

1 December 2003



Dr Thomas Parry
Independent Pricing and Regulatory Tribunal
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Dear Dr Parry

Review of Gas and Electricity Regulated Retail Tariffs

This submission from the Energy Retailers Association of Australia (ERAA) is in response to the “Review of Gas and Electricity Regulated Retail Tariffs - Issues Paper” recently released by the Tribunal.

The ERAA is an amalgamation of the National Retailers **Forum**, the Retail Directorate of the Electricity Supply Association of Australia, and the Retail Committee of the Australian Gas Association. The ERAA is the focal point for matters of shared interest to Australia’s energy retail organisations (both Government and privately owned), and it is also the peak body representing energy retailers in Australia.

The ERAA welcomes the referral by the Minister of Energy and Utilities to the Tribunal of the determination of regulated retail tariffs and regulated retail charges to apply to small retail customers in NSW for the period from 1 July 2004 to 30 June 2007. Whilst the terms of reference imply an extension of price regulation to 2007 (without a full assessment or consultation on whether price regulation should remain), the ERAA is encouraged by the Tribunal’s consultation on appropriate forms of regulation for a competitive energy market.

It has been nearly three years since the previous determination for electricity and the Voluntary Pricing Principles (VPPs) for gas commenced on 1 January 2001 and February 2001 respectively. Since that time all but the smallest end of the market – those customers consuming less than 40MWh of electricity and 1 TJ of gas – have had nearly three years of exposure to the competitive market and choice of retailer. And, with the introduction of FRC in NSW in January 2002, all small customers will have had two and a half years exposure to the competitive market by the time of the commencement of the new arrangements on 1 July 2004.

The ERAA members' experiences since the implementation of full retail contestability are that where there are price savings, customers will churn from their regulated tariffs to market contracts. Research recently undertaken in the UK by Ofgem supports this and led to Ofgem's Chief Executive Callum McCarthy issuing a press release¹ which included the following statement:-

“... All the evidence suggests price competition is a key driver of consumer choice. To artificially set one price for all customers would kill competition, as well as stopping those who shop around from getting better deals. It would also remove the competitive pressure on prices for those customers who remain with their traditional supplier.”

The ERAA members' experiences bear this out: where there are price savings, customers do churn from their regulated tariffs to market contracts. However, the current low level of regulated tariffs in NSW is making it difficult for competing retailers to offer price savings to customers at the lower end of the small retail consumption spectrum.

The ERAA is particularly pleased therefore that the Minister's terms of reference for electricity acknowledge that the “the level of regulated retail tariffs relative to market-based prices is the key determinant of how many customers remain on regulated arrangements”.

¹ Ofgem Press Release “Vigorous Competition for domestic customers, but Ofgem remains vigilant” – 16 June 2003

The ERAA strongly believes that regulated arrangements offer second-best outcomes to customers compared to effective competition and that, ultimately, retail price controls should be removed.

The ERAA believes that while NSW regulated tariffs are below cost-reflective levels (particularly for smaller consumption customers) it is difficult for competing retailers to offer contracts which would be attractive to customers. Retaining retail prices below cost-reflective levels also suppresses the need or desire for retailers to offer innovative new products.

For competition to be effective in the small retail segments, regulated rates need to be cost-reflective.

While understanding the imperative to manage price shocks through a transition period, the ERAA believes the sooner market competition sets customer prices - and not a regulator - the sooner more efficient outcomes will be realised. We therefore support regulated tariffs reaching cost-reflective levels as soon as possible and by no later than June 2007 as indicated in the terms of reference. Consequently the Tribunal will need to consider what is an acceptable rate of change taking account of other mechanisms to manage customer pricing impacts (eg government rebates, hardship policies).

With the passage of time since the last determination/VPPs, implementation of effective customer transfer systems, increased customer awareness and increased competition affording added protection to customers, the ERAA considers it is appropriate for the Tribunal to now take a more light-handed approach than with previous reviews. Consistent with a principle of encouraging markets to work effectively, the ERAA would encourage the Tribunal to move away from overly intrusive analysis of detailed costs and margins to a more light-handed approach.

In this context, the ERAA's view is that where retailers propose average price increases less than or equal to CPI then these should be allowed without further review. This arrangement ensures a cost effective and stable price path (no increase

in real terms) for customers whilst allowing default prices to transition to levels determined by the market.

If retailers' proposals lead to an average price increase of more than CPI (a reason for which may be to seek changes to the level of pass-through costs allowed) then these should be justified. Proposals to seek changes to the level of allowed pass-through costs may result from changes to distributors'/network operators' charges or changes in compliance costs associated with the Commonwealth Government's Mandatory Renewable Energy Target (MRET) scheme and the NSW Government's Greenhouse Gas Abatement Certificates (NGAC) scheme).

Where retailers' tariffs are below cost-reflective levels, the form of regulatory controls should be relaxed to allow these tariffs to be moved to cost-reflective levels quickly. The ERAA envisages that price controls will need to differ between retailers if cost reflective levels are to be achieved within the next regulatory period. Arrangements could include average price paths in the form of $CPI + X$ controls and/or a step change (ie a P_0 adjustment at July 2004²). Should tariffs move above cost-reflective levels, competing retailers will offer alternative market contracts.

In the same press statement referred to previously, Ofgem's McCarthy also said:

"...The best way Ofgem can help customers is to continue to make markets work and to ensure customers are well aware of the benefits of switching supplier."

The ERAA encourages the Tribunal to take a similar position to its UK counterpart.

The ERAA believes the Tribunal should undertake this determination with a view to allowing the NSW retailers increased flexibility to set customers' prices in accordance with an agreed set of principles. The Tribunal should review pricing proposals in

² One Second Tier ERAA member does not support the option of a step change control. All other members of the ERAA see this as a valid option,

accordance with these principles for reasonableness without the need for detailed review and consultation.

ERAA proposes the following principles in reviewing the reasonableness of default retail pricing proposals:

1. Facilitate retail competition

Competition is the best form of customer protection. However, as noted earlier, price is a key driver in customer choice and regulated tariffs below cost-reflective levels are stifling competition. The Tribunal should encourage NSW retailers to move regulated tariffs to cost-reflective levels as soon as practicable.

Consistent with facilitating competition, lighter handed regulation with clearer and simpler regulatory frameworks and processes is required. This would reduce the administrative and compliance burdens associated with a price review for retailers and all other stakeholders, resulting in further savings for consumers. Retailers' pricing proposals should be reviewed for reasonableness and to ensure customer price impacts are within any parameters set. If they are, they should be allowed.

2. Managed transition to market-based prices

The ERAA recognises the need to manage customer price impacts in transitioning to an effective competitive energy market in NSW. Our proposal for a light handed approach based on a $CPI + X$ arrangement (with P_0 adjustment to speed up the transition where required) will:

- provide for a managed transition to market-based rates;
- reduce the need for future significant price adjustments;
- allow the electricity default prices of NSW retailers to adjust from wholesale energy costs based on LRMC costs to the actual wholesale energy costs applicable in the market;
- provide retailers with regulatory certainty to manage retail business operations; and
- provide stability and certainty for investors in upstream assets such as generation.

The ERAA urges the Tribunal to adopt the proposed light handed approach to provide the maximum capacity for the market forces to come into effect.

3. Ultimately, regulated tariffs should be removed

While artificially low regulated tariffs remain attractive alternatives to market contracts, competition from retailers will continue to be stifled. The ERAA would promote that regulated tariffs should transition to cost-reflective levels quickly and then, ultimately be removed. The Government may continue to monitor prices and take action under competition law or alternatively maintain reserve powers under jurisdictional regulations. The ERAA has a consultancy under way to examine effective customer protection frameworks with a view to developing a “road map” to achieving effective competition and removal of price regulation supported by effective hardship management programs for vulnerable customers. We are hopeful the findings of this research will assist regulators in constructing paths to a more competitive environment.

We trust you find these comments useful. If the Tribunal would like to clarify these comments further please contact Nicole Stillman of the ERAA Secretariat on Ph: 0417 101 452.

Yours sincerely,



Tony Wood

Chair, ERAA