



independent competition and regulatory commission

Australian Energy Market Commission

**First Draft Report: Review of the Effectiveness of Competition in the
Electricity Retail Market in the ACT**

(Reference: EPR0017)

Submission from the
ACT Independent Competition and Regulatory Commission

17 August 2010

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(see page 7 for clarifying information)**

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Introduction

The Australian Energy Market Commission (AEMC) has released its First Draft Report as part of its Review of the Effectiveness of Competition in the Electricity Retail Market in the ACT. Submissions on the Draft Report have been requested by 27 August 2010.

The purpose of the First Draft Report is to address the question of whether competition in the ACT electricity retail market is effective. Based upon its consideration of submissions received, the AEMC will prepare a First Final Report on the effectiveness of competition. In conjunction with the release of the First Final Report, AEMC has foreshadowed its intention to release a Second Draft Report on options to phase out retail price regulation (where the First Final Report has concluded that competition is effective), or provide advice on ways to promote competition if the First Final Report has concluded that competition in the ACT is not effective. In the public forum held in Canberra on 13 August 2010, the AEMC advised that, should the First Final Report find that competition is not effective, this would not constrain the advice that it might offer in its Second Draft Report on options to phase out regulation of retail electricity prices in the ACT.

Thus, given the importance of the findings in the First Final Report for any recommendations made by the AEMC, the Independent Competition and Regulatory Commission (ICRC) is of the view that it is fundamental that the AEMC's assessment and the data upon which it is made is soundly based and rigorously applied to the conclusions reached in the First Final Report. It is in this context that the ICRC makes this submission. The ICRC does not necessarily seek to promote its publicly stated views on what action needs to be taken concerning the future of retail price regulation in the ACT, but to ensure that the analysis and conclusions presented in the First Final Report are based upon properly researched and analysed data.

The ICRC has had 14 years experience in regulating the retail price of electricity in the ACT. The retailing of electricity to customers consuming more than 160 MWh per annum was made contestable from 1998. The electricity supply industry in the ACT was then further opened to competition from 1 July 2001 with the extension of competition provisions to customers consuming more than 100 MWh per year. Full retail competition (FRC) was finally extended to all customers from 1 July 2003, although at that time the ICRC was required to determine a transitional franchise tariff (TFT) for those small customers who opted not to accept or seek a contestable price offering for their electricity supply. The regulated TFT has continued to operate up until the present, notwithstanding advice from the ICRC that there was no longer a requirement for this form of price regulation in the ACT market.

The ICRC has maintained the view that in the long term the removal of the regulated TFT is desirable. As stated in its most recent report on the setting of the TFT¹, *'this will allow the market to find the most appropriate pricing structures and encourage competition in the development of alternative products and level of service'*. The ICRC has linked this recommendation with a recommendation that a retail price monitoring arrangement similar to that operating in Victoria be introduced which would enable action to be taken to re-regulate prices should the market not reflect what might be broadly described as 'competitive pricing outcomes'.

Over the period during which it has played a significant role in the pricing of electricity in the ACT, the ICRC has been acutely aware of the factors and issues that have played upon the operation of the market in the ACT, and this has been reflected in the analyses and considerations that have guided the ICRC in the derivation of the regulated retail tariff in its various forms over the past 14 years. It is from this perspective that the ICRC offers the following comments on the data and analysis contained in the First Draft Report.

Competition in the ACT market

The ICRC does not disagree with the AEMC's findings that the level of competition in the ACT market for small household sized customers is currently very weak. While there is some market presence by competing suppliers, effectively ActewAGL Retail holds almost all of the household customer market, either by way of franchise customers (who pay the TFT determined price) or customers who have opted to accept a bundled package of services from ActewAGL Retail with differing levels of discounts on their electricity charges or the charges for other bundled services. The ICRC has discussed the issue of the level of competition and possible causes in some detail in its most recent electricity price determination report.²

The AEMC recognised this situation in the First Draft Report but has not addressed some of the fundamental reasons for this current situation which in turn have important implications for its findings on the ACT market and what actions the AEMC may ultimately propose. Particular emphasis has been given in the First Draft Report on the issue of the customer acquisition costs or customer acquisition and retention costs (CAC/CARC) as a reason for the current state of competition in the ACT market. However, as discussed further below, there appears to be a misunderstanding or omission in the analysis that has been undertaken concerning these matters, and it is contended that the emphasis that has been given by the AEMC to CAC/CARC may be overstated.

Leaving aside the assessment of the CAC/CARC issue for the moment, the AEMC in the First Draft Report does not appear to have critically analysed other possible factors influencing the decisions of retailers to enter or actively compete in the ACT market. Rather, the AEMC notes in the First Draft Report a number of possible factors but puts these aside as secondary to the CAC/CARC issue. In support of this view, the AEMC has relied heavily upon comments received in its retailer interviews undertaken by the Roy Morgan Group.

¹ ICRC *Final Decision, Retail Prices for Non-contestable Electricity Customers 2010-2012*, Report 7, June 2010

² Ibid, noting particularly Chapter 8

However, as demonstrated by comments made at the Canberra public forum by at least two retailers (other than ActewAGL Retail) who are active in the ACT market, there are alternative views on the reasons for the apparent reduction in direct competition being expressed by retailers. These views do not necessarily accord with the conclusion reached by the AEMC that these other factors are secondary.

The difficulty that the AEMC faces (and that the ICRC has had to address over the 14 years of experience in regulating these retail prices), is how to evaluate independently and critically the comments that are made by interested stakeholders. The AEMC assessment of what are the fundamental determinants of the level of retail competition in the ACT is critical to the decisions that will ultimately be taken by the Ministerial Council on Energy and the ACT Government in response to the AEMC's Second Final Report. Thus, there is a need for a more stringent consideration of the issues that have been raised by retailers and by the ICRC in its public reports than is demonstrated in the First Draft Report.

The First Draft Report makes reference to the volatility in the wholesale electricity price around 2007, and implies that this is possibly part of the cause, although there is still the emphasis back to the CAC/CARC issue. Noting that the volatility issue has been a significant issue for regulators of retail electricity prices in other jurisdictions, the First Draft Report goes on to say that the *'market-based approach to the WEC (wholesale electricity cost) estimate combined with the frequency of pricing decisions would appear to accommodate wholesale price volatility (for ACT suppliers) without the need for an additional term in the calculation'* (pp 54-55). The ICRC would not disagree with this conclusion. However, the difference in approach used in the ACT by comparison to that applied by other regulators also raises the much larger question as to what other differences exist between, for example, the NSW pricing system as administered by IPART and that adopted by the ICRC in the ACT.

There are fundamental price determination issues involved here that the AEMC does not appear to have addressed, but the ICRC has endeavoured to consider in its reports on the modelling of the wholesale electricity price³ and the determination of the TFT. To the extent that fundamental differences in regulatory price setting methodologies exist between the ACT and other east coast electricity regulated markets which can result in WEC prices significantly above the observed market price (viz NSW and Queensland), and where these markets are substantially larger than the ACT, foundation issues are raised that must be properly evaluated by the AEMC if it is to come to balanced conclusions and recommendations on competition issues in the ACT.

As an example of further work that needs to be undertaken by the AEMC, attention is drawn to Box 5.1 in the First Draft Report in which the activity of competing electricity retailers in the unregulated large customer segment of the ACT market is noted. A fundamental question that must be addressed is the behaviour of first-tier and second-tier retailers in terms of this market, and in particular the apparent withdrawal of some of these larger retailers from the ACT market post 2007.

³ See ICRC, *Model for Determining the Energy Purchase Cost Component of the Transitional Franchise Tariff, Final Technical Report, Report 3, 2010*

There is little doubt that the market volatility that occurred in 2007 caused a rethink by some retailers of their marketing and target market strategy. In this large customer segment of the market, however, there was no question of what may or may not have been included in the regulated tariff set by the ICRC. Yet Integral Energy and Energy Australia significantly withdrew their presence in what otherwise might have been seen as an attractive and, in terms of government presence, potentially high-profile market. What caused this change in approach, and to what extent were the factors that influenced these decisions by major retailers also reflected in their decisions in terms of the household market in the ACT?

Treatment of customer acquisition costs

In the First Draft Report, the AEMC has given considerable emphasis to this issue, drawing upon the work undertaken for it by the Allen Consulting Group (ACG). It is noted that in the interviews with retailers which were undertaken by Roy Morgan, this issue was also placed high on the list of issues that retailers considered influential on why they had not continued or progressed with their entry into the ACT market (although still retaining their licence to retail in the ACT market).

In focussing upon the CAC/CARC issue, the AEMC has replicated tables taken from the ACG report, in particular tables 7.2 and 7.3. These purportedly show that the effective margins that operate in the ACT under the TFT after allowance has been made for the CAC/CARC costs are *'below the level that has been set by the ICRC'*. The First Draft Report goes on to add that the effective margin *'is also less than what retailers expect to prevail in a market that has effective competition'*, and further *'also appears to be less than that available in other jurisdictions'*.⁴

The ACG analysis upon which the AEMC has relied is not a complete picture, but rather gives a slanted view of the position in the ACT. To support its argument, ACG has relied upon its own calculation of effective margins using CAC/CARC costs taken from NSW and Queensland price determinations and applying these to the ACT. However, it failed to note that the build up of retail operating costs (ROC) as used by the ICRC already incorporates a sales and marketing cost element⁵ which has been adjusted annually by movements in the Consumer Price Index. Thus, the ROC used in the ACT already includes some element of a CAC/CARC cost, the presence of which should be taken into account in the analysis on effective margins undertaken by ACG.

Consideration should also be given to the **actual dollar value** of the ROC allowance made by the ICRC by comparison to the other jurisdictions. Table 7.5 in the ICRC's 2010 TFT price determination⁶ provides the dollar value of the ROC allowed by the ICRC and other regulators on a per customer basis. In absolute terms, the ICRC allowance in the 2010 determination of \$104.90 per customer is on a par with the IPART allowance of \$109.80 per

⁴ AEMC, *Review of the effectiveness of competition in the electricity retail market in the ACT, First Draft Report*, 30 July 2010, p61

⁵ See *ICRC Final Determination: Investigation into retail prices for non-contestable electricity customers in the ACT*, May 2003, and referenced in ICRC Report 7, June 2010, p39

⁶ *Op cit*, p 40

customer (including CARC costs) and greater than the South Australian and Tasmanian allowances. However, it is not as high as the Queensland allowance including a CARC cost.

In section 7.3.6 of its 2010 determination, the ICRC presented a discussion of economies of scale in the retailing function. The results presented in Table 7.4 of that report provide a comparison which suggest that after allowing for suggested economies of scale, there may be some merit in the argument concerning the difference between the ROC allowed in NSW and Queensland and that allowed in the ACT where a specific CARC allowance was not included (noting that sales and marketing costs have to some extent already been included in the ACT ROC estimate).

Certainly, the point was made by at least one of the major retailers at the Canberra public forum held by the AEMC that the size of the ACT market was such that after a very brief period a retailer's sales force has fully canvassed the area and there is little value in keeping that sales force active in the ACT when there are much larger market opportunities available in NSW and in particular in the Hunter to Illawarra coastal region (including metropolitan Sydney) where a sales force team can be kept productively active on an ongoing fulltime basis.⁷ Thus, economies of scale would appear to be a relevant factor as previously acknowledged by the ICRC. However, does the exclusion of a designated CAC/CARC allowance fully explain the reason why competitive activity in the ACT market has declined over the last three to four years?

What has not been fully explored in the AEMC First Draft Report is the link between the quantum of the inclusion of a specific CARC allowance and the adjustment in retail prices that retailers have advised the ICRC and the AEMC that they 'desire' before re-entering the market.⁸ Both the AEMC and ICRC have had participants in the electricity retail sector submit that they would seek price increases of the order of 5 to 10% as a prelude to re-entering the ACT market. However, a simple calculation demonstrates that the inclusion of the CAC/CARC estimate assumed by ACG does not increase retail prices by the level indicated by the retail industry as desirable. For example, ACG has used three CARC estimates, viz:

- \$26 per customer per year (\$2.80/MWh)
- \$36 per customer per year (\$3.87/MWh)
- \$42 per customer per year (\$4.52/MWh)

The intermediate estimate (\$36 per customer per year) reflects the IPART decision, and the high estimate reflects the QCA decision. From Table 7.8 of the ICRC's Final Decision for 2010-2012, the inclusion of these amounts (notwithstanding that some allowance has already been made for sales and marketing costs in the ROC which the ICRC would otherwise seek to adjust out so as to avoid double counting) would result in a total retail plus energy plus network costs for each of these estimates thus:

⁷ It was also noted in these comments that the back office costs specifically to meet ACT market and regulatory requirements added to the disincentive to be active in the ACT household market

⁸ ICRC Draft Decision: *Retail Prices for Non-contestable Electricity Customers 2010-2012*, Report 5, April 2010 p52, AEMC op cit, p60

- \$153.81/MWh
- \$154.88/MWh
- \$155.53/MWh

The retail margin would then be applied at a rate of 5.4% as per the ICRC's determination (and in line with practice adopted by other regulators), resulting in a total retail price for TFT purposes as follows:

- \$162.12/MWh
- \$163.24/MWh
- \$163.93/MWh

In terms of the nominal adjustment that this would imply for the 2010/11 year, the increase would have been:

- 4.2%
- 5.0%
- 5.4%

The Commission's final decision for regulated retail electricity tariffs released in June 2010 resulted in a 2.35% nominal increase in the TFT. Thus, the additional impact of including CAC/CARC would have increased tariffs from 1.8% to 3%.

At best, the inclusion of the CARC estimates derived from other jurisdictions only meet the lower end of the range of price increases that retailers have identified as being required before they will re-enter the ACT market.

Having previously considered these outcomes, the ICRC has concluded that the CAC/CARC issue does not of itself explain why retailers have withdrawn or downgraded their activities in the ACT. Although the retailers have talked about the level of the TFT and have linked this to the treatment of CAC/CARC by the ICRC, the evidence would not appear to support the view that a simple inclusion of a CAC/CARC allowance even at the higher end would meet the stated expectations of these retailers. Indeed, it would appear that retailers do not necessarily understand fully just what would be involved should the CAC/CARC allowance be made, but in making a comment on the level of the TFT may in fact be reflecting a view that the cost of operating in the ACT market is higher than that in other markets. If this is so, the question that then needs to be asked is 'what are these additional costs,' and 'what action, if any, might government take to remove or minimise these additional costs'?

The AEMC needs to consider this matter in further detail and not rely on the ACG analysis without further critical examination of the data and the underlying issues involved.

Conclusion

The issues that the AEMC needs to address are complex and possibly further made so by the characteristics of the ACT market and its location within the NSW market yet independent

of it. The ACT market is unlike the markets in other jurisdictions, being essentially a 'city state' without the larger metropolitan components existing in NSW, Victoria, Queensland and South Australia. While the market has characteristics which are potentially similar to other nearby parts of NSW in terms of its household usage of electricity (for example, Queanbeyan, Wagga Wagga and Goulburn), it has other characteristics in terms of large non residential electricity requirements, and separate regulatory arrangements which make it a different prospect for energy retailers.

Yet despite what might be regarded as being a market that would be highly attractive to retailers who are seeking to sell into a national market, its physical location and lack of close geographical links with other major metropolitan areas within Australia, potentially make it a market that is not as easy to service from a retailer's perspective. At the same time, there are still major industry structural changes occurring in NSW in particular, and the 2007 volatility in wholesale prices and the continuing prospect of some form of carbon pricing, has made retailers wary about renewing their marketing presence in this location.

These are issues that the AEMC needs to consider carefully in the context of advice that it might give in its Final Report and against a full consideration of the data that is available. The ICRC stands ready to assist in any way possible in this process so as to ensure the best outcome for the ACT and in particular for consumers in the Territory.

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Independent Competition and Regulatory Commission
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