12 July 2013

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235
Email: aemc@aemc.gov.au

Dear Mr Pierce

Advice on best practice retail electricity pricing methodology – response to issues paper

ActewAGL Retail (ActewAGL) welcomes the opportunity to respond to the Australian Energy Market Commission's (AEMC's) Issues Paper *Advice on best practice retail electricity pricing methodology* (the Issues Paper).

ActewAGL is a joint venture formed in 2000 comprising two partnerships, ActewAGL Retail and ActewAGL Distribution. ActewAGL Retail provides electricity and natural gas (gas) retail services in the Australian Capital Territory (ACT) and in South East New South Wales (NSW) markets. ActewAGL is required to offer ACT customers who consume less than 100MWh of electricity per year a non negotiated standard customer contract incorporating a tariff approved by the Independent Competition and Regulatory Commission (ICRC). ActewAGL participates in the NSW electricity retail market as a non-standard retailer, focussing on customers in the region surrounding the ACT.

ActewAGL notes that the Issues Paper provides an extensive overview of a number of very important issues related to retail price regulation of electricity, and commends the AEMC on this comprehensive approach. However, owing to the relatively short period of time available to make submissions, ActewAGL's submission focuses on a select number of key issues relevant to the ongoing policy debate surrounding retail price regulation.

The AEMC's review

ActewAGL notes that the AEMC is conducting this review under instruction from the Standing Council on Energy and Resources (SCER), which issued terms of reference[1] to the AEMC as part of a broader Council of Australian Governments (COAG) reform agenda.[2]

ActewAGL considers that nearly two decades after the process of electricity market reform commenced, and more than a decade after reform of retail price regulation started, the removal of retail price regulation remains one of the key outstanding issues for microeconomic reform in Australia. This view is supported by the Productivity Commission's recommendation in its review of electricity network regulation calling for the removal of all retail price regulation by 2015.[3]

[1] SCER (2012), *Terms of Reference – Australian Energy Market Commission reporting on a best practice retail electricity pricing methodology*, 2 May 2013
[2] See COAG Energy Reform – Implementation Plan, 7 December 2012
[3] Productivity Commission (2013), *Electricity Network Regulatory Frameworks – Inquiry Report*, recommendation 12.3

While ActewAGL appreciates that the AEMC has been instructed by SCER to undertake this review, ActewAGL is concerned that such a review may hinder the process of price deregulation or further entrench price regulation in those markets where it continues to apply. ActewAGL has long held the view that maintaining a regulated price in a competitive environment stifles competition and product innovation, and delivers less than optimal outcomes to consumers.

Price deregulation is also supported by jurisdictional regulators such as the ICRC in the ACT[4] and the Independent Pricing and Regulatory Tribunal (IPART) in NSW.[5]

With the exception of Victoria and South Australia, all jurisdictions that are party to the Australian Energy Market Agreement (AEMA) have an outstanding commitment to remove price regulation.[6] This commitment was reaffirmed by COAG at its December 2012 meeting, where the states and territories agreed to a number of actions in relation to retail price deregulation.[7] In light of these broad commitments, it is important the AEMC clarify for stakeholders that the advice stemming from this review should not be seen as precluding any jurisdictional efforts already underway to remove price regulation.

In relation to the process of the AEMC's review, comments in the Issues Paper suggest that only jurisdictional governments and regulators will be given the opportunity to comment on the draft report.[8] If this reading is correct, and other stakeholders will not be afforded an opportunity to make submissions on the draft report, it is at odds with general best-practice approaches to consultation.

As COAG has noted, effective consultation with affected key stakeholders should occur at all stages of the regulatory cycle and that a "lack of consultation can lead to regulation that is inappropriate to the circumstances, costly to comply with and poorly adhered to."[9] ActewAGL considers that it is appropriate that retailers, in additional to jurisdictions and relevant jurisdictional pricing regulators, are consulted on the draft report.

Key points in the Issues Paper

On the basis that stakeholders such as ActewAGL may only be afforded this single opportunity to make written submissions to the review, ActewAGL takes this opportunity to register its views on a number of key points raised in the Issues Paper. However, ActewAGL stresses that this should not be viewed as tacit support of continued retail price regulation. Rather, ActewAGL provides these insights in order that the AEMC may better consider the various issues and challenges present in establishing a 'best practice approach' for retail electricity price regulation.

Objective of retail price regulation

ActewAGL believes it is important that the AEMC clarify the proposed objective of retail regulation on two points.

The second limb of the proposed objective is that "...retail price regulation should determine electricity prices for small customers, which: ... facilitate the development of competition in retail electricity markets, where competition may be feasible."[10]

In order to improve certainty, it would be helpful to stakeholders if the AEMC's advice indicated what is meant by "the development of competition" (and implicitly, the necessary market conditions which allow for the removal of price regulation). In particular, the costs and risks (including

---

[4] ICRC (2010), *Final Report – Retail prices for non-contestable customers 2010-12*, June, p. 7
[5] IPART (2013), *Final Report – Review of regulated retail prices for electricity,* p. 30
[6] AEMA clause 14.11
[7] See for example, items 8.2, 8.3 and 8.6 of the COAG Energy Market Reform – Implementation Plan
[8] AEMC (2013), *Issues Paper – Advice on best practice retail price regulation methodology*, p. 7
[9] COAG (2007), *Best Practice Regulation: A guide for ministerial councils and national standard setting bodies*, p. 30
[10] AEMC (2013), *Issues Paper – Advice on best practice retail price regulation methodology*, p. 14

regulatory costs and the risk of setting prices below market clearing levels[11]) of maintaining retail price regulation in the presence of effective competition should be recognised and taken into consideration. As Professor George Yarrow has noted "...it is to be expected that the withdrawal of price controls will be most appropriate *before* competition has become fully effective, in periods when the risks/hazards of the alternative courses of action are more evenly balanced."[12]

The second proposed amendment is to remove the words "...where competition may be feasible." This condition could be construed as meaning that there are markets within the National Electricity Market (NEM) where competition may not be possible. ActewAGL would disagree with this view, and believes that in a single market of more than nine million customers, selling a product and service with many homogenous features and with very limited geographical limits on where a retailer may operate, effective competition is possible in all jurisdictions in the NEM where the appropriate policy and market settings are in place.

Appropriate form of regulation

Competitive markets provide in-built incentives for firms to improve their performance over time. The exercise of choice by customers creates competitive tension between firms leading to innovative product offerings and constraints on pricing decisions.

Consistent with the AEMC's proposed objective that retail price regulation should reflect the costs of providing retail electricity services and facilitate the development of competition, ActewAGL considers that, where regulation is maintained, the most appropriate form of regulation is an incentive-based approach.

ActewAGL supports a weighted average price cap (WAPC) methodology for adjusting how regulated prices can change over time, and agrees with the comments made in the Issues Paper that such an approach allows retailers to better manage their risks, and also minimises administrative costs for jurisdictional regulators.[13] Side constraints on regulated price changes should not be used, as they may run counter to cost-reflectivity, and are effectively price control. Side constraints can also limit development of innovation by retailers, thereby limiting competitive differences and reducing consumer options.

Defining a standard retailer

The Issues Paper correctly identifies that the definition of 'standard retailer' affects the level and type of costs which are included in the retail operating cost allowance.[14] The proposed objective provides that retail price regulation should determine electricity prices which "...reflect the efficient costs of providing retail electricity services;"[15] In Australian retail electricity markets, retail electricity services are provided by a variety of firms, each facing its own set of costs. It is important that any advice the AEMC issues on best practice regulation should include guidance on what the 'standard retailer' is. Currently, there is divergence across jurisdictions, with resultant variation in regulated outcomes. In the case of the ACT, the ICRC has consistently determined the appropriate benchmark is the efficient incumbent retailer.[16] However, the AEMC has found that this approach inhibits effective competition in the ACT retail electricity market.[17]

ActewAGL proposes that 'standard retailer' should be an efficient, mass-market, single fuel new entrant operating in a competitive market. This would allow consistency with the fundamental

---

[11] AEMC (2013), *Draft Report – Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales*, p. 94-95
[12] Yarrow, G (2008), *Report on the impact of maintaining price regulation*, p. 31
[13] AEMC (2013), *Issues Paper – Advice on best practice retail price regulation methodology*, p. 56
[14] AEMC (2013), *Issues Paper – Advice on best practice retail price regulation methodology*, p. 33-35
[15] AEMC (2013), *Issues Paper – Advice on best practice retail price regulation methodology*, p. 14
[16] ICRC (2012), *Draft Report – retail prices for franchise electricity customers 2012-14*, p. 6
[17] AEMC (2010), *Stage 1 Final Report – Review of the effectiveness of competition in the electricity retail market of the ACT*, p. i

principle that price regulation should not inhibit competition but facilitate competitive market outcomes. Determining commercial costs (and hence regulated retail prices) on the basis of benchmarks for efficient incumbent retailers could result in setting a price that falls below the efficient cost of providing electricity services in a competitive setting.

Adopting the standard of an efficient, mass-market single fuel new entrant to the competitive market would also allow for regulated retail prices to provide for cost-reflective retail operating costs (discussed further in the following section).

Retailer operating costs

The Issues Paper raises a number of questions on the topic of retailer operating costs (ROC), namely:

- should ROC be estimated by reference to a 'standard retailer'?
- if a 'standard retailer' approach is taken, how should 'standard retailer' be defined?
- should benchmarking be used in determining the efficient level of ROC? and
- how should ROC be escalated over time (including consideration of productivity improvements)?[18]

On the first two questions, ActewAGL's views on the issue of standard retailer more generally have already been outlined above.

In the context of ROC, ActewAGL maintains the view that the appropriate method is to estimate the costs of an efficient, mass-market, single fuel new entrant operating in a competitive market. In particular, this means that ROC allowances should allow for full recovery of customer acquisition and retention costs (CARC). This is currently one of a few key reasons for divergence in regulatory outcomes between the ACT, Queensland, and NSW.

The impact of this divergence is illustrated by the current regulatory allowances for ROC across the jurisdictions for 2013-14. In the ACT, ActewAGL is allowed an indicative total ROC allowance of around $120 per customer.[19] In Queensland, the Queensland Competition Authority's final decision was for a total ROC allowance (ROC and CARC) of around $160 per customer[20], and in NSW, based on IPART's final decision for 2013-14, an indicative total ROC allowance is around $167 per customer.[21]

ActewAGL notes that the absence of CARC in the ACT regulated price has been found to be a barrier to competition in the ACT retail electricity market. Work undertaken by The Allen Consulting Group (ACG) on behalf of the AEMC in the *Review of the of the effectiveness of competition in the electricity retail market of the ACT* found that the absence of CARC in ACT regulated prices results in very low retail margins for competing retailers.[22] ACG analysis estimated that the result of this regulatory approach was that, dependent on the level of CARC faced by a competing new entrant retailer, the effective retail margin available in the ACT was between around 43 and 65 per cent of the regulated margin.[23]

Accordingly, any efforts to foster rather than impede competition through regulation need to provide for the full inclusion of commercial costs such as CARC in regulated ROC allowances.

---

[18] AEMC (2013), *Issues Paper – Advice on best practice retail price regulation methodology*, p. 37
[19] ICRC (2013), *Final Decision – Retail price adjustment for franchise electricity customers 2013-14*, p. 14 and ActewAGL analysis
[20] QCA (2013), *Final Determination – Regulated retail electricity prices 2013-14*, p. 50
[21] IPART (2013), *Final Report – Review of regulated retail prices for electricity*, p. 98 and 110, and ActewAGL analysis
[22] The Allen Consulting Group, 2010, *Effectiveness of electricity retail competition in the ACT – price and profit margins analysis*, p. 26
[23] The Allen Consulting Group, 2010, *Effectiveness of electricity retail competition in the ACT – price and profit margins analysis*, p. 18 and ActewAGL analysis

On the third question, ActewAGL broadly agrees with the use of benchmarking to determine ROC allowances as outlined in the Issues Paper. However, ActewAGL also notes that the Issues Paper does not provide any comment on the presence of economies of scale in electricity retailing and the impact this has on a retailer's ROC. The issue of economies of scale is particularly relevant under a benchmarking approach, given the significant variation in the size of the various regulated retailers that operate in the NEM.

At only around 150,000, ActewAGL's regulated electricity customer base in the ACT is one of the smallest in the NEM. In comparison, regulated businesses in NSW and Queensland serve considerably larger customer bases – around 4.5 million and 2 million, respectively.

Economic theory would suggest that in the presence of a smaller customer base, an electricity retailer will have inherently higher average costs (as it has fewer customers over which to spread its fixed costs) than retailers with larger markets. Many current regulatory approaches do not adequately recognise this.

Independent modelling undertaken on behalf of ActewAGL shows that when various jurisdictional ROC allowances are adjusted for customer bases of 150,000, the total ROC allowance in the ACT is significantly lower than in other jurisdictions, by up to approximately $50 per customer. This shortfall is a useful illustration of the types of challenges retailers currently face under jurisdictionally-based regulation. It also highlights the challenges that any approach to cost estimation based on benchmarking must explicitly resolve.

In the presence of such divergent allowances, price regulation will continue to inhibit competitive market outcomes unless benchmarking appropriately recognises economies of scale.

Competition allowance

As noted above, with the exception of Victoria and South Australia, all jurisdictions that are party to the Australian Energy Market Agreement (AEMA) have an outstanding commitment to remove price regulation.[24] ActewAGL also notes that the ACT is the only jurisdiction where the AEMC has found competition not to be effective, and that the ICRC does not incorporate a full accounting of CARC in ACT regulated prices. In line with the AEMC's proposed objective, ActewAGL views a "competition" allowance or "headroom" as an important part of ensuring that regulated price outcomes reflect those that would be expected in a competitive market.

Wholesale energy costs

Given the significance of wholesale energy costs to end-use prices, estimation of wholesale energy cost allowance is one of most important aspects of regulatory determination, and is also one of the most significant sources of regulatory risk for regulated electricity retailers.

In terms of the method that should be used to determine the wholesale energy cost allowance, ActewAGL has consistently stated that the long run marginal cost (LRMC) should be used as a reference point in establishing a deemed purchase cost for electricity.[25] In a sustainable energy market, the energy purchase cost must reflect measures of the LRMC to ensure adequate investment in new generation capacity and security of supply for customers is maintained. If the generation, retail and finance sectors do not have confidence in the underlying stability of retail prices, the ongoing viability of new generation will be at risk, thereby putting at risk security of supply.

---

[24] AEMA clause 14.11

[25] See for example, ActewAGL (2012), *ActewAGL Retail Response to the Independent Competition and Regulatory Commission Issues Paper: Retail Prices for non-contestable electricity customers 2012-2014*, p. 9

However, ActewAGL also recognises that there can be divergences between estimates of wholesale energy cost outcomes under an LRMC approach and the wholesale energy costs that an electricity retailer faces in the short and medium term. A best practice approach to regulation would need to ensure that regulated prices are set at levels that allow recovery of both short term and longer term costs. This could involve a combination of both LRMC and market modelling approaches. ActewAGL notes that regulatory approaches relying on the LRMC (to varying degrees) has been successfully used for a number of years in NSW.

As a retailer that operates in a jurisdiction where the wholesale energy cost allowance has been determined exclusively by reference to a market model approach, ActewAGL is well placed to provide some insights into some of the key hurdles with such an approach.

Any market modelling approach would need to address the regulatory risk and uncertainty imposed by the use of a modelling approach. Prudent wholesale energy purchasing behaviour by electricity retailers involves progressively layering of hedges up to three years in advance to diversify the portfolio and manage risk. Accordingly, there is a need for commitment to a method and explanation well ahead of a decision.

Further, in the event of changing the approach to modelling wholesale energy costs, it is very important that there is a smooth transition from the current method to any new regime. This transitional process is necessary due to the fact that a prudent retailer would have made wholesale purchasing decisions that take into account the current approach. Any advice on best practice regulation methodology should recognise the need and role for transitional processes.

In determining an approach to estimating the wholesale energy purchase cost, it is very important that the approach aligns as nearly as possible to actual retailer behaviour. It should reflect the risk management behaviour of prudent retailers operating in the absence of price regulation otherwise regulators risk distorting the free operation of the competitive market. Along with electricity network costs, wholesale energy costs are among the largest elements of a retail price build-up, and the implications of incorrectly setting the energy cost allowance can be severe.

Importantly, this risk is asymmetric. If a regulator sets the wholesale energy cost allowance above cost-reflective levels, under incentive regulation retailers will seek to outperform the allowance and competition will erode any 'headroom'. However, if the allowance is set below cost reflective levels, then the regulated retailer could fail, imposing a substantial economic cost on society.

Handling of costs external to retailer operations

Any best practice regulation methodology should allow for the full pass-through of costs that are beyond a retailer's control, including network costs, environmental costs such as carbon pricing and the costs of renewable energy targets, and other jurisdictional government scheme costs (such as energy efficiency schemes). This would be consistent with current jurisdictional approaches.

Noting the level of uncertainty that has been (and may continue to be) associated with environmental schemes in recent years, and the emerging difficulty in estimating the costs to retailers of these schemes, it is important that as part of the full pass-through of these costs, regulation also includes a 'true-up mechanism'. This will enable retailers to recover genuine out of pocket expenses where the estimated costs are different from the actual cost and where there are changes within regulatory periods that a regulated approach did not anticipate.

Noting that retailers will face both federal and state and territory based schemes, it is important that in this regard, regulators are given enough flexibility to ensure the full pass-through of costs.

Regulatory control periods

Electricity retailers operate in an environment that is continually changing. However, by definition, regulatory control periods seek to replicate competitive market outcomes for the length of the regulatory control period. Retailers will then need to operate under these established parameters (and face the associated regulatory risks), despite operating in a dynamic environment.

On the one hand, shorter regulatory periods alleviate the problem of market changes over time and allow flexibility, but at the cost of increased uncertainty for retailers and consumers alike. On the other hand, longer regulatory control periods create certainty of approach, but leave electricity retailers in the short term and customers in the longer term carrying all the risk of inappropriate regulatory settings. A good example of this is the experience in Western Australia, where retail prices were held below cost-reflective levels for nearly a decade. Following that period, there has been a number of years during which prices have had to 'catch up', with consumers bearing the burden of price increases.

On balance, short regulatory control periods (say two years) but with firmly embedded regulatory principles that are not subject to change from one period to the next would seem to be the most appropriate approach to this issue.

ActewAGL Retail looks forward to continuing engagement with the AEMC throughout this review. Please contact David Graham, Director Regulatory Affairs and Pricing, on (02) 6248 3605 if you would like to discuss this submission.

Yours sincerely

Kate Dean
Acting General Manager Retail