme (EEIS) costs (determined by the ACT Government) and energy losses (determined by the Australian Energy Market Operator). These elements of the retail price are not subject to ICRC regulation and cannot be influenced by the hypothetical efficient mass-market retailer. Consequently, AAR agrees they should be excluded from the ICRC's current review. AAR also notes that some elements of the green scheme costs, such as the cost of certificates, are outside of the control of the ICRC and retailers and therefore supports the ICRC's proposed approach of focusing the review of green schemes on holding costs and administrative costs.

Other elements of the retail price such as National Electricity Market (NEM) fees are also outside of AAR's control, however, AAR is supportive of including the methodology for estimating these costs in the current review to determine whether an alternative

¹ ICRC (October 2018) Issues Paper: Electricity Model and Methodology Review 2018-19 Report 8 of 2018

² ICRC (October 2018) Technical Appendix: Electricity Model and Methodology Review 2018-19 p.1

³ ICRC (2017) Price Direction, Standing offer prices for the supply of electricity to small customers, Report 7 of 2017, 11 Reset principle page 13

⁴ ICRC (October 2018) Issues Paper: Electricity Model and Methodology Review 2018-19 Report 8 of 2018, p. 1.

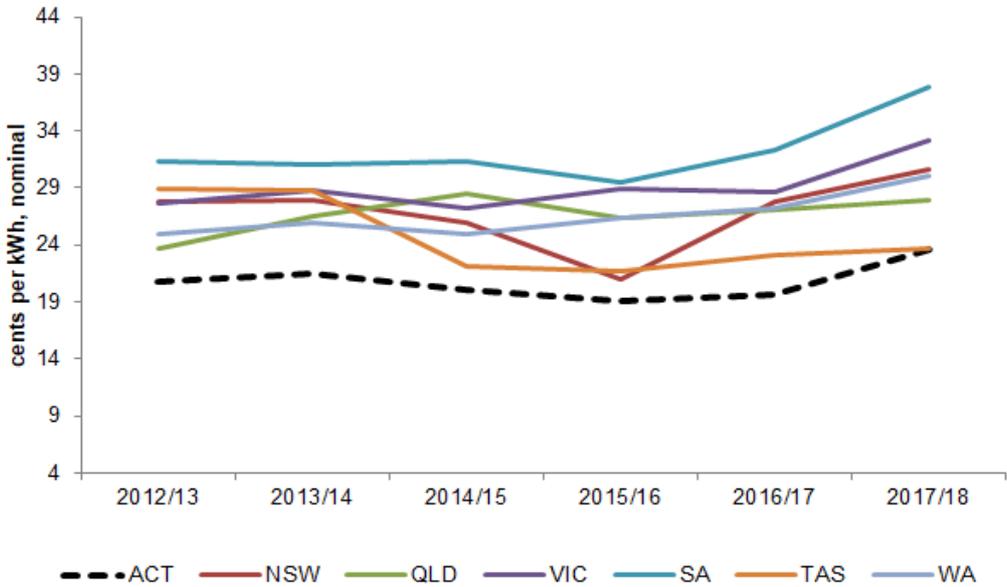
⁵ Network costs are comprised of distribution, transmission, jurisdictional schemes and regulated metering.

approach to the current CPI indexation methodology would result in a more accurate estimate of efficient costs.

The most significant cost element included in the scope of the review is the energy purchase cost (EPC), which the ICRC states will be considered in a separate investigation in the form of an individual consultation paper planned for release in February 2019. Based on the ICRC’s Issues Paper, the focus of the separate investigation will be the hedging strategy used in the model. AAR maintains its position that the current methodology understates the uplift factor that would be faced by a hypothetical efficient mass-market retailer. AAR would welcome the opportunity to engage with the ICRC’s consultants early in the review process to provide input on the appropriate hedging strategy for use in the cost model. AAR assumes that the forward price will continue to be based on the 23-month averaging approach using ASX data, as determined in the ICRC’s 2017 final decision⁶.

In considering any changes to the existing model methodology, the results produced by the current model should be taken into account. Under the current model, retail prices in the ACT have been the lowest of all jurisdictions in the national electricity market (NEM) (see Figure 1 below). This is despite a higher level of environmental related costs passed through in the retail price compared with other NEM jurisdictions⁷. Importantly, the existing model has also provided a stable and predictable business environment for retailers competing in the ACT. Given these outcomes, any changes to the existing model should be considered carefully to ensure that the balance between lower retail prices and efficient cost recovery are maintained.

Figure 1: Retail prices by jurisdiction



Source: AEMC retail price trends report, various.

⁶ ICRC (2017) Standing offer prices for the supply of electricity to small customer from 1 July 2017, Report 6 of 2017, June, p.39.
⁷ For example, the AEMC 2017 Residential electricity price trends data reports environmental costs for ACT to be 3.5 cents per kWh in 2017/18 compared with the national average of 1.32 cents per kWh. See <https://www.aemc.gov.au/markets-reviews-advice/2017-residential-electricity-price-trends>.

The remainder of AAR’s submission discusses each element of the cost model that is within the scope of the ICRC’s review. Given that the ICRC will be conducting a separate review process with the support on an external expert on the energy purchase cost component and that this will be the subject of a specific consultation paper to be released in February 2019, AAR has not provided comments on this component of the model.

2. National Green Scheme Costs

AAR supports the ICRC’s current approach to calculating national green scheme costs.

Questions 3, 4 and 5 – National green scheme costs		
(3)	Do you have any comments or suggestions on the ICRC’s current approach for calculating average renewable certificate costs?	Based on the ICRC’s Issues Paper, AAR understands that the ICRC’s current review will focus on holding costs and administrative costs. In AAR’s view, this is appropriate given that the cost of small-scale and large-scale certificates are outside of the hypothetical efficient mass-market retailer’s control.
(4)	Should the ICRC include a holding cost and administrative mark-up cost? Please give reasons.	<p>The ICRC should include the holding cost component in the estimation of green costs in order to acknowledge a retailer’s legitimate costs of holding certificates purchased from spot markets (for surrender against future liabilities).</p> <p>AAR is not aware of any factors that would suggest holding costs or administrative mark-ups can now be avoided or reduced.</p> <p>Holding costs of 10% are required because a prudent retailer purchases its green certificates in advance of the time that the certificates are required to be surrendered. To delay acquiring certificates until the time they are to be surrendered would leave the retailer, and therefore consumers exposed to the short term fluctuations of certificate markets. Purchasing in advance and over a period of time, is an obvious hedge against spot market volatility. The holding cost of certificates reflects the fact that money tied up in certificates is unavailable for other purposes.</p> <p>The administrative mark-up cost of 5% is the operating expenditure incurred by an efficient retailer to participate in mandatory green schemes like LRET and SRES. It is required to perform functions such as certificate trading, compliance related activities and to cover utilisation of IT systems. For any retailer, these costs are unavoidable and not trivial.</p> <p>AAR considers the 5% administration mark-up is a reasonable reflection of the administrative costs for managing the LRET and</p>

		SRES scheme on behalf of government through retail prices.
(5)	If you consider that these costs should be included, how should these (holding and mark up costs) be calculated?	As discussed above, AAR considers that the current estimates are reasonable.

3. NEM Fees

AAR supports the ICRC’s review of the current NEM fee methodology. Whilst only representing a relatively small component of the cost index model, AAR holds the view that there is no certainty that these costs will remain in line with CPI in the future and that more accurate methods are easily applied.

Questions 7 and 8 – NEM fees		
(7)	Do you have any comments or suggestions on the current approach for estimating NEM fees?	<p>The NEM fees are comprised of pool fees and ancillary charges. The current approach of adjusting the historical value of the fees by the change in CPI will likely be inadequate to recover rising fees over the next regulatory period. With respect to pool fees, AEMO is forecasting annual fee increases for the pool fees of 12%, full retail contestability fees to increase by 3% per annum and national transmission planner fees to increase by 7% per annum.⁸</p> <p>Ancillary costs can rise significantly and unpredictably at any time subject to physical changes in the network.</p>
(8)	What alternatives should the ICRC consider in this review? Please explain reasons why these alternatives may be appropriate.	<p>Pool Fees: The indexation approach should be replaced with the forecast value \$/MWh as provided by AEMO.</p> <p>Ancillary Fees: AEMO publishes data for ancillary service recoveries from customers (ie retailers) aggregated by state and week.</p> <p>AAR supports the reference of the past 12 month average for NSW as a proxy for costs in the following 12 month price period.</p>

⁸ AEMO (June 2018) Electricity Functions 2018-19 AEMO Final Budget and Fees p.2

4. Retail Operating Costs

AAR supports the ICRC's current approach to calculating retail operating costs (ROC) subject to two key adjustments. First, the cost to serve component of retail operating costs, which is based on indexation of Independent Pricing and Regulatory Tribunal's (IPART's) benchmarking in NSW, requires an adjustment factor for AAR to operate in the ACT where there are low economies of scale compared to the NSW benchmark. Second, the ROC requires the addition of a CARC allowance to represent the efficient costs of a hypothetical efficient mass-market retailer in the position of AAR, which has faced increased competition since 2014.⁹

In considering potential changes to the current approach, the ICRC indicates that it is waiting for the findings of other regulatory investigations currently in progress, such as the ACCC report on prices, profits and margins, AEMC and Essential Services Commission (ESC) reviews to inform its considerations.¹⁰ AAR will provide further response after the ICRC has assessed any new information from these concurrent regulatory investigations.

4.1 Economies of Scale

AAR requests that the ICRC make an adjustment to factor in the lower economies of scale associated with operating in the ACT. Economy of scale is a key difference between the ROC for NSW standard retailers and a hypothetical efficient mass-market retailer operating in the ACT.

The ACT's electricity market is reported as one of the smallest in the NEM.¹¹ The significant impact of economies of scale on the unit cost to serve was acknowledged by the ACCC in its recent Retail Electricity Pricing Inquiry.¹²

As competition intensifies, AAR is subject to a fall in customer numbers and consumption on regulated tariffs, which increases AAR's costs to serve per customer. The ICRC's model does not make any adjustment for falling customer numbers or consumption. The ROC allowance per MWh does not increase as the volume of consumption declines, which leaves AAR under-compensated for fixed retail costs.

4.2 Customer Acquisition and Retention Costs

A CARC allowance should be added to retail costs at a sufficient level to allow a hypothetical efficient mass-market retailer in the position of AAR to recover costs incurred from engaging in competition with competitors. This is consistent with IPART's then established regulatory approach, which separately accounted for CARC from other ROC components.¹³

⁹ AEMC (June 2018) Retail Energy Competition Review, Final Report p.286

¹⁰ ICRC (2018) p.19

¹¹ AEMC (June 2018) Final Report 2018 Retail energy Competition Review p. 282

¹² ACCC (2018) p.145, 147, 224

¹³ IPART (2013) Review of Regulated Retail Prices for Electricity Final Decision p.108

Questions 9, 10 and 11 – Retail operating costs		
(9)	Do you have any comments or suggestions on the scope of retail activities included in the ICRC’s current cost allowance?	AAR believes it is appropriate for the ICRC to include CARC in the cost allowance, particularly given the intensified level of competition occurring in the ACT.
(10)	For its comparative assessment of the retail costs for electricity retailers and retailers in other industries, the ICRC seeks stakeholder inputs on comparable businesses and industries with retail activities and costs similar to an efficient electricity retailer.	AAR considers that retail costs should include an allowance for CARC in the ACT which is consistent with prior established regulatory practices in other jurisdictions.
(11)	Does the ICRC’s current approach for setting the retail operating cost allowance remain appropriate, and are there alternative approaches that should be considered in this Review?	AAR supports the ICRC’s current approach to calculating the retail operating costs, but with the addition of a CARC allowance and an adjustment for economies of scale.

5. Retail Margin

The ICRC indicated that the ACCC’s reporting on retail electricity prices, profits and margins and other regulatory inquiries may be relevant to its consideration of the retail margin. AAR will provide further response after the ICRC has considered how it may use this new information in informing its estimate of the retail margin of a hypothetical efficient mass-market retailer.

In the recent 2017 Final Report, the ICRC reduced AAR’s retail margin from 6.04% to 5.3%. The allowed margin is now smaller than in all the other jurisdictions with retail price regulation: the retail margin for Aurora in Tasmania, which is regulated by Office of the Tasmanian Economic Regulator (OTTER) is 5.7% for standing offers¹⁴ and for regional Queensland services offered under notified prices from Ergon Retail, which is regulated by the Queensland Competition Authority (QCA), the retail margin is 5.7%.¹⁵

As noted in the ICRC 2017 Final Report on the retail margin, IPART estimated a recommended range for the retail margin of between 5.3% and 6.1% and the ICRC adopted the bottom end of this range.¹⁶ However, the retail margin used by IPART is calculated and applied on an ex-post basis. In contrast, the ICRC applies the retail margin on an ex-ante basis, which means the ex-post margin needs to be adjusted to ex-ante terms at a minimum. The appropriate adjustment is set out in the ICRC’s 2014 final decision, where it converted the IPART ex-post margin of 5.7% (midpoint of the

¹⁴ OTTER (May 2016) Final Report Investigation to determine maximum standing offer prices for small customers on mainland Tasmania p.vii

¹⁵ Queensland Competition Authority (June 2017) Final Determination Regulated retail electricity prices for 2017-18 Appendix E p.87 and Queensland Competition Authority (May 2016) Final Determination Regulated retail electricity prices for 2016-17 p.24

¹⁶ ICRC (2017) Final Report Standing offer prices for the supply of electricity to small customers from 1 July 2017 p.65

range 5.3% to 6.1%) to an ex-ante margin of 6.04%¹⁷. Similarly, in using the bottom end of the IPART range in its 2017 final decision, the ICRC should have converted the ex-post margin of 5.3% to an ex-ante margin of 5.6%. AAR requests that the ICRC correct this error as part of its current review. If an alternative benchmark is adopted, the appropriate adjustment should be implemented.

Question 12 – Retail margin		
(12)	Please comment on the ICRC’s current approach for setting the retail margin and alternative approaches that should be considered in this Review.	AAR’s margin of 5.3% is amongst the lowest reported margin in the industry, with 2016-17 retail margins for the big three over 8.5% and the mid-tier retailers over 11.5% ¹⁸ . The ACCC review found that the national average retail margin across Australia in 2017-18 is over 8% ¹⁹ . Amongst regulated firms, AAR’s margin is the lowest. OTTER allows Aurora Energy a margin of 5.7% and the QCA allows Ergon Retail a margin of 5.7%.

¹⁷ ICRC (2014) Final Report Standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017, Report 4 of 2014, June, p. 33-34.

¹⁸ ACCC (2018) Figure 6.4 p.146

¹⁹ ACCC (2018) Figure A p.v and Figure B p vi