



EnergyAustralia

12 July 2013

Mr John Pierce
Mr Neville Henderson
Dr Brian Spalding
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

EnergyAustralia Pty Ltd

ABN 99 086 014 968
Level 33
385 Bourke Street
Melbourne Victoria 3000

Phone +61 3 8628 1000
Facsimile +61 3 8628 1050

enq@energyaustralia.com.au
energyaustralia.com.au

Submitted online at aemc@aemc.gov.au

Dear Commissioners

Project reference: EMO0027: Response to the issues paper on advice on best practice retail price regulation methodology

EnergyAustralia welcomes the opportunity to make a submission on the issues paper released by the Australian Energy Market Commission (AEMC) for the best practice retail price regulation methodology (Issues Paper).

EnergyAustralia is one of Australia's largest energy companies, providing gas and electricity to over 2.7 million residential and business customers. EnergyAustralia owns and operates a multi-billion dollar portfolio of energy generation and storage facilities across Australia including coal, gas and wind assets with control of over 5,500 MW of generation in the National Electricity Market.

We have long held the view that retail price regulation in contestable energy markets is a net cost to consumers, government and industry. We therefore support recent moves by South Australia to remove price regulation and the announcement by Queensland to deregulate the south east in 2015. We also support the initial recommendations by the Commission that the conditions exist to move to price monitoring in New South Wales.

However, where retail price regulation remains, EnergyAustralia believes there is benefit for consumers and industry from the adoption of a consistent framework that encourages competition and promotes the eventual transition to price deregulation.

We therefore support the Commission's review. In the attachment provide detailed comments on all aspects of the review.

If you would like more information on this submission, please contact me on (03) 8628 1242.

Yours sincerely

Melinda Green
Regulatory Manager - Pricing

**EnergyAustralia response
to the AEMC Issues Paper on
Best Practice Retail Price
Regulation Methodology**

July 2013

Contents

1.	Introduction	4
2.	Approach, objectives and principles	5
	2.1. Approach to advice.....	5
	2.2. The objective of retail price regulation	5
	2.3. Principles	6
3.	Wholesale energy costs	7
	3.1. Energy purchase costs	7
	3.2. Market fees and ancillary service fees	12
	3.3. Energy losses	13
4.	Time-of-use prices and network costs	13
	4.1. Setting regulated time-of-use retail prices	13
5.	Retail operating costs and retail margin.....	15
	5.1. Retail operating costs	15
	5.2. Retail margins	16
	5.3. Competition allowance	17
6.	Environmental and jurisdictional schemes	19
	6.1. Large-scale Renewable Energy Target	19
	6.2. Small Scale Renewable Energy Scheme.....	19
	6.3. Jurisdictional energy scheme costs	21
7.	Form and timing of price controls	23
	7.1. Review of the best practice retail price regulation framework	23
	7.2. Form of regulation	23
	7.3. Determination length and cost pass through reviews	25

1. Introduction

There is broad consensus across government and industry about the importance of retail energy price deregulation to increase competition, innovation and investment, and provide benefits for end use consumers. However, as retail price regulation remains across multiple jurisdictions, EnergyAustralia believes there could be benefit for consumers and industry from the adoption of a consistent framework for regulation.

Given the mandate of the AEMC to work towards efficient, reliable and secure energy market frameworks, which serve the long-term interests of consumers, and as an expert, state funded and well-resourced market institution, the AEMC is well placed to establish a framework for determining regulated retail prices for electricity and gas. The AEMC also has responsibility under the Australian Energy Market Agreement to review the effectiveness of retail competition in each jurisdiction within the National Electricity Market and is therefore positioned well to ensure that the model terms of reference promote retail competition.

A consistent framework would reduce the overall cost of regulation by allowing industry debate about the framework to occur once thus avoiding duplication and continued litigation, while also allowing it to be informed by a body, which has greater visibility over all the issues affecting energy markets. A consistent framework would provide confidence to industry and capital providers, and reduce the likelihood of retail businesses shifting focus between jurisdictions in response to unfavourable regulatory outcomes in specific states.

However, for this framework to be effective, it's vital that prices are set at an appropriate level and do not vary unpredictably. Inevitably, a regulated price is seen as a benchmark price and, if set at the wrong level, can have negative consequences for customers and the market. However, it is a difficult task for any regulator to set a regulated price in the market as they have imperfect information, must use transparent and predictable methods, and have to justify their approach to all stakeholders. These are complications that a retailer does not have to contend with in setting market-based prices.

EnergyAustralia therefore believes that price regulation should be removed in all contestable retail energy markets as this provides the best environment for creating efficient pricing and best supports the long-term interests of customers and long-term industry outcomes. For states that still retain electricity price regulation, the best practice framework established by the AEMC should aim to transition the framework to a lighter-handed approach over time in such a way that state governments are not hindered in removing price regulation as soon as practicable.

2. Approach, objectives and principles

2.1. Approach to advice

Question 1

- (a) Is the proposed approach to the advice appropriate for developing a best practice methodology for setting regulated retail prices?
- (b) Are there any specific factors in relation to Western Australia and/or the Northern Territory that the AEMC should consider in developing a best practice method for regulated retail prices?

The AEMC's proposed approach to developing a best practice regulated retail pricing methodology is appropriate.

EnergyAustralia believes that appropriate retail pricing methodologies should ideally be used in all markets, including Western Australia and the Northern Territory. Progress towards market contestability and the removal of price regulation is also desirable in these states. However, the appropriate methods for Western Australia and the Northern Territory may differ from the approach taken for National Electricity Market (NEM) states.

Solar feed-in tariffs

Although the terms of reference does not refer to solar feed-in tariffs, we suggest that it may be useful to include these in scope (if possible) when these tariffs also remain regulated. The reason for this is that the solar feed-in tariff relies on some of the same inputs as the regulated electricity price and therefore it is likely to be more efficient if the feed-in tariff is considered at the same time. It would also be beneficial to encourage competition within the solar market and transition to the removal of price regulation from solar feed-in tariffs also.

2.2. The objective of retail price regulation

Question 2 – Is the proposed objective appropriate in guiding the development of the AEMC's advice?

We support the objective put forward by the AEMC, but suggest it should explicitly refer to the aim to progress to full deregulation of retail pricing.

The proposed objective of retail price regulation with suggested addition:

Having regard to the long-term interests of customers, retail price regulation should determine electricity prices for small customers, which:

- reflect the efficient costs of providing retail electricity services; and
- facilitate the development of competition in retail electricity markets, where competition may be feasible.

The retail price regulation framework should allow markets to transition to lighter-handed forms of price regulation to provide a pathway to the removal of price regulation.

2.3. Principles

Question 3 - Are the proposed principles appropriate in guiding the development of the AEMC's advice?

Principles 1-5 and 7, which deal with having cost efficiency and reflectivity, transparency, having an open and consultative process, predictability and stability and allocation of risk are entirely appropriate for a best practice regulated pricing methodology.

We also agree that minimising the administrative burden (principle 6) is a good idea for any regulatory methodology. It can be true that shorter retail regulatory periods (one to three years) can lead to higher administrative costs than if the regulatory period was longer. However, the administrative overheads created by the length of the regulatory period should be considered in context. Issues with the approach or outputs of the regulatory pricing methodology tend to drive up administrative costs much more so than the length of the regulatory period. For recent regulatory price reviews, we note that:

- In South Australia, a very contentious reopening of the regulatory period began with a small issues paper from the Essential Services Commission of South Australia (ESCOSA) and resulted in a detailed review of the wholesale pricing methodology and the ability of the regulator to alter the methodology at that point.¹ The incumbent retailer, AGL, began legal action against ESCOSA² (which was later withdrawn when the SA Government decided to remove price regulation).
- In NSW, the 2012/13 annual electricity price review generated a lot of additional feedback from stakeholders (including consultants reports) on the weighted average cost of capital (WACC) even after the methodology had already been established by a major triennial review.³
- In Queensland, although the regulatory period is only one year, a dispute over the wholesale electricity pricing methodology resulted in Origin Energy taking the Queensland Competition Authority (QCA) to court, adding extra administrative costs for all parties involved in the dispute.⁴

Also, a retail price calculation methodology must take into account various market changes and it may be difficult for these to be foreseen very far into the future (for example for the weighted average cost of capital or carbon pricing). For retailers, it is likely to be a bigger issue to have longer-term regulatory period, which becomes out-dated than to incur smaller administrative costs in a major regulatory review of the pricing methodology. Review mechanisms for any new regulated pricing methodology should be should not be too far apart and ideally the time period would be defined up front to provide regulatory certainty.

¹ ESCOSA, Electricity Standing Contract Price – Wholesale Cost Investigation: Discussion Paper, 20th Jun 2012

² AGL, media release, 4th Dec 2012, <http://www.agl.com.au/about/ASXandMedia/Pages/AGLtochallengeESCOSAsrighttoreviewprices.aspx>

³ IPART, Changes in regulated electricity retail prices from 1 July 2012: Electricity – Final Report, June 2012, Appendix B, particularly pages 104-106

⁴ Courier Mail, *Origin Energy loses its legal challenge to overturn the State Government's price freeze*, 19th Dec 2012, <http://www.couriermail.com.au/news/queensland/origin-energy-loses-its-legal-challenge-to-overturn-the-state-governments-price-freeze/story-e6freoof-1226540250910>

3. Wholesale energy costs

3.1. Energy purchase costs

Question 4(a) - As considered in our proposed objective, should the wholesale energy cost allowance aim to:

- (i) recover the efficient costs retailers face at a particular point in time; or
- (ii) have a more long-term focus in recovering costs?

We support a long-term focus to recovering costs in the energy purchase cost (EPC) component of regulated retail prices. Our preferred approach is a combination of the long run marginal cost (LRMC) and the market cost (the wholesale electricity market purchase cost) in what is commonly referred to as the LRMC-based floor approach. Under this approach the EPC has a minimum value based on LRMC and uses market cost in years when this spikes above LRMC. The benefits of this approach are that the LRMC is more stable over time than the market cost and it provides more regulatory certainty for industry and a more stable price for customers.

The major proportion of energy costs faced by retailers are reflective of LRMC (e.g. physical plant, power purchase agreements) and even market-based costs are expected to average out at the level of LRMC over time. In the current wholesale environment, both stand-alone generators and retailers who have invested in generation need to be able to recover long-term costs. If this doesn't occur they will not be incentivised to make investment in maintaining the levels of historical reliability and availability of plant.

An LRMC-based floor approach to the EPC component assists retailers to cover these long-run costs that are still incurred despite the prevailing market conditions. For retailers and generators who make a long-term commitment to the electricity retail and generation, an LRMC-based floor approach is more conducive to the ongoing viability and competitiveness of the industry whilst supporting the long-term interests of customers or to retail competition.

As outlined by the AEMC,⁵ the LRMC-floor approach can be used to support retail competition. The dynamics of a retail business are such that retailers will use their utmost means to attract and retain customers and will not complacently enter into high priced hedges with generators. That is, a retail business is incentivised to 'compete away' any additional 'headroom' in the retail price that is not required to support the minimum level of generation costs required at that point in time. This retail behaviour is not dissimilar to that which occurs in the electrical and white goods industry where it is common practice for customers to be offered a substantial discount off the recommended retail price before they even begin to negotiate with the salesperson.

A long-term LRMC-based approach to recovering wholesale electricity costs also benefits customers as it leads to a more stable price year-to-year. A point-in-time approach is usually based on wholesale market costs and produces more highly variable EPC component that can lead to additional price shocks for customers. There is an inevitable time lag in these price signals as regulated retail prices are typically only set once a year, so it is unlikely that retail customers would respond effectively to the price signals based on a point-in-time market-based approach from up to a year ago.

⁵ AEMC, Issues Paper, page 26

Question 4(b) - What is the appropriate method (or combination of methods) to estimate wholesale energy costs?

(i) Does the appropriate method differ depending on the state of competition in the market? For instance, should a different method be applied in jurisdictions that have limited competition in the wholesale market, such as Western Australia, Northern Territory or Tasmania?

LRMC

The LRMC of electricity generation represents the least-cost combination of electricity generation plant required to meet each Standard Retailer's forecast regulated load. There are generally two approaches for estimating the LRMC, the greenfields (or stand-alone) approach and the average incremental approach. We agree with the key arguments discussed by IPART in their issues paper for regulated electricity prices for 2013-16⁶ in support of the greenfields method. The greenfields approach appears to be the most appropriate for estimating the LRMC of generation for regulatory price determinations because:⁶

- It assumes the generation plant will earn an economic return on their market value, as it takes both capital and variable costs into account when estimating the LRMC. In contrast, under the incremental approach, the capital costs of existing and committed generation plant are treated as sunk costs. Therefore, capital costs are not reflected in the estimate of incremental LRMC unless new plant is part of the least-cost outcome.
- It produces a more reliable and stable value from year to year than the average incremental or perturbation methods.
- The average incremental LRMC approach is problematic for estimating the LRMC of meeting any load other than the system load. This is because investments in the existing mix of generation plant have been undertaken to meet total system load; as such, it does not make sense to treat the entire stock of existing plant as sunk in the estimation of costs to serve a subset of system load (such as the regulated load).

As commented by the AEMC, the perturbation method involves a more complex calculation and suffers from some of the same problems as the average incremental approach in that the capital costs of generation are not reflected in the estimate of LRMC unless a new generation plant is required.⁷ Similarly, the levelised unit electricity cost method has some limitations as described by the AEMC. We note however, that some of these methodologies can be adapted somewhat to overcome differences in assumptions and can produce similar results at times.

For these reasons, we generally support the greenfields approach for estimating the LRMC of generation. It is also important that the LRMC value be based on the practical realities of the NEM and generation plant assumptions. The IPART approach considers an optimised combination of plant using today's technologies to meet the regulated load at least cost. This is a suitable approach.

Additionally, as any LRMC method still remains highly dependent on input assumptions: for example, fuel costs, capital and operational costs, WACC, and load profiles. It is critical that these components are given due consideration and are consulted on as part of the regulated pricing process, particularly the inputs noted above. Many of these inputs were consulted on at length in the recent IPART review of regulated pricing.⁸ We suggest that these inputs are

⁶ IPART, Review of regulated retail prices and charges for electricity 2013 to 2016 – Electricity: Issues Paper, Nov 2012, page 47

⁷ AEMC, Issues Paper, page 22-23

⁸ IPART, Review of regulated retail prices and charges for electricity 2013 to 2016 – Electricity, http://www.ipart.nsw.gov.au/Home/Industries/Electricity/Reviews/Retail_Pricing/Review_of_regulated_electricit

formally included in the best practice retail pricing methodology, as low quality inputs would certainly undermine the credibility of the resultant LRMC value.

The LRMC can be calculated over a period as short as one year, but particular cost inputs should be considered over a longer period. For example, capital costs should be annualised over a suitable period, while other cost inputs such as fuel costs can be determined for the current year.

Market cost

The calculation of market cost requires several key inputs: load forecasts, contract prices, hedge strategy and forecast spot prices. When the wholesale electricity futures market is liquid then it is appropriate that the calculation of market cost is based on futures contracts prices.⁹ Ideally this data would be an input into an industry standard approach based on a rolling average of layered hedges over a two-year period. This straightforward method provides the best valuation of wholesale market costs, and is generally considered to be the approach a prudent retailer would take to hedging.

Future spot prices must also be developed as an input into the market cost. These need to be modelled and are usually an input that regulators source from an independent consultant. The methods used are proprietary and we can only judge the outputs based on how various measures and trends (e.g. price duration curves) compare to historical spot price data and our own internal modelling. The regulated load profile is discussed in the next section.

The methods used by many regulators¹⁰ to calculate the market cost component are quite contentious and attract a great deal of discussion from stakeholders. We recommend that the AEMC establish specific guidelines on each component and we would be willing to provide input on the type of detailed approach that is required.

Load profile

It is critical that the load modelling approach leads to sensible profiles as the majority of the asymmetric volume risk for the regulated retail price rests within these profiles. Ideally, the methodology should be separately specified as part of the best practice regulated retail price framework. The load forecasts shouldn't be developed for a period longer than three years as there would otherwise be too great a risk of a significant divergence between the actual regulated load and the forecasts.

Some of the aspects that should be considered in developing regulated load forecasts are:

- For which customer group/s load forecasts will be created
- Data sources and data validation approaches (e.g. to ensure that data has been extracted correctly, that it contains no material anomalies, etc.)
- How many years of historical data should be used
- How assumptions should be made about future demand levels

[y_retail_prices_2013_to_2016](http://www.ipart.nsw.gov.au/Home/Industries/Electricity/Reviews/Retail_Pricing/Review_of_regulated_electricity_retail_prices_2013_to_2016/17_Jun_2013_-_Consultant_Report_-_Frontier_Economics_-_June_2013/Consultant_Report_-_Frontier_Economics_-_Input_assumptions_for_modelling_wholesale_electricity_costs_-_June_2013) and http://www.ipart.nsw.gov.au/Home/Industries/Electricity/Reviews/Retail_Pricing/Review_of_regulated_electricity_retail_prices_2013_to_2016/17_Jun_2013_-_Consultant_Report_-_Frontier_Economics_-_June_2013/Consultant_Report_-_Frontier_Economics_-_Input_assumptions_for_modelling_wholesale_electricity_costs_-_June_2013

⁹ See also the discussion on contract prices in response to question 4(d).

¹⁰ For example: IPART (2013-16 price review), QCA (2013-14 price review) and ESCOSA (Wholesale cost investigation review 2012)

- How the forecasts should be constructed to create a sample that is likely to be representative of future weather patterns and doesn't rely too heavily on too few historical data points
- How any adjustments such as scaling and combination of data will be done (e.g. to add interval meter and controlled load data to net system load profile data)
- What cross-checks and verification should be done to confirm the final load forecasts are suitable

Load profiling methodologies are just as complex and are less visible and less able to be described succinctly compared to other elements of the regulated price (e.g. LRMC or market cost approaches). If desired, we are willing to discuss an appropriate approach to load profiling further with the AEMC.

Question 4(c) - Are there any other allowances or costs that should be included in the wholesale cost allowance? e.g. a volatility allowance or allowance for prudential capital?

Additional cost allowances with the wholesale cost allowance are usually set up by regulators when other elements of the regulatory methodology do not fully account for the costs or risks faced by retailers. The AEMC should consider these allowances where the methodology requires. Below we discuss two of the common additional allowances that are needed to ensure the EPC is fully cost-reflective.

Volatility allowance

Depending on the market cost approach used to calculate the wholesale cost allowance, it would be appropriate to calculate a volatility allowance. Given the market cost approach that IPART use, we support the inclusion of a volatility allowance. IPART explain the reason they apply a volatility allowance is that:

"The volatility of regulated load means that retailers are not able to perfectly manage variations in the expected cost of purchasing load through their contract portfolio (which Frontier assume consist only of swaps and caps). Therefore, they need additional working capital to cover the residual risk associated with the portfolio."¹¹

The method IPART use is broadly appropriate, however, there are ways that the market cost can be calculated that would preclude the need for this type of allowance.

Prudential capital allowance

A cash flow mismatch occurs between the actual trading day that the retailer incurs a liability with AEMO for market purchases, and the day this purchase is settled in the market. AEMO calculates a retailer's potential exposure and requires a retailer to provide a cash margin or bank guarantee to protect the market against default. AEMO have done extensive modelling around the levels of security required and may be able to advise the AEMC on the best approach. Note that this cash flow mismatch covers the entire purchase each retailer - not the difference between the hedged and physical volumes. The cost of providing bank guarantees is effectively the opportunity cost of our WACC. This cost should be addressed via an AEMO prudential requirements allowance within the wholesale cost component.

¹¹ IPART, Review of regulated retail prices and charges for electricity 2013 to 2016 – Electricity: Final Report, June 2013, page 72

Question 4(d) - What sensitivities should surround the calculation of wholesale energy costs? e.g. in relation to estimating a carbon cost?

Current carbon assumption

We stress the importance of the carbon price assumption embedded within the regulated price being properly representative of the costs that retailers face. If a misleading carbon price estimate is used for reporting purposes, then customers will have an expectation of the value of carbon that may be inaccurate. Any later carbon-based adjustment to the regulated prices may therefore adjust incorrectly for carbon.

Carbon inclusive Sydney Future Exchange (SFE) contract prices are currently trading with an implied carbon discount of over \$1/MWh. Market participants are required to value and hedge their generation (for generators) and loads (for retailers) under the current carbon legislation. This means that the cost of energy to generators and retailers includes the full cost of carbon, regardless of market uncertainty surrounding the carbon scheme. We therefore argue that the wholesale cost allowance should be based on carbon exclusive contract prices with a carbon cost as determined via the Australian Financial Markets Association (AFMA) Carbon Benchmark Addendum clause.

If the EPC allowance is based on prices from the SFE futures then an allowance for this discount to the cost of carbon should be included within the energy cost. We propose that a 'carbon pass-through correction' should be added to the overall energy cost equal to the calculated implied discount of carbon within the SFE price.¹²

Managing carbon costs post the fixed price period

Hedging the floating carbon liability post July 2015 is difficult in the face of potential change to the Carbon Price Mechanism (CPM). The challenge for a retailer is to provide a fixed price to regulated customers for a period that does not have a fixed carbon price. Given this uncertainty, a prudent retailer would use 'At the Money' Call Options to gain the right (but not the obligation) to purchase carbon at a fixed price during the year priced. The premium of those options adds a cost to the carbon cost. As this is an inherent cost that arises due to regulatory uncertainty, it should be added to the energy cost allowance under any methodology and should remain irrespective of changes to carbon legislation during any determination period.

Under the current CPM design, this should be achieved by adding a rolling average premium fee for 'At the Money' Options expiring in December 2015. European Union Allowances (EUA) are used for the following reasons:

- EUA are the marginal abatement unit in Australian carbon scheme and therefore, will represent the best proxy of Australian Emission Units prices; and
- the EUA option market is the most liquid world carbon market and therefore a regulator can source daily premium prices for the relevant period's options.

We believe that the carbon option payment should be taken into account in the calculation of both LRMC and market based costs. Both these pricing methodologies rely on hedging carbon before the regulated pricing year and the inclusion of carbon option payments are part of the costs that retailers face. For example, a prudent generator would hedge its carbon cost of

¹² This 'carbon pass-through correction' could be calculated using the approach shown in Appendix D of EnergyAustralia's recent submission to IPART's Review of regulated retail prices and charges for electricity 2013 to 2016, 20th May 2013, http://www.ipart.nsw.gov.au/Home/Industries/Electricity/Reviews/Retail_Pricing/Review_of_regulated_electricity_retail_prices_2013_to_2016/23_Apr_2013_-_Draft_Report_-_Review_of_regulated_retail_prices_for_electricity_2013_to_2016/Draft_Report_-_Review_of_regulated_retail_prices_for_electricity_2013_to_2016_-_April_2013

generation in the same way as they do with their fuel costs (coal or gas) as part of their cost management policy. This could be achieved by paying for a carbon option via an option premium payment.

Transparency and predictability of the modelling approach

Another sensitivity associated with the wholesale cost allowance approach is the modelling that is done (usually by the regulator's independent consultants). We completely agree with the AEMC's assertion that "stakeholders should be able to understand how any change in the underlying assumptions will impact the output prices."¹³ Many regulators aim to have a transparent and predictable process and do provide a substantial amount of inputs and outputs in support of the final wholesale energy cost allowance.

Transparency is somewhat achieved, but is limited by the proprietary nature of the consultants' models. Retailers are typically not satisfied that the modelling methods could be described as predictable. Arguably, predictability would also suffer under this new regulated retail price methodology being developed by the AEMC as different consultants may still be involved in providing modelled data in different states.

We would be more satisfied if a modelling approach were to be developed that retailers can at least replicate using our own in-house models. Without this level of predictability, we are often at a loss to estimate what wholesale energy component a regulator will calculate during the annual regulate price review process within a ~\$10/MWh window. This situation affects industry confidence and hinders the achievement of the objectives of retail price regulation.

3.2. Market fees and ancillary service fees

Question 5(a) - What is the appropriate method to estimate NEM market fees?

NEM market fees are easily obtained from for AEMO budgeted revenue requirements as discussed in the Issues Paper.¹⁴

Question 5(b) - What is the appropriate method to estimate ancillary service fees?

Many regulators estimate future ancillary services to be the arithmetic average of ancillary service costs for the last ten years. Although the data does indicate the long-term average is relatively stable, the asymmetric nature of these costs makes it possible that dramatic cost increases could be seen during the regulatory period.

Therefore, we would prefer that ancillary service costs be based on the previous year's actual costs instead of a ten-year average. This allows real pass-through of these costs with only a one year lag. The price volatility to the customers should be low as these costs are generally stable and a relatively small component of the total energy cost. Updating ancillary services costs each year would require a quick and straightforward calculation.

¹³ AEMC, Issues Paper, page 15

¹⁴ AEMC, Issues Paper, page 28

3.3. Energy losses

Question 6 - Is using loss factors, as published by AEMO, the most appropriate method to estimate energy losses?

Distribution and marginal loss factors are published annually by AEMO. Regulators combine these for use in the determination of regulated retail prices. The calculation of losses should not be controversial and is rarely debated by stakeholders.

4. Time-of-use prices and network costs

4.1. Setting regulated time-of-use retail prices

Question 7 - What issues should regulators take into account in passing through time of use network prices in setting regulated retail electricity prices?

The AEMC correctly notes in the Issues Paper that setting regulated retail prices based on time-of-use (TOU) network tariffs will be more complex than for flat tariff options. Although there are already a number of TOU regulated (and market-based) prices, part of the additional complexity is likely to result from the AEMC's recommendation that:¹⁵

- customers are offered a different level of choice of flat/TOU pricing depending on which of three consumption bands they fall in;
- all residential and small business customers would be able to opt-in or opt-out of TOU pricing, unless they have high consumption; and
- customers should only be able to shift into higher consumption band if their consumption increases to above the threshold over a period of two years and they should further not be able to shift into lower bands if their consumption drops.

There are three related topics that the AEMC touches on in the discussion of TOU tariffs: (1) the passing through of TOU network tariffs to regulated retail prices, (2) the passing through of wholesale electricity costs (via the load shape), and (3) the impact of the method on retail operating costs. The issues that could arise in each area are:¹⁶

1. Time-of-use network cost pass through

- The question should be asked if a separate regulated retail tariff is required for each TOU network tariff that a distributor creates. This currently occurs in Queensland and can lead to inefficiencies if customer take up of some of the new retail TOU tariffs is very low.¹⁷
- Assumptions made by the distributor in setting their network prices (e.g. on consumption level and TOU consumption splits, customer take up and movements between tariffs) and the distributor's business objectives (e.g. preferential pricing of some tariffs) can materially impact on the setting of regulated retail prices and can lead to unexpected or undesirable outcomes. This may need to be assessed on a case-by-case basis rather than having a regulated pricing methodology that is applied in a rigid way.

¹⁵ AEMC, Power of Choice Review – Giving consumers options in the way they use electricity, Final Report (Power of Choice Final Report), Nov 2012, pages 177-179

¹⁶ Some of these are noted in the Issues Paper

¹⁷ QCA, Regulated Retail Electricity Prices 2013-14, Final Determination, May 2013, pages 6-9

2. Time-of-use wholesale cost pass through

- Under the usual metering arrangements, customers are likely to transfer to and from the net system load profile (NSLP) and their own interval load profile. The NSLP and interval metered load profiles may alter significantly each year and be difficult to forecast initially.
- A different load profile may be preferred in setting the time-of-use pricing if this is very different from the NSLP. While having different profiles may add complexity, it may add risk to use the same load profile for flat and time-of-use prices if the load shapes are very different.
- Setting up regulated load profiles for a diminishing regulated customer base, or subsets of the customer base is more difficult than a large customer base for which the NSLP can be used as a reliable proxy.
- Having customers swap between flat and time-of use pricing¹⁸ creates risks (not all of which have been addressed yet by the Power of Choice Review or subsequent actions).

3. Impact of time-of-use approach on retail costs

- Having customers swap between flat and time-of use pricing also adds to retailers' operational costs.
- Having several bands for customers based on consumption thresholds also adds operational complexity and retail cost when dealing with customers as:
 - The usage thresholds are a new construct that has to be overlaid on existing categories (business/residential, regulated/market price, pricing zone, meter type, etc.) This complicates quoting and billing - more options usually translate to higher error rates.
 - At the point of sale, the retailer has no usage history for the customer.
 - Customers moving into a new premise and may no longer be able to access a flat tariff due to the high usage of the previous tenant.

While these issues are not insurmountable, it is difficult to put forward a sensible generic solution at this point when the detail of many of the Power of Choice recommendations are still to be discussed and decided upon.

Time-of-use tariffs are a useful way to improve the cost-reflectivity of prices and can help to send price signals to customers that will put downward pressure on prices. Therefore, the general principle that should be applied is that the best practice retail price regulation methodology should find a balance between achieving full cost reflectivity and minimising additional complexity through the regulatory approach that will add cost.

¹⁸ See discussion of 'reversion risks' in AEMC, Power of Choice, Final Report, page 195

5. Retail operating costs and retail margin

5.1. Retail operating costs

Question 8(a) - What method should be used to estimate retail operating costs? I.e. should a 'standard retailer' be used?

The benefit of a regulator defining a 'standard retailer' for use in setting retail operating costs is that stakeholders have some input and insight into what approximate weighting the regulator will apply in assessing costs from different sources. This approach also helps stakeholders to understand how the determination of retail operating costs fits in with other elements of the regulated price. For example, a regulator may define the 'standard retailer' to be a large retailer with economies of scale, but use another mechanism to provide headroom for competition that will encourage smaller or new entrant retailers.

Question 8(b) - If a 'standard retailer' is used, how should the 'standard retailer' be defined and what issues should be taken into account in defining a 'standard retailer'?

(i) Are there any considerations specific to Northern Territory and Western Australia that should be taken into account when defining a 'standard retailer'?

The attributes of the 'standard retailer' should be selected so that the retail operating costs are at a level that will encourage competition from new entrant retailers. There are reasons why a new entrant retailer may have higher or lower costs than a 'standard retailer'.

Therefore, to encourage competition in this market, we suggest that the AEMC should have a view of the type of new entrant retailer they would like to encourage and either develop or assess the benchmark costs against this hypothetical retailer also. A new entrant retailer is likely to have very low levels of gearing and require a higher risk premium from investors.

More important than the characterisation itself, is that the application of this characterisation needs to be realistic. In previous regulatory pricing determinations, we believe the costs have been set at a level of efficiency that cannot be achieved by even the largest retailers in the market. Setting benchmark costs at such a low level not only means that large retailers have limited funds to invest in product and service innovation, but this also makes the market a lot less attractive to new entrants.

The type of 'standard retailer' may differ in different markets depending on if the market is contestable (i.e. in Northern Territory and Western Australia) and the level of competition in the market.

Question 8(c) - Should benchmarking be used in determining the efficient level of retail operating costs? How could benchmarking be improved?

Benchmarking should remain a part of the approach to determining retail operating costs, but should not be the only method used. IPART has a comprehensive approach to setting retail operating costs, which is based on bottom up analysis of electricity retailers' costs, and benchmarking with retail costs from other regulators and costs in other industries.

The danger with only relying on a benchmarking approach is that there can be a circularity of decision making with fewer regulators now undertaking a detailed or independent analysis of retail operating costs. Ideally, a regulator would carry out a detailed periodic analysis of retail operating costs to ensure that any differences in costs between states have been addressed.

Question 8(d) - How should retail operating costs be escalated over a determination period and how should the potential for productivity improvements be considered?

For a short-to-medium regulatory period of one to three years, a CPI escalation of retail operating costs is often acceptable if no step changes occur during the period. However, there should be a method for dealing with any significant changes in costs. For example, a change in retail operating costs could be handled in one of the following ways:

- a different amount for retail operating costs could be set for each year at the start of the regulatory period;
- the retail operating costs could be updated each year of the regulatory period; or
- the retail operating costs could be updated via a cost pass through review during the regulatory period if required.

Productivity improvements are usually secondary to wage inflation and escalation of retail costs. Therefore, CPI is often used to appropriately escalate costs over the regulatory period.

5.2. Retail margins

Question 9(a) - What methodology should be used to calculate a retail margin? I.e. how should risks facing electricity retailers be compensated for?

A best practice price regulation methodology should consider all types of risks faced by the retailer and ensure that prices adequately reflect and compensate retailers. Generally, the retail margin is used to address sources of systematic risk faced by electricity retailers.¹⁹

Question 9(b) - Should the retail margin be set as a fixed percentage of 'total costs' (wholesale, network, retail) or of the controllable costs to the retailer (wholesale, retail)?

Cost base for calculation of the retail margin

In NSW and Queensland, the percentage retail margin in the regulated price has been set as a fixed percentage of 'total costs'.²⁰ We agree with this approach. The AEMC is correct in stating that there are timing mismatches in recovering network costs from customers compared to when network businesses require payment (as well as a risk that network costs will not be fully recovered from all customers).²¹ Therefore, it is reasonable that the retail margin applies to network costs in addition to the retailer's wholesale and retail costs.

Application of the percentage retail margin to prices

IPART and QCA reapply the retail margin each year as a consistent percentage of the total costs. This approach is sensible as the margin expressed in dollar terms will then increase and decrease with the overall cost total. We believe it would be incorrect to determine a margin based on a percentage of total revenue for year one, translate this to a dollar margin and hold the dollar margin constant in real terms in subsequent years. There is no clear justification for holding the retail margin at a fixed dollar level in contrast to a percentage retail margin that has been derived via a detailed method.

¹⁹ For example see: IPART, Review of regulated retail prices and charges for electricity 2013 to 2016 – Electricity: Final Report, June 2013, page 88

²⁰ IPART, Review of regulated retail prices and charges for electricity 2013 to 2016 – Electricity: Final Report, June 2013, page 89. QCA, Regulated Retail Electricity Prices 2013-14, Final Determination, May 2013, page 55

²¹ AMEC, Issues Paper, page 40

Question 9(c) - To what extent should the relationship between the retail operating cost and the retail margin be taken into account?

Retail operating costs, along with retail capital expenses, network and wholesale costs, form part of the cost base that should all be included when determining retail margins. There should be no need to consider the margin on retail operating costs in isolation of items in the cost base.

5.3. Competition allowance

Question 10(a) - Should some form of competition allowance be included in the regulated retail electricity price to encourage competition?

When a competition allowance should be set

In a contestable market, we believe that it is essential to include an allowance in the regulated price that is designed to promote competition. This allowance wouldn't be required if the customers had no choice of retailer. In a competitive market, retailers incur significantly higher costs to offer discounts, undertake sales and marketing activities, maintain systems, staff and functions than in a non-contestable market. These costs are ongoing, but are a means to drive investment, and in turn, drive prices down to an efficient level that could not be achieved otherwise. A competition allowance is therefore not an additional cost when other components of the retail price are driven to lower levels than achievable in a monopoly situation.

A competition or headroom allowance can be seen as an additional cost that customers have to pay. However, we point out that it would only be introduced in a market where customers have a choice of retailer and can access prices that are typically lower than the regulated price. In any competitive market there are always some customers paying more than others. If a choice is made to set up a competitive market, this is one of the corollaries that must be accepted. While not all customers may participate in the competitive market, it is a quick and straightforward process for customers to contact their existing retailer (or any other retailer) and transfer to a better price. All customers have this option.

Evidence for a link between headroom and observed competition levels

The competition or headroom allowance contribute to competition where the remainder of the regulated price is set at an efficient level. IPART recently assessed the level of competition compared to the amount of margin above the efficient cost that came from their Customer Acquisition and Retention Cost allowance and margin that wholesale energy cost allowance was above market cost for each year from 2007/08 to 2012/13.²² There was a clear link between the amount of headroom and the level of competition seen in the NSW electricity market (which has been at high levels in recent years). IPART found that it was:

“reasonable to conclude that the incentives included in regulated prices will significantly influence the level of competitive activity. The evidence suggests that as the incentives in regulated retail prices increase, so does the level of competitive behaviour by retailers and market participation by customers.”

A similar analysis has not been conducted for Queensland, but we note that competition levels in Queensland have been declining over recent years²³ despite the headroom allowance remaining constant at 5% of cost-reflective prices. In our view, the headroom allowance has

²² IPART, Review of regulated retail prices and charges for electricity 2013 to 2016 – Electricity: Final Report, June 2013, pages 112-115

²³ EnergyAustralia response to the QCA, Regulated Retail Electricity Prices 2013-14, Draft Determination, 22nd Mar 2013, pages 17-18

not promoted competition in the way intended in Queensland, as the regulated price has previously been set below efficient levels. Therefore, retailers have used the 'headroom allowance' to recover costs rather than compete for customers.

Question 10(b) - How should this competition allowance be included in the regulated retail electricity price and how should it be estimated?

A competition allowance should be included in regulated retail prices for all contestable jurisdictions or when a jurisdiction first starts to open up to retail contestability and competition.

There are many different types of competition allowance that are included in regulated electricity prices. We don't have a strong preference for which method is used. Of primary importance are that the derivation of the allowance is straightforward and predictable, that it is set at a reasonable level and doesn't vary greatly from year-to-year.

The calculation of the value of the headroom allowance should include both top down and bottom up approaches and benchmarking to ensure that it is reasonable. As for retail operating costs, a full assessment of the competition allowance may only be required once per regulatory period. A CPI escalation may be appropriate if the competition allowance is based on a dollar amount rather than a percentage (as it is in Queensland).

6. Environmental and jurisdictional schemes

6.1. Large-scale Renewable Energy Target

Question 11 - Which methodology is more efficient in terms of estimating the 'price' of the compliance costs of the LRET - historic market prices, futures market prices, LRMC or the penalty price?

The cost based approach to estimating the cost of the certificate is preferred over an approach referenced to market prices. In 2013, the liquidity in the traded large scale generation certificate (LGC) market has been very low. Trading levels have greatly reduced since the removal of supply from small-scale technologies from the beginning of 2011.

Retailer's obligations under the scheme are largely met through either building large scale renewable generation (predominantly wind farms) or long term contracting of the output of such generators. As the legislated target increases significantly to achieve the 20% renewable energy goal by 2020, significant new capacity will need to be built and will be the main driver of the cost of compliance. As such, the LRMC approach better reflects the costs to retailers than the limited volumes trading through the market.

While LRMC is the best methodology in current market conditions, it is possible that this may change for a variety of reasons. Building the large scale generation required may not be feasible due to reasons such as permitting restrictions, construction expertise shortage, or other unforeseen issues. In such an environment, retailers would most likely have to pay a higher market price or even the scheme penalty price to meet their obligations. A best practice approach should be flexible enough to accurately reflect the real cost to retailers of the LRET if prices rise above LRMC

6.2. Small Scale Renewable Energy Scheme

Question 12(a) - How should the issue of the timing difference between when the STP is set under the SRES (by calendar year), and when regulated retail prices are set (by financial year) be addressed?

The Australian Government has recommended that the STP be released by the 1st December prior to the calendar year in which it applies.²⁴ This is four months earlier than the past release date and alleviates some of the timing issues of the release of the binding small scale technology percentage (STP) being for use in setting regulated prices based on a financial year.

Regulators have always been able to set the first half year (July – December) prices based on a binding STP value for the current calendar year. For the second half of the regulatory price year (January – June), the regulator will still need to rely on the non-binding estimate for the STP. However, as the final, binding estimate for the next calendar year will be available much earlier, there will be time to undertake a cost pass through review and update prices if the binding estimate differs from the non-binding estimate. This was not a feasible option when the STP was released at the end of March as the cost pass through review would coincide with the annual regulatory price review.

The AEMC correctly notes that "retailers may still be required to bear some cost recovery risk due to the timing difference between when they are required to purchase STCs to meet their

²⁴ See recommendation 15 at: <http://www.climatechange.gov.au/reducing-carbon/renewable-energy/renewable-energy-target/ret-scheme-updates/australian-government>

liabilities and when regulators undertake [pricing reviews].”²⁵ When this occurs, IPART calculates a holding cost using the weighted average cost of capital they estimate for retail businesses and based on the period that retailer will have incurred costs (including incremental margin) prior to recovery.²⁶ We believe this is an appropriate approach.

Question 12(b) - Which methodology is more efficient in terms of calculating retailers' compliance costs of the SRES - the clearing house approach or a market based approach?

Under the current design of the SRES, the opportunity cost of the Small-scale Technology Certificate (STC) remains at \$40 and therefore we recommend that the price continues to be set at that level. The Small-scale Renewable Energy Scheme is not designed as a free market. It is purposefully designed so that creators of STCs can obtain \$40 for each STC. This is done by setting demand to match supply, and through the use of the clearing house mechanism, which guarantees \$40 for the seller. In efficient market conditions where supply equals demand, the cost to retailers for STCs will be \$40 per certificate.

Historically in the STC market, demand has not matched supply and the market has traded below \$40 in response. This has been due to the inability of the Clean Energy Regulator (CER) to forecast the effect of market factors such as the Solar Credits Multiplier and various state based feed-in-tariffs when setting the target Small-scale Technology Percentage (STP). These factors have largely been removed from the start of 2013, which will reduce greatly the creation of STCs, and will enable the CER to set a target more accurately in line with supply. The removal of these incentive mechanisms also decreases the overall size of the STC market, which enables demand to be more accurately set in line with supply. With demand equal to supply, sellers will obtain the guaranteed \$40 offered by the clearing house.

Attempting to model other factors that may lead to market participants selling below the \$40, such as their individual holding costs, would be extremely difficult. As the STC market has matured, it has also consolidated and the number of cash constrained participants has decreased.

Question 12(c) - If a market based approach is used, what methodology should be used in forecasting future STC market prices?

The use of a volume weighted spot price is not an accurate method for determining the cost to retailers for purchasing their STC obligation. The price recently calculated by Frontier Economics for IPART in the review of regulated electricity prices in NSW was \$33.77 per certificate (based on a 40-day period). This was nearly \$4 below the current spot price at the time (7th May 2013). Similar issues are expected using a volume weighted spot price over a longer period due to the issues with the artificially depressed spot prices noted in response to question 12(b) above. This highlights the inappropriateness of using this simplistic approach alone, without consideration of the scheme design.

However, if a market based approach is to be taken, it should reflect the risk that a retailer faces in trying to secure its entire STC obligation at a given market price. A premium to reflect this risk could be based on the pricing of 'At the Money' Call Options, with a duration covering the time from the market price calculation period to the surrender date of the STCs (see section 3.1, question 4(d), 'Managing carbon costs post the fixed price period'). The inclusion of this adjustment in the SRES methodology would partially address the risks that retailers face under a market-based approach.

²⁵ AEMC, Issues Paper, page 49

²⁶ IPART, Review of regulated retail prices and charges for electricity 2013 to 2016 – Electricity: Final Report, June 2013, page 217

6.3. Jurisdictional energy scheme costs

Question 13(a) - What factors should be taken into account in estimating the cost of jurisdictional environmental schemes?

NSW Energy Savings Scheme (ESS)

The certificates for the ESS trade infrequently and in low volumes in the OTC market, and those that do trade do so only at a slight discount to the after-tax penalty price. For the 2011 compliance year, certificates were difficult to obtain with some retailers forced to pay the penalty. Supply was tight again in 2012, and it is expected this will continue as the demand increases with higher scheme targets in 2013 and 2014. The uncertainty around supply, increasing demand, and illiquidity of the OTC market, support the setting of the price at the after-tax penalty.

We therefore agree with the comments made by IPART and support the approach they used to determining ESS costs in their recent price determination:²⁷

“In our view, there is a lack of depth in the observed spot market for ESCs that makes it difficult to rely on the traded price data to estimate the cost of an ESC. We also consider it would be difficult to use a cost-based approach for this estimate (as we did in calculating the cost of complying with the LRET). This is because a cost-based approach involves estimating the cost of overcoming barriers to the take-up of energy efficiency projects, as opposed to the cost of energy efficiency projects themselves (these should be at least cost-neutral). Therefore, we have made a final decision to continue to use the base penalty price (currently \$27.07 per MWh) as a proxy for the price of ESCs.”

ACT Energy Efficiency Improvement Scheme (ACT EEIS)

The ACT EEIS is relatively new and the estimation of costs has recently been based on an ICRC methodology using costs supplied by ActewAGL.²⁸

Going forward, we would like to see this methodology consider the efficient costs of both tier 1 and 2 retailers. As the scheme outlines different obligations for tier 1 and 2 retailers, the allowance should be set at the level of the tier 1 retailer (ActewAGL)²⁹, except when the price paid by tier 2 retailers is higher, in which case the tier 2 cost should be used instead. It would be detrimental to competition if the scheme design and the price regulation approach were to prevent tier 2 retailers from recovering their full (efficient) costs under this scheme.

The Queensland Gas Scheme

The Queensland Government announced recently that the Queensland Gas Scheme will be closed at the end of 2013;³⁰ therefore, we do not believe it should be included in any future retail price methodology that sets prices from 1st July 2014.

²⁷ IPART, Review of regulated retail prices and charges for electricity 2013 to 2016 – Electricity: Final Report, June 2013, page 84

²⁸ ICRC, Retail Price Adjustment for Franchise Electricity Customers 2013–14, Final Decision, Report 4 of 2013, June 2013, pages 12-13

²⁹ The majority of electricity customers in the ACT are with incumbent retailer, ActewAGL.

³⁰ <http://www.business.qld.gov.au/industry/energy/gas/queensland-gas-scheme>

Question 13(b) - Is a national approach to estimating these costs appropriate given the differences between jurisdictional environmental schemes?

It would be difficult to establish a national approach to calculation costs for jurisdictional environmental schemes given that they are all set up differently. We recommend that the AEMC determine the most suitable cost estimation approach for each one and allow cost pass through reviews on this component if unforeseen changes occur during the regulatory period.

7. Form and timing of price controls

7.1. Review of the best practice retail price regulation framework

It is important that the best practice retail price regulation framework being created by the AEMC includes a mechanism by which the framework is periodically reviewed. It should particularly be reviewed and consulted on prior to use in any jurisdiction. Periodic reviews should be able to be triggered by a submission to the AEMC by retailers as well as regulators, government and government entities.

7.2. Form of regulation

Question 14(a) - What is the most appropriate form of regulation to apply given our objective for retail price regulation?

(i) Does the appropriate method differ depending on the state of competition in the retail market? For instance, should a different method apply in jurisdictions with limited competition, such as Western Australia, the Northern Territory, and Tasmania?

Building block compared to an index-based approach

A building block approach is more transparent and predictable than an index approach to setting prices. When cost pass through reviews occur, a building block approach also provides a more direct and straight forward approach to adjusting the regulated price. Usually when prices need to be adjusted, the most immediate measure of the change is a variation in the dollar amount.

If using an index approach, any cost differences either need to be calculated based on the dollar amount or need to be assessed using a less direct approach (e.g. a top down approach). The AEMC is correct in pointing out that it is difficult to maintain cost-reflective prices when using an index approach as all regulated prices in each state are likely to need to be differing percentages each year.³¹

For all these reasons we suggest that AEMC base the best practice retail price regulation on a building block approach.

Methodologies for adjusting prices

A weighted average price cap (WAPC) approach is generally our preferred form of regulation for adjusting regulated prices. This approach is more suitable for transitioning to a state where price regulation can be removed as it is a flexible method by which retailers can ensure that each regulated price moves towards, and maintains, cost-reflectivity.

A revenue cap is only a real option in a monopoly market as contestable markets make the idea of allowable revenue from a moving customer base a much more challenging and less useful concept. However, we believe that all electricity markets in Australia should aim to become competitive and have price regulation removed (see further comments in next section – Evolving the form of regulation).

Having a regulator set individual prices takes the price rebalancing/cost-reflectivity decisions out of retailers' hands and would create more uncertainty of the pricing decisions that would be made once pricing is deregulated.

³¹ AEMC, Issues Paper, pages 54-55

Evolving the form of regulation

In all the regulated energy markets we operate in, our traditional preference has been for a building block approach to setting regulated prices and a WAPC approach to adjusting prices (along a cost pass through mechanism). We believe this approach would also be suitable for Western Australia, the Northern Territory, and Tasmania, and that these states should progress towards this form of price regulation quickly once they become contestable for retail customers.

However, in regulated markets where competition is effective, such as NSW and Queensland, we prefer that a lighter-handed form of regulation be used instead. This lighter-handed approach would still be based on a building block and WAPC approach, but would be more similar to the Voluntary Pricing Arrangements that IPART has put in place for the regulation of NSW gas prices for small customers.³² IPART recently determined how such an approach would work for regulated NSW electricity prices in future:³³

“EnergyAustralia proposed we use a more light-handed approach whereby annual reviews are based on the Standard Retailers’ pricing proposals for the coming year. Under this approach, IPART would assess these proposals to determine whether they are ‘reasonable’ having regard to the terms of reference and the Act. We would then decide whether or not to agree with them based on this assessment.”

...

“In particular, we consider the proposal will provide greater opportunity for retailers to be involved in the annual review and take ownership of pricing outcomes. This is consistent with our view that given the increased competitiveness of the market, there should be more reliance on competition to protect consumers and provide them with better outcomes.”

...

“In light of the above, we have made a final decision to commence the annual reviews by inviting each Standard Retailer to submit an annual pricing proposal.”

Question 14(b) - Should a form of regulation be applied to all cost components?

The weighted average price cap approach should be applied to all cost components. Although the building block approach used to construct the prices often references a network pass through component, there is no necessity for the ‘pass through’ to be applied rigidly when setting prices. Where cost-reflectivity issues exist in tariffs (or when they are newly created by a distributor who radically alters their network tariffs from the previous year), a WAPC approach has the flexibility to soften the impact to customers until prices return to full cost-reflectivity.

Question 14(c) - What costs should be reflected in the variable and fixed components of regulated prices?

As discussed in the responses to the other questions in this section, we have a strong preference for the WAPC approach where the incumbent retailer is responsible for setting the fixed and variable components of regulated prices.

However, if this were not to be the case then we suggest that the fixed component of the regulated price should include any costs that are fixed with respect to energy usage. For

³² IPART, Review of regulated retail prices and charges for electricity 2013 to 2016 – Gas: Final Report, June 2013, page 1

³³ IPART, Review of regulated retail prices and charges for electricity 2013 to 2016 – Electricity: Final Report, June 2013, page 134

example, these include fixed network costs, virtually all of the retail costs. Retail costs tend to vary more with customer numbers than they vary with electricity consumption. The only retail cost component that we believe is partly influenced by consumption is the cost of bad debts. However, even taking this into account only a small percentage of the overall retail operating costs could be considered variable.

7.3. Determination length and cost pass through reviews

Question 15(a) - What is an appropriate length of a retail price determination?

Although we are comfortable with a one to three-year retail regulatory period, we suggest that the decision is often best made on a case-by-case basis for each state depending on market objectives, and expected market events or changes. This could mean that it would not be sensible to set a long regulatory period if, for example, pricing regulation may be removed, or a major market structure change was anticipated within the next year or two.

We question that a shorter or longer regulatory period will have any material effect on incentives for cost efficiencies in the retail electricity market. The reason for this is that major cost components such as the wholesale energy cost are usually recalculated every year using updated inputs. Each year the regulator's prediction of forward market costs might be better or worse than the previous year. Therefore, within the regulatory period, retailer's revenues may fluctuate according to this difference to actual energy costs (assuming all retailers set their market prices at the same level as the regulated price, which is not always the case). This effect often outweighs any other regulatory certainty on price levels that might otherwise extend over the whole regulatory period.

Question 15(b) - If a retail price determination lasts longer than a year, what cost components should be subject to an annual review and should the methodologies for estimating cost components remain unchanged?

The following components of the regulated prices should be reviewed and updated annually:

- Network costs (implicit in a network pass through building block approach)
- All components of the wholesale energy cost allowance (except the load forecasts)
 - LRMC
 - Market cost
 - Green costs
 - Energy losses, NEM fees, ancillary services costs
- Parameters involved in the weighted average cost of capital calculation

Other components may be escalated by CPI (such as the retail operating costs and competition allowance) but not fully reviewed.

This approach provides regulatory certainty whilst reassessing inputs where the costs are unpredictable or partially/wholly uncontrollable for retailers.

Question 15(c) - Should retail price determinations include a pass through mechanism? If so, what events should be included the pass through mechanism and what should be the materiality threshold?

The need for a cost pass through mechanism

A cost pass through mechanism is essential in the regulatory package as there are often events that occur during a regulatory period that cannot be foreseen or for which the impact of the event cannot be adequately predicted at the start of the pricing year.

Due to the heightened sensitivity to electricity prices and the interest in addressing peak demand and other challenges currently faced by the energy industry we are seeing a greater level of government and regulatory change. This adds risks and therefore cost for retailers. It is critical that retailers can recover costs that where:

- it is out of their control to avoid or minimise those costs; and
- the costs would have been included in the regulated price had they been known earlier.

The AEMC notes that:³⁴

"A list of pass through events reduces the incentive on retailers to manage or mitigate the risks associated with the occurrence of these events, if they have improved certainty they will be able to recover the cost impact through the pass through mechanism."

We completely disagree with this statement. Looking back over past regulatory pricing cost pass through reviews, we question that retailers would have acted in a way to not manage or minimise their costs. Under these cost pass through reviews, the regulator doesn't guarantee that the cost pass through will be successful and will only ever allow for efficient costs to be passed through.

Materiality clauses

Many regulators consider having a materiality clause in their cost pass through mechanism, This type of clause is not necessary when price change can only be made from the start on the next pricing year. The reason for this is that the administrative costs for regulators and retailers are considerably less if cost pass through reviews and price updates are made concurrently with the annual pricing review.

If a cost pass through is to be considered and prices changed mid-way through the pricing year then it may be appropriate to use a materiality threshold to balance the administrative costs of participating in an out-of-cycle regulatory review and for retailers having to make out-of-cycle price changes.

Cost pass through event triggers

The events that should trigger either a cost pass-through review or the inclusion of a catch-up amount relate to any change that is made by a statutory or industry body that is outside of retailers' control. This includes decisions made by government, regulators and other government bodies, the tax office and distributors. It should also include events where an expected change is rescinded or substantially revised after costs have been incurred by retailers. For example, if a state government were to decide not to implement the National

³⁴ AEMC, Issues Paper, page 61

Energy Consumer Framework (NECF) after retailers had begun preparations in the reasonable expectation that it was due to come in within the next 12 months.