



Independent Pricing and Regulatory Tribunal

Early Termination Fees

Regulating the fees charged to small electricity customers in NSW

Electricity — Final Report
December 2013



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1 Executive summary

In the competitive electricity market, retailers provide small customers with a range of market offers. In NSW there are some offers where customers are free to change retailers at any time and at no cost to them.¹ However, there are also offers where customers can agree to a contract with a fixed term, or a fixed benefit period (typically between 1 and 3 years).

In exchange for agreeing to provide their business over the fixed term, retailers generally provide these customers with discounts or other benefits. However, there is a risk that customers terminate a contract before the fixed term ends. To manage this risk, a market contract may include an 'early termination fee'. The early termination fee (ETF) acts both as an incentive for customers to fulfil their contract obligation, and as a means for retailers to recover their costs associated with early termination.

Currently, ETFs are unregulated in NSW. Energy retailers can decide whether or not to charge an ETF, and how much to charge. The fee must be a reasonable estimate of the costs to the retailer resulting from the early termination and it must not include costs based on lost supply or lost profit.²

The NSW Government has recently decided to impose requirements on retailers in relation to ETFs under the new National Energy Retail Rules (NSW).³ These rules will come into effect on 1 March 2014.⁴ The Premier of NSW has asked the Independent Pricing and Regulatory Tribunal (IPART) to conduct a review of the maximum amount for one component of ETFs for small customers under market contracts for electricity, or the electricity component of dual fuel contracts.

¹ In some circumstances a special meter reading fee may apply.

² Since 1 July 2013 retailers set this amount subject to Rule 49A of the National Energy Retail Rules.

³ The National Energy Retail Rules as modified by the *National Energy Retail Law (Adoption) Regulation 2013*, and which apply in accordance with the *National Energy Retail Law (Adoption) Act 2012* (NSW) (referred to as the National Energy Retail Rules (NSW)).

⁴ *National Energy Retail Law (Adoption) Amendment (Commencement) Regulation 2013* (NSW).

1.1 What have we been asked to do?

Our terms of reference ask us to set a cap (or caps) for one component of ETFs under the new National Energy Retail Rules (NSW). We refer to this component as the 'base early termination fee' (**base ETF**). The maximum level of the base ETF is referred to as the '**base ETF cap**'.

The second component of ETFs is an amount that represents the monetary costs to the retailer of any upfront inducements offered to the customer. This amount is uncapped and is determined by the retailer.

This means under the new National Energy Retail Rules (NSW) ETFs must not exceed the sum of:

- ▼ the base ETF cap(s) determined by IPART, and
- ▼ the inducement costs of the retailer.

The amount (or amounts) that IPART determines for the base ETF cap must reflect a retailer's reasonable costs of giving effect to the early termination of a market contract or fixed benefit period. We are required to exclude the retailer's inducement costs and costs based on lost supply or lost profit. We must also consider the potential impacts on consumer prices and on competition in the relevant markets, and any other matters we consider relevant, including possible regulatory impacts.

Under the regulations, base ETF caps cannot be applied to:^{5,6}

- ▼ customers on hardship programmes
- ▼ customers receiving the Low Income Household Rebate or the Medical Energy Rebate on the last bill before termination, or
- ▼ customers that paid any part of the last bill by an Energy Accounts Payment Assistance (EAPA) Scheme voucher.

1.2 Our final decision on the base ETF caps

Under our final decision, we have determined base ETF caps of:

- ▼ **\$130** within 12 months of the date of first supply, and
- ▼ **\$45** thereafter (until the end of the fixed term contract or fixed benefit period of a market retail contract).

This is unchanged from our draft decision. These amounts exclude GST.

⁵ Clause 73A, *National Energy Retail Law (Adoption) Amendment (Early Termination Charges and Site Specific Conditions) Regulation 2013* (NSW).

⁶ A retailer is *not* required to waive the recovery of upfront inducements to these customers, calculated on a pro rata basis (according to the period for which the contract was in force).

We have set the base ETF caps to allow retailers to recover the reasonable costs of giving effect to early termination. In response to our draft report, some stakeholders submitted that we had included costs that were not directly related to early termination, but were instead normal costs of doing business. However, some retailers noted that our approach had understated costs for the purpose of setting base ETF caps.

The costs we have included in the base ETF caps represent a subset of the costs that the retailer faces in doing business and we consider that they are relevant costs of early termination. This is because by breaking a contract, customers prevent retailers from recovering certain costs that are generally recovered over the term of the contract. Therefore, we consider that these specific unrecovered costs are costs of early termination. If retailers cannot recover these costs from the customers who impose them, then they will be recovered from all other customers through higher prices.

We consider that our base ETF caps appropriately balance the requirements in our terms of reference to:

- ▼ reflect the reasonable costs of giving effect to early termination, and
- ▼ consider the impact on consumer prices and competition.

It is important to recognise that our final decision will place a cap on fees that already exist in NSW. Therefore, compared to current arrangements, our decision will provide added protection for customers.

We do not expect that the majority of retailers will respond to our decision by changing their ETFs to the level of our caps. Instead, we expect that robust competition in the NSW market will ensure that retailers continue their current practice of providing a diverse range of offers, including:

- ▼ lower prices together with higher ETFs, and
- ▼ higher prices but no (or low) ETFs.

Customers will be able to choose an offer that best suits them.

The longer a customer stays with a retailer during the contract term, the more costs that a retailer recovers before early termination. For this reason, our base ETF cap is lower if a customer terminates after the first year of a contract. This is consistent with what can be seen in many existing ETFs in the market.

As discussed above, the base ETF caps cannot be applied to customers who are on hardship programmes, are receiving certain rebates, or who have paid any part of their last bill using an EAPA voucher. The base ETF caps are also not applied to customers who do not terminate their contract early.

1.3 How we made our final decision

To make our final decision we undertook a process that included public consultation and detailed analysis.

We released an issues paper in August 2013 which outlined the main issues in the scope of the review, set out our preliminary views and invited stakeholders to make submissions. We received 8 submissions to this paper.

In October 2013 we released our draft report and received 11 submissions from stakeholders. We also held a public hearing in November 2013 to discuss our draft decision and receive further stakeholder feedback.

In making this final decision we carefully considered the views put forward in submissions and at the public hearing. We thank stakeholders for their helpful contributions to this review.

1.4 What does the rest of this report cover?

The rest of this report discusses our review and final report in detail. It is structured as follows:

- ▼ Chapter 2 discusses the terms of reference and other context for the review.
- ▼ Chapter 3 sets out our process for the review and the approach we used to make our final decision.
- ▼ Chapters 4 to 6 discuss our key decisions, analysis and considerations in each step of our approach, including those on:
 - the types of costs that retailers currently consider in setting their ETFs
 - the types of costs that should be included in the base ETF caps, having regard to our terms of reference
 - the level and range of these costs and setting the base ETF caps taking account of this range as well as the potential impacts on consumer prices and competition.
- ▼ Appendices A to E provide additional information.

2 Terms of reference and context

The Premier has asked IPART to conduct a review and determine a cap for one component of early termination fees in fixed term contracts in NSW. This cap will apply to early termination fees under the new National Energy Retail Rules (NSW). The relevant provisions are due to come into effect on 1 March 2014.

This chapter describes our terms of reference for undertaking this task. To provide the context for this review, the sections below also discuss the role of early termination fees in competitive markets and the regulation of ETFs in NSW.

2.1 Terms of reference

The terms of reference (**Appendix A**) ask IPART to specify a maximum amount (or amounts) that retailers may charge for the early termination of:

- ▼ a fixed term contract (or the fixed benefit period of a contract) for the sale of electricity, and/or
- ▼ a fixed term dual fuel contract (or the fixed benefit period of a dual fuel contract) in relation to the sale of electricity.

The terms of reference specify that this maximum amount (or amounts) must reflect a retailer's reasonable costs in giving effect to the early termination of the contract. It **must not** include an estimate of costs based on lost supply and lost profit, or an estimate of inducement costs not recovered due to the early termination of the contract. However, retailers will be able to add an (uncapped) amount that reflects these inducement costs to the amount we specify. The amount of these inducement costs included in retailers' early termination fees must represent the monetary costs to the retailer of any up-front benefits offered to the customer, calculated on a pro-rata basis.⁷

In other words, we have been asked to set a cap for one component of the early termination fees retailers can include in their product offerings in the competitive retail electricity market (see Box 2.1). As discussed in chapter 1, we refer to this component as the 'base early termination fee' (**base ETF**) and the maximum level of the base ETF as the '**base ETF cap**'.

⁷ The full definition of inducement costs is provided at Appendix B.

Box 2.1 IPART's role in regulating market contracts

IPART's role in regulating market contracts is limited to setting the maximum Early Termination Fee base (ETF), to which retailers may also add their own conditions to recover any upfront benefits they offer to customers entering into the contracts.



In making our decision on the base ETF caps, we must consider the potential impacts on consumer prices and on competition in the relevant markets, and any other matters we consider relevant, including possible regulatory impacts.

We are also required to review the base ETF caps every 2 years.

2.2 What is the role of ETFs in competitive markets?

Early termination fees are commonly included in the terms and conditions for a range of service contracts, including energy supply, telecommunication and internet services, and business loans. One of the main reasons for their inclusions is to manage the risk associated with the contracting process.⁸

For example, retailers can incur a range of costs in establishing service contracts – including upfront inducements to attract and encourage the customer to sign the contract, investments made on behalf of the customer (eg, purchasing assets, organising services), and administrative costs associated with establishing the contract.

Where these costs are significant, retailers typically structure their product offerings (including the terms and conditions) to recover these costs over a fixed contract term. However, there is a risk that the customer may simply ‘walk away’ from the contract by terminating it before the end of the term.

To manage this risk, retailers often incorporate an ETF as part of the terms and conditions of the contract to protect the ‘investments’ they have made in securing and establishing a contract.⁹ In short, ETFs act as a deterrent to early contract termination, while also allowing retailers to recover some of the contract costs they would otherwise recover over the term of the contract. Thus, ETFs can be seen as a logical market response.

This suggests that subject to the competitive pressures in the market, there should be some relationship between the terms and conditions of a contract and the potential for and risk associated with customers ‘walking away’ from the contract by terminating it before the end of this term.¹⁰ Generally, the benefit for a customer in signing a market contract with a fixed contract period is a relatively lower price compared to an offer with no fixed contract period and no ETF.

⁸ Other reasons could be that retailers value the predictability that comes with term commitments. For example term commitments can allow retailers to organise and plan their business. It can also provide retailers with a predictable revenue stream that can fund capital investment, as well as lower the cost of raising capital.

⁹ Likewise, other terms and conditions may act to protect the ‘investments’ made by the customer (for example, terms and conditions that restrict the movement in prices to certain events).

¹⁰ This relationship, particularly the literature on transaction costs was pioneered by Oliver Williamson O. E., 1979, “Transaction-Cost Economics: The Governance of Contractual relations”, *Journal of Law and Economics*, Vol. 22: 233-262.

2.3 Why is the NSW Government regulating ETFs?

The NSW Government has made amendments to the National Energy Consumer Framework by regulating ETFs to customers wanting to exit their market retail electricity contracts in NSW. This includes regulating the levels of ETFs and prohibiting the imposition of the base ETF amount to:^{11,12}

- ▼ customers on hardship programmes
- ▼ customers receiving the Low Income Household Rebate or the Medical Energy Rebate on the last bill before termination, or
- ▼ customers that paid any part of the last bill by an Energy Accounts Payment Assistance Scheme voucher.

In doing this the NSW Government has sought to provide additional customer protections,¹³ improve customer engagement and participation in the market, and reduce barriers to switching between retailers.

Submissions from energy retailers have questioned the need for government regulation of ETFs in NSW. For example, they have questioned whether there is a market failure that requires regulation and whether setting a cap on ETFs will actually make customers better off.¹⁴

¹¹ Clause 73A, *National Energy Retail Law (Adoption) Amendment (Early Termination Charges and Site Specific Conditions) Regulation 2013* (NSW).

¹² A retailer is *not* required to waive the recovery of upfront inducements to these customers, calculated on a pro rata basis (according to the period for which the contract was in force).

¹³ Minister for Resources and Energy, Special Minister of State, Minister for the Central Coast, Media Release – *NSW families to be protected from early termination fees*, 17 September 2012.

¹⁴ For example, see submissions from Alinta Energy, September 2013, p 1; Energy Retailers Association of Australia, September 2013, p 1; Lumo Energy, September 2013, p 1 and EnergyAustralia, September 2013, p 1.

3 Our process and analytical approach for this review

In conducting this review we have followed a process that includes public consultation and detailed analysis. In making this final decision, we used an analytical approach designed to ensure we consider all the matters we were required to consider and make decisions consistent with our terms of reference. We have also had regard to submissions made and stakeholder input to the review.

The sections below explain our process and analytical approach in more detail.

3.1 Our process for this review

Our process for this review is summarised in Table 3.1 below.

Table 3.1 Review timetable

Key tasks	Timing
Release Issues Paper	15 August 2013
Submissions on Issues Paper due	9 September 2013
Release draft report	21 October 2013
Public forum	4 November 2013
Submissions on draft report due	18 November 2013
Release final report	16 December 2013

In addition to the formal steps outlined above, we have undertaken workshop meetings with key stakeholders in developing our approach to assessing the relevant costs of early termination.

3.2 Our approach for determining the base ETF caps

Our approach for determining the base ETF caps is consistent with the requirements of the terms of reference. In broad terms, our approach includes the following steps:

1. Consider the types of costs that retailers typically seek to recover through current unregulated ETFs,¹⁵ taking account of information provided by retailers, and evidence from other markets.
2. Consider which type of costs should be included in the base ETF caps, consistent with the terms of reference.
3. Consider the level and range of these costs, taking account of information provided by retailers, analysis included in our retail price determination, benchmarks and expert advice provided by consultants that we engage.
4. Set the base ETF caps, taking account of the range of our estimate of relevant costs as well as the potential impacts on consumer prices and competition, and other relevant matters.

To implement this approach, we have used our judgement to balance the matters for consideration specified in the terms of reference. In particular, we have exercised our discretion in applying the terms of reference by considering the:

- ▼ Policy intent of providing protection to customers by constraining the regulated base ETF caps. This involved excluding some costs from the regulated base ETF caps that retailers typically seek to recover through the currently unregulated ETFs (Step 2).
- ▼ Impact this may have on consumer prices and competition. This included consideration of the potential responses of customers and retailers to the introduction of regulated base ETF caps, the potential impacts these responses will have on electricity prices and the level of competition in the retail electricity market (Steps 3 and 4).

We note that if we were to set base ETF caps that recovered a reasonable proportion of the costs that retailers face as a result of early termination, there is less risk of detrimental impacts on electricity prices and competition. Setting cost-reflective base ETF caps means that electricity prices do not need to increase to allow the retailers to recover their legitimate costs. Conversely, if we were to set the base ETF caps too low, market prices for all customers would increase – the ‘average’ customer would then face the costs imposed by other customers who terminate early.

We also note that when we review the level of the cap in 2 years’ time, we can assess the extent to which it has protected customers, allowed the recovery of the reasonable costs associated with early termination and minimised any distortionary impacts on electricity prices and the competitive market.

¹⁵ Subject to Rule 49A of National Energy Retail Rules.

4 Types of costs currently recovered in ETFs

The first step in our review approach was to consider the types of costs retailers typically seek to recover in their current ETFs. There is currently no cap on ETFs, however retailers must ensure that an ETF is a reasonable estimate of the costs to the retailer resulting from the early termination and must not include costs based on lost supply or lost profit.¹⁶

To inform our review we invited electricity retailers to provide information on the costs that they typically seek to recover through their ETFs. This includes both the type of costs and the level and range of these costs. We also examined the ETFs that can be observed in current market contracts. The sections below discuss these findings.

4.1 Costs retailers consider in setting their current ETFs

In their submissions to our issues paper, retailers indicated that they typically consider a broad range of costs in setting their current ETFs.¹⁷ These types of costs include:

- ▼ upfront inducements
- ▼ costs to acquire customers
- ▼ administration costs to establish a contract and to close a contract
- ▼ investments made on behalf of the customer, and
- ▼ energy purchase adjustment costs.

These categories of costs are consistent with those we outlined in our issues paper and draft report. We briefly discuss these cost categories below. In the following chapters we provide more information on these costs and respond to submissions made to our draft report.

¹⁶ Rule 49A of the National Energy Retail Rules.

¹⁷ Origin Energy submission, p 3; AGL submission, pp 1-2; EnergyAustralia submission, p 5; Lumo Energy, p 1.

Upfront inducement costs

Retailers often provide upfront inducements to attract and encourage customers to sign a market contract. These include, for example, a rebate on the first bill, an allocation of reward points, or a magazine subscription. Upfront inducement costs are specifically excluded from the base ETF cap that we are determining. However, retailers will still be able to recover these costs. Under the National Energy Retail Rules (NSW), they will be able to add the proportion of these cost that are unrecovered at the time the contract is terminated to the base ETF.

Customer acquisition costs

Retailers incur costs in attracting customers in the competitive market. For example, these costs include marketing campaigns and commissions paid to sales agents. As outlined in our issues paper, these costs will vary over time and by retailer and customer as a result of several factors, including:

- ▼ the retailer's type and position in the market – for example, new entrant retailers may incur higher costs to build or retain a customer base than incumbents
- ▼ the methods used to acquire customers and the rules associated with these different sales methods
- ▼ whether the customer is a dual fuel customer (electricity and gas) and the impact this has on lowering overall customer acquisition costs per fuel¹⁸
- ▼ the level of competition in the market (ie, how challenging it is to acquire new or retain customers in the market).

In their submission EnergyAustralia noted that external commission payments for dual fuel customers are additive and therefore do not result in a reduction in costs per fuel.¹⁹

Administration costs of establishing and finalising a contract

There are a number of administrative costs involved in establishing a new contract. These include processing the customer details and sending out a confirmation/welcome pack.

Similarly, there are administrative costs when a customer leaves a retailer. These include the costs of final bill enquiries and back office costs. The retailers claim that a customer is also more likely to not pay their final bill which creates costs related to late payment including third party collection costs. Ultimately, some proportion of these bills will remain unpaid and will be written off as bad debt.

¹⁸ Bell Potter, *Australian Power & Gas (APK), Electrifying and energising*, September 2011, p 8.

¹⁹ EnergyAustralia submission, September 2013, p 9.

Investments made on behalf of the customer

Retailers may incur costs by making investments on behalf of the customer they enter into a contract with. These could include the costs associated with purchasing assets or organising services to be able to provide the customer with the service. For example, retailers may become more involved in investing in metering technology or metering services as these functions become increasingly contestable. Investments in these assets or metering services on behalf of the customer could be costly.

Energy purchase adjustment costs

Energy purchase adjustment costs are a direct result of a customer terminating the contract before the end of the agreed term. Where a customer terminates its account early, a retailer may need to adjust its energy purchase portfolio position to account for the reduced load. This adjustment is likely to impose costs on the retailer.

The Public Interest Advocacy Centre (PIAC) submitted that the hedging arrangements of retailers should be able to manage the loss of a single customer without significant cost. It suggests that customers are more likely to switch retailers when prices are rising and therefore retailers are set to make a gain because hedge contracts are 'in the money'. It also suggests that it is inequitable to fully compensate retailers for this risk while also allowing them to gain when market conditions are favourable.²⁰

We agree that rebalancing a hedge position may result in a gain or loss to a retailer. However, we do not agree that retailers are more likely to make a gain because customers switch more when prices are rising. We consider it more likely that customers will switch retailers when prices are falling, to take advantage of lower priced offers. In any case, not rebalancing a hedge position will expose the retailer to additional risk. In our electricity price determinations, our modelling assumes that retailers will seek to minimise their energy purchase cost risk. Consistent with this, our approach to estimating energy purchase adjustment costs involves estimating the premium for reducing the risk of facing a sub-optimal hedge position due to the loss of a customer. We consider that this is a risk management cost for a retailer, not a cost of lost supply. More information on energy purchase adjustment costs is provided in Appendix E, and in a report from Frontier Economics.²¹

²⁰ PIAC submission, September 2013, p 4.

²¹ Frontier Economics, *Estimating energy purchase adjustment costs – A final report prepared for IPART*, December 2013.

4.2 The level and range of ETFs in current market offers

In the previous section, we noted that retailers consider a broad range of costs in setting their current ETFs. In this section we review ETFs that can be observed in current market offers.

We reviewed over 300 electricity market offers available to NSW customers in September 2013 from the Energy Made Easy website (www.energymadeeasy.gov.au). While this is a large number of offers, many contain very similar terms and conditions but are available to customers in different locations and with different characteristics.

These market offers had a range of contract lengths; from no fixed term up to 3 years. Some offers had no ETFs, while the largest ETF we found was \$270 (for an early termination in the first year). These ETFs included any upfront inducements.

The best comparison between ETFs in current market offers and the base ETF cap that we are determining is when upfront inducements are removed from current market offers. It is difficult to do this, for example because sometimes we are unable to determine the monetary value of the inducements (such as reward points). Where it was reasonable to ascertain the monetary value, we estimate that most ETFs would be below \$150 in the first year after excluding upfront inducements. However, we consider this to be indicative only.

It is not surprising that there are a wide variety of ETFs in current market offers. As we noted in our issues paper, this may reflect different costs of supplying customers and retailers' responding to competitive market conditions.²² Both EnergyAustralia and AGL noted that in a competitive market there is a trade-off between cost recovery and the risk that a high ETF will deter customers from taking up an offer.²³ For this reason, ETFs may not be set to recover all relevant costs.

4.3 Disclosure of current ETFs in market offers

In its submission, the Energy and Water Ombudsman NSW (EWON) noted the importance of clearly disclosing early termination fees to customers. It suggested that the end date of contracts and the applicable ETFs should be specified on a customer's invoice prior to the final bill.²⁴

²² IPART, *Early termination fees – Regulating the fees charged to small electricity customers in NSW – Issues Paper*, August 2013, p 12.

²³ AGL submission, September 2013, p 2; EnergyAustralia submission, September 2013, p 5.

²⁴ EWON submission, September 2013, pp 1-2.

Similarly, the Combined Pensioners and Superannuants Association of NSW (CPSA) recommended that information on ETFs should also be included in each bill so customers remain well-informed. In addition, it should be clear whether an ETF will apply if a customer changes address but stays with a retailer.²⁵

We agree that clear disclosure of ETFs is very important for the market to work effectively. We note that the Australian Energy Regulator's (AER's) Retail Pricing Information Guideline requires Energy Price Fact Sheets to include information about ETFs.²⁶ Furthermore, as part of its review of retail energy market competition in NSW, the Australian Energy Market Commission (AEMC) has developed a 'consumer engagement blueprint' aimed at improving customer engagement in the market (which incorporates ETFs). The initiatives include:

- ▼ providing information to consumers through a media campaign that uses different channels to target specific consumer segments as well as the broader community
- ▼ refinements to existing comparison tools, many of which are already being considered by the AER, and
- ▼ training services for community organisations to communicate key messages and assist customers that they work with to use the comparison tools.²⁷

We note that retailers would already have an incentive to waive ETFs in the situation where a customer changes address but remains with their retailer, in order to retain the customer.

In their submission, PIAC recommended that IPART monitor retailer compliance in relation to ETFs.²⁸ We note, however, that this function is already being performed by the AER.

²⁵ CPSA submission, November 2013, pp 3-4.

²⁶ AER, *Retail Pricing Information Guideline*, June 2012, p 6.

²⁷ AEMC, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales, Supplementary Report: Increasing consumer engagement*, October 2013, pp i-ii.

²⁸ PIAC submission, September 2013, p 6.

5 Types of costs to be included in the base ETF cap

In Chapter 4 we found that currently retailers consider a broad range of costs in setting their ETFs. The next step in our approach was to consider the types of costs that should be included in the base ETF cap, having regard to our terms of reference.

The terms of reference requires that the base ETF cap must reflect “a retailer’s reasonable costs of giving effect to the early termination of a market retail contract”. It also requires us to consider the potential impact on electricity prices and competition. Finally, it excludes any costs of lost supply or lost profit, and the costs of upfront inducements.

The key issue in this step is to decide how to interpret this guidance. The sections below explain our final decisions including our consideration of issues raised in submissions.

5.1 Final decision on the types of costs for inclusion in the base ETF cap

Our final decision is that the relevant costs for inclusion in the base ETF cap should be estimated by considering the costs a retailer would avoid if the customer had not signed the contract. This is consistent with our draft decision.

We consider that this approach most appropriately balances the requirements in our terms of reference as it:

- ▼ reflects the reasonable costs of giving effect to early termination, and
- ▼ considers the impact on consumer prices and competition.

This approach was supported by most retailers. However, PIAC, CPSA and the Council of Social Services of NSW (NCOSS) submitted that our alternative approach (the costs a retailer would incur if the customer did not complete the contract) is more aligned with our terms of reference.

A key difference between these approaches is that our adopted approach considers all relevant costs of early termination, whereas the alternative approach only considers incremental costs. Our approach recognises that there are costs that retailers will generally seek to recover over the term of a contract.

Early termination prevents them from doing this. By allowing retailers to fully recover legitimate costs of early termination, it means that they do not need to be recovered from all other market customers through higher prices. In addition, our approach will allow retailers the flexibility to continue to offer a range of different market offers, including some with zero ETFs as they do at present.

In contrast, if we were to account for only incremental costs of early termination then retailers would not be able to fully recover their costs. They would need to recover these costs from other customers, or limit the range of products they offer. If base ETF caps are less than cost-reflective, retailers are likely to respond by setting their ETFs at the level of the cap. This would reduce the diversity of offers available to customers in the market.

In the sections below we describe these 2 approaches in more detail and respond to issues raised in submissions.

5.2 Costs a retailer would avoid if the customer had not signed the contract

One way of interpreting the reasonable costs of giving effect to early termination is to define these costs as those the retailer could reasonably have avoided if the customer had not signed the contract. In this case, the test for whether a type of cost, or what proportion of a cost, should be included in setting the base ETF cap would be whether the cost incurred by retailer would vary as a result of the customer signing the contract. If the cost does not vary, then it may not fall within the set of costs that we must take into account. Table 5.1 summarises the types of costs that we have included under this approach.

Several retailers provided support for this approach as it more closely reflects the types of costs that they typically seek to recover in ETFs.²⁹ In its submission, AGL recommended that a regulated ETF cap should involve a broad interpretation of costs. It noted that upfront acquisition costs are expected to be recovered over the life of the contract and early termination removes the opportunity to fully recover these costs. Therefore, the base ETF should include an amortisation of acquisition costs.³⁰

²⁹ See submissions from Lumo Energy, September 2013, p 1; ERAA, September 2013, pp 1-2; EnergyAustralia, September 2013, p 6.

³⁰ AGL submission, September 2013, p 2.

Table 5.1 Costs retailer would avoid if the customer had not signed contract

Type of cost	Vary as a result of signing contract?	Comment
Customer acquisition and marketing costs (excluding inducement costs)	Some no, some yes	Some costs may not have been incurred had the customer not signed the contract (for example, commissions paid to brokers) while other costs may have been incurred regardless (for example, general marketing costs).
Investments made on behalf of the customer	Yes	These costs are incurred as a result of the customer signing the contract (for example purchasing a meter on behalf of a customer).
Administrative costs of establishing a new account	Yes	These costs are incurred as a result of the customer signing the contract.
Energy purchase adjustment costs	Yes	The cost of rebalancing the energy purchase portfolio to account for the reduced load when a customer terminates early would vary if the customer had not signed the contract.
Administrative costs of finalising a customer account, including bad debt costs	Yes	These costs are incurred as a result of the customer signing the contract.

Of the 2 approaches that we raised, Origin supported the costs a retailer could avoid if the customer had not signed the contract. However, it submitted that this approach may need some refinement to clearly exclude normal retail operating costs that are offset by revenue during the term of the contract, prior to early termination.³¹ We agree with this view and note that the costs considered under this approach are largely fixed costs of acquiring and losing a customer. It does not include, nor did stakeholders submit it should include, variable costs for example, sending out a customer's bill each quarter.

Stakeholders did not consider that these costs were related to 'lost supply and lost profit'. For example, EnergyAustralia noted that the majority of these costs are operational costs and could not be considered lost profit or lost supply.³² We agree with this view. Indeed, as noted in our issues paper, we consider that the exclusion of costs related to lost supply and lost profit prevents us from including amounts that reflect the expected margin over the remainder of the contract term, but do not prevent us from including operating costs.³³

³¹ Origin Energy submission, September 2013, p 5.

³² EnergyAustralia submission, September 2013, p 7.

³³ IPART, *Early termination fees – Regulating the fees charged to small electricity customers in NSW – Issues Paper*, August 2013, p 16.

PIAC, NCOSS and CPSA submitted that some of the costs listed in Table 5.1, for example bad debt and customer acquisition costs, are costs of doing business and not directly related to early termination. On this basis, they noted that the alternative approach discussed in the following section would better reflect the terms of reference.³⁴

The costs we have included in the base ETF cap represent a subset of the costs that the retailer faces in doing business and we consider that they are relevant costs of early termination. This is because by breaking a contract, customers prevent retailers from recovering certain costs that are generally recovered over the term of the contract. Therefore, we consider that these specific unrecovered costs are the costs of early termination. If retailers cannot recover these costs from the customers who impose them, then they will be recovered from all other customers through higher prices.

Under the arrangements for early termination fees coming into place next year, retailers will be able to recover the pro rata amount of any upfront inducements provided to the customer. Our approach to determining the base ETF caps follows a similar logic. We recognise that there are costs that retailers need to recover over a contract term. Early termination prevents retailers from fully recovering these costs, so any unrecovered amounts are costs of giving effect to early termination.

5.3 Costs a retailer would incur if the customer terminates early

Another way of interpreting the reasonable costs of giving effect to early termination is to define these costs as those the retailer would incur if the customer did not complete the contract.

In this case, the test for whether a type of cost, or what proportion of a cost, should be included in setting the base ETF cap would be whether or not the cost incurred by the retailer would vary as a result of early termination. If the costs do not vary, then they may not fall within the set of costs that we must take into account.

Table 5.2 summarises the types of costs that are included under this approach.

This approach essentially captures incremental costs of early termination as opposed to the total costs of early termination. As noted by NCOSS, this is similar to the approach used by the Essential Services Commission in Victoria.³⁵ Because a smaller range of costs are taken into account, it will lead to lower base ETF caps than the approach we have adopted.

³⁴ See submissions from PIAC, November 2013, pp 3-4; NCOSS, November 2013, p 2; CPSA, November 2013, pp 5-6.

³⁵ NCOSS submission, November 2013, p 2.

A number of stakeholders submitted that this approach more closely aligns with the terms of reference for our review. This is because it only captures costs directly related to early termination and excludes ‘costs of doing business’ such as customer acquisition and bad debt costs.³⁶ As outlined above, we consider that the costs we have taken into account are relevant costs of giving effect to early termination.

Table 5.2 Costs a retailer would incur if the customer did not complete the contract

Type of cost	Vary as a result of early termination?	Comment
Customer acquisition and marketing costs	No	These costs are incurred in winning the customer and so do not vary as a result of early termination.
Investments made on behalf of customer	No	These costs are incurred in establishing the services required to meet the retailers obligations under the contract and so do not vary as a result of early termination.
Administrative costs of establishing a new account	No	These costs are incurred in establishing the account and so do not vary as a result of early termination.
Energy purchase portfolio adjustment costs	Yes	The cost of rebalancing the energy purchase portfolio to account for the reduced load when a customer terminates early would vary if the customer did not complete the contract.
Administrative costs of finalising a customer account	Some no, some yes	Some of these costs – such as finalising the bill and returning the security deposit – will be incurred regardless of early termination. However, the timing/frequency of those costs might be affected by early terminations. Further, the inclusion of the ETF in the final bill might affect payment delinquency rates.

Other reasons put forward by stakeholders in support of the ‘costs a retailer would incur’ approach include that the lower base ETF caps that would arise:

- ▼ are more conducive to competition
- ▼ will not increase prices in the market, and
- ▼ will not affect product diversity.

Impact of lower base ETF caps on competition

Some stakeholders submitted that lower base ETF caps would be better for competition. PIAC and Red Energy note that despite the relatively low cap of \$20 in Victoria, this is one of the most competitive energy markets in the world. They are concerned higher base ETF caps under our approach would ‘lock-in’

³⁶ PIAC submission, November 2013, pp 3-4; CPSA submission, November 2013, pp 5-6; NCOSS submission, November 2013, pp 2-3.

customers and make it difficult for them to determine whether they would be better off on an alternative offer. It may also encourage retailers to set their fees at the level of the caps, or to compete on the basis of fees and not price. Red Energy submits that by locking in customers it will be difficult for second tier retailers to gain market share.³⁷

In our view the fact that the Victorian electricity market is competitive is not evidence that the \$20 cap has had no impact on the market. The more appropriate question is whether the Victorian market would be even more competitive if the \$20 cap was higher (or there was no cap). There are also important differences in the Victorian and NSW markets that mean these markets are not directly comparable. For example, in Victoria there is a higher penetration of smart meters which facilitates more innovation in market offers.

As discussed in more detail below, the presence of different ETFs is not detrimental to the competitive market. This is particularly so given we have set our base ETF caps so that they reflect only the reasonable costs of early termination. We do not anticipate that most retailers will change their fees to the caps we set. Instead we expect that competition in the market will ensure that retailers continue to offer a range of different products (including zero ETF offers) to meet the needs of different customers. Setting very low base ETF caps would reduce the diversity of offers available to customers.

Importantly, there are already requirements for retailers to disclose the terms and conditions of ETFs to customers (see section 4.3). Therefore, customers can be fully informed before they sign a contract that includes an ETF. It should be recognised that generally customers are signing a contract for relatively low prices, so long as they agree to remain with the retailer over the contract term. There is concern that retailers change their prices during the term of the contract in a way that customers were not expecting (despite the fine print). This problem is not best dealt with through the regulation of early termination fees. A more targeted response would better deal with this problem including clearer contract provisions.

As we are required to update our decision on the base ETF caps we will closely monitor the market to see how it responds to our decision.

Impact of lower base ETFs on prices

PIAC submitted that competitive pressures in the market will force retailers to respond to lower caps by increasing their efficiency or through innovation, rather than simply increasing prices.³⁸

³⁷ PIAC submission, November 2013, p 7; Red Energy submission, November 2013, pp 2-3.

³⁸ PIAC submission, November 2013, pp 6-7.

We agree that competitive pressure in the market is resulting in retailers setting ETFs that are below the costs that early termination imposes on them. As discussed in section 4.2, retailers often trade-off between higher prices and the need to offer competitive products to customers. Our base ETF caps will allow this practice to continue. However, as discussed above, we do not agree that setting the base ETF caps below cost-reflective levels will not lead to price increases. This was supported by AGL and EnergyAustralia in their submissions.³⁹ Furthermore, as retailers already have an incentive to innovate and improve efficiency, setting very low base ETF caps is not necessary to achieve this. Instead, setting very low caps will distort the market and force retailers to recover their costs through other means.

Impact of lower base ETF caps on product diversity

PIAC submitted that lower base ETF caps would not have adverse impacts on product diversity in NSW. In its submission it provided figures from a St Vincent de Paul Society presentation that showed annual bills in NSW and Victoria (before discounts are applied). It notes that despite the \$20 ETF cap in Victoria, this market has greater product diversity than NSW.⁴⁰

The evidence PIAC refers to relates more to price diversity as opposed to product diversity. In any case, because the annual bills it refers to exclude price discounts it does not consider price diversity. This is because in NSW prices are still regulated and it is common for retailers to quote their prices as a percentage off regulated prices. Therefore it is not surprising that in NSW their appeared to be less price diversity when discounts are excluded. The analysis more reflects the nature of the regulated market in NSW as opposed to real diversity in prices.

When we refer to product diversity we mean, for example, higher prices accompanied with lower ETFs (and vice versa). This diversity allows customers to opt for a greater discount if they are prepared to lock in to a contract period and/or pay a higher ETF. However, if a customer prefers to avoid an ETF this can also be accommodated through zero ETF offers that are also available. We consider that setting very low caps would likely mean that most retailers set their ETF at the cap, thereby reducing the diversity of offers available to customers. In the same document that PIAC reference, it mentions that usually market offers work on the principle of the greater the price discount, the longer the contract and the higher the ETF.⁴¹ It is this sort of diversity that meets the needs of different customers.

³⁹ EnergyAustralia submission, November 2013, p 1; AGL submission, November 2013, p 1.

⁴⁰ PIAC submission, November 2013, pp 7-8.

⁴¹ See slide 14:

http://www.piac.asn.au/sites/default/files/news/attachments/9.10.13_gavin_dufty_piac_presentation.pdf.

6 Setting the base ETF caps

The last steps in our approach were to assess the level and range of relevant costs for the base ETF cap and to set the cap(s) having regard to the requirements in our terms of reference.

To assess the level and range of costs for the base ETF cap we have taken account of cost data provided by retailers. We assessed whether this data should be included in the base ETF cap given the approach we have adopted, as discussed in the previous chapter. We also assessed the data for reasonableness, including benchmarking between retailers, comparing it to information provided as part of electricity price determinations and considering expert advice from our consultant, Frontier Economics.

In the sections below we outline our final decision and provide more detail on the approach and analysis we undertook to reach this decision.

6.1 Final decision on the base ETF caps

Our final decision is that the base ETF cap is:

- ▼ \$130 within 12 months of the date of first supply, and
- ▼ \$45 thereafter (until the end of the fixed term contract or fixed benefit period of a market retail contract).

These base ETF caps are for small customers under market contracts for electricity, or the electricity component of dual fuel contracts. This is unchanged from our draft decision.

6.2 Cost data provided by retailers

We invited retailers to provide data on the costs of early termination. We received confidential cost information from AGL, Origin Energy and EnergyAustralia.

We assessed the data and liaised with the retailers to determine whether:

- ▼ the nature of the cost was relevant for the base ETF cap (given our framework outlined in chapter 5), and

- ▼ the level or range of the cost appeared reasonable given information we have from our electricity price determinations and advice from Frontier Economics.

Based on our assessment we decided to exclude certain cost categories from our analysis. These include:

- ▼ Price discounts provided to customers - even if we could attribute these discounts to the offering of a fixed term contract, we consider that allowing the recovery of the costs of early termination as well as rolling back discounts would be allowing double-recovery.
- ▼ General marketing costs - we consider that some of these costs were general overheads and would not vary if a customer had not signed a contract.
- ▼ Costs for calling a customer to encourage them not to leave early - we consider this is a discretionary cost for a retailer and should not be added to the amount of the ETF.
- ▼ The energy purchase adjustment cost submitted by Origin Energy - this was based on the difference between the Energy Purchase Cost Allowance and the Market-Based Energy Purchase Cost from our electricity price determination.⁴² We do not consider this is an appropriate way to estimate this cost and would significantly over-estimate the cost.

We also adjusted the costs as a result of our benchmarking analysis.

Table 6.1 summarises the data provided by retailers after we excluded the costs outlined above. These costs are unchanged from our draft decision.

Table 6.1 Average benchmarked costs based on data provided by retailers

Category	\$2013/14
Costs associated with acquiring customers (per customer)	83
Costs associated with losing customers (per customer)	61
Energy purchase adjustment costs (per customer, per annum)	17

Note: These are the costs that would be incurred if a customer terminated immediately after signing a contract.

Source: Information provided by EnergyAustralia, Origin Energy and AGL.

The 2 most significant costs submitted by retailers were customer acquisition costs and the cost of bad debt (relating to losing customers). Other administrative costs were relatively small.

The costs summarised in Table 6.1 are average costs. This means for any particular customer, the costs of early termination may be higher or lower than the average. To account for every different circumstance would require that we set many more base ETF caps. We consider that this would make it very difficult for customers to understand which ETF would apply to them. Our approach is simpler, and allows retailers to recover their costs, on average.

⁴² Origin Energy submission, September 2013, pp 7-8.

AGL and the Energy Retailers Association of Australia (ERAA) submitted that for the purposes of setting base ETF caps, we should use the upper range of our estimates rather than the average. Conversely, at the public hearing PIAC argued for using the lowest estimate.⁴³ Using the lowest estimate or even the average may restrict some retailers from recovering their actual costs of early termination should they wish to do so, as some of these costs will be above the average.⁴⁴ While we appreciate using an upper range may be appropriate in the context of setting a cap, ultimately we need to exercise judgement to balance reasonable cost recovery with customer protection. In light of this trade-off, we consider that using average costs is a reasonable approach. We note that Origin Energy and EnergyAustralia submitted that we have appropriately balanced these requirements.⁴⁵

In submissions to our draft report, AGL and Origin Energy noted there are differences in early termination costs between business and residential customers and that we should consider separate base ETF caps for these customers.⁴⁶ While we received some additional data in this regard, we do not consider that it is sufficient to set separate residential and small business caps. It is important to note that data for both groups of customers is incorporated in our base ETF caps. We intend to examine this issue further when we update our decision in 2 years.

PIAC, NCOSS and CPSA submitted that we have over-estimated the costs in Table 6.1, in particular for customer acquisition and bad debt costs. In general, they indicated that we included costs that are not relevant under our framework or that the amount we have included is too high. However, we consider that the types of costs and the way we have estimated these costs is consistent with the framework outlined in Chapter 5. In particular, we consider that costs of bad debt are relevant costs of early termination as some customers, including some early terminating customers, will leave bad debt on their final bill. Had a retailer not signed a contract with a customer it would avoid this cost of bad debt. We have provided more detailed information and responded to the issues raised in submissions at Appendix E.

We consider that the costs in Table 6.1 in relation to an electricity contract would be incremental to the costs of establishing a gas contract. The possible exception is customer acquisition costs. However, as outlined in section 4.1, EnergyAustralia submitted that the customer acquisition costs for a dual fuel contract are additive. For this reason, we consider the costs in Table 6.1 to be applicable to electricity market contracts and the electricity component of dual fuel contract.

⁴³ Transcript of public hearing, 4 November 2013, p 22.

⁴⁴ AGL submission, November 2013, pp 1-2; ERAA submission, November 2013, p 1.

⁴⁵ Origin Energy submission, November 2013, p 1; EnergyAustralia submission, November 2013, p 2.

⁴⁶ AGL submission, November 2013, p 2; Origin Energy submission, November 2013, p 1.

6.3 Financial model of early termination costs

We have used the data summarised in Table 6.1 in a financial model of early termination costs. The model estimates a base ETF cap (in present value terms) taking account of:

- ▼ the level of costs and when they are incurred, and
- ▼ how retailers recover these costs over the life of the contract and when the customer terminates the contract.

The model is available on our website.

6.3.1 Assumptions for the model

There are 2 important assumptions in the model. The first is the length of the contract (or fixed benefit period) with the customer. Because most costs are recovered through quarterly bills over the life of the contract, the length of the contract period will affect the rate at which costs are recovered.

The second important assumption is the length of the relationship before the early termination occurs. This affects the amount of costs which are recovered before early termination. Obviously over time more costs are recovered through the price and therefore fewer costs need to be included in the base ETF cap.

For our final decision we have assumed a **2-year contract**. From our assessment of current market offers, 2-year contracts were the most common term and therefore we consider this to be a reasonable assumption.

The length of time before early termination is likely to vary depending on conditions in the market. For example, in periods of high churn the average period before an early termination might be lower than when there is less activity in the market. We have set a first year base ETF cap reflecting the costs where a customer remains for **6 months**. We have set a base ETF cap for customers terminating after the first year and have assumed that the customer terminates the 2-year contract after **18 months**.

These assumptions are consistent with our draft decision. While few stakeholders provided comment on this aspect of our draft report, EnergyAustralia supported a 2-year contract period as this reflects prevailing market practices.⁴⁷

⁴⁷ EnergyAustralia submission, November 2013, p 2.

AGL noted that the assumption of early termination after 6 and 18 months produces a large step-down in the base ETF from years 1 to 2.⁴⁸ However, we were provided with some additional information on the number of customers who terminate early during each month for a 2-year contract. We consider that this data broadly supports our original assumptions that, on average, early termination in the first year of a fixed term contract would occur after 6 months and early termination in the second year would occur after 18 months. On this basis, and because no other stakeholders commented on this issue, we have retained our assumptions for the final decision.

Also consistent with our draft decision, we have assumed that the early termination period commences when the customer starts being supplied with electricity under the contract (the ‘supply commencement date’). Our final decision (Appendix D) has been drafted on this basis. Based on information from retailers, we understand that there are currently different practices in terms of when the early termination period begins (either when a contract is signed or when supply actually commences). Lumo Energy submitted that the period should apply after the contract has been established and the cooling off period expires.⁴⁹ However, on balance we have decided to retain our draft report decision based on the supply commencement date.

The model uses a discount rate for which we have applied an updated retail electricity weighted-average cost of capital of 10.1% (real, pre-tax).⁵⁰ This is slightly higher than under our draft decision (9.9% real, pre-tax).

6.3.2 Outputs from the model

In Table 6.2 below we provide a summary of the base ETF caps from the model using different assumptions about the contract length and how far into the contract the customer terminates. Currently in the market these are 1, 2 or 3 year contracts. The base ETF caps are almost unchanged since our draft decision. The only input to the model that has been updated is the weighted-average cost of capital (WACC), however this had a very small impact on the results.

Table 6.2 Variability of base ETF caps (\$)

	Month of termination											
	3	6	9	12	15	18	21	24	27	30	33	36
1 yr	118	80	40	0								
2 yr	148	129	108	88	67	45	23	0				
3 yr	167	153	140	125	111	96	81	66	50	34	17	0

Source: IPART.

⁴⁸ AGL submission, November 2013, p 2.

⁴⁹ Lumo Energy submission, November 2013, p 1. Note that a cooling off period is a period of time after a contract is entered into during which the contract may be rescinded.

⁵⁰ This is based on the same WACC methodology as used in our 2013 electricity retail price determination. Appendix C provides a summary of our updated WACC parameters.

Using our assumption of a 2-year contract where a customer remains for 6 months or 18 months, the base ETF caps are:

- ▼ **\$130** within the first year, and
- ▼ **\$45** thereafter.

We have rounded the base ETF caps to the nearest \$5. These amounts exclude GST.

The table shows that as the period before early termination increases, the base ETF cap falls. This is because the retailer recovers more of its costs before early termination, leaving less to be recovered through the base ETF.

6.4 Impact of our final decision on customers

As discussed in Chapter 1, the NSW Government has provided protection for certain customers. Under the regulations, base ETF caps cannot be applied to:

- ▼ customers on hardship programmes
- ▼ customers receiving the Low Income Household Rebate or the Medical Energy Rebate on the last bill before termination, or
- ▼ customers that paid any part of the last bill by an Energy Accounts Payment Assistance (EAPA) Scheme voucher.

NCOSS submitted that despite these protections, our base ETF caps will disproportionately affect low income and vulnerable customers. For example, these customers:

- ▼ may not be aware that there is assistance available to them and therefore that they would be exempt from the base ETF caps
- ▼ may not be eligible for assistance and could not afford to pay a high ETF even though they are most in need of a better deal
- ▼ may be in insecure housing and therefore more susceptible to cutting short a contract.⁵¹

Submissions from CPSA and L. Denel (individual) made similar comments in this regard. CPSA suggested that exclusions from the base ETF cap should be extended to customers who have accessed assistance at any time during their contract (not just the last bill). It also suggested that retailers be required to offer a product that has no ETF.⁵²

⁵¹ NCOSS submission, November 2013, pp 1-2.

⁵² CPSA submission, November 2013, pp 3-5; L. Denel submission, November 2013, p 1.

While we consider that our decision protects customers from unreasonably high fees, some customers may still be vulnerable. We support increasing awareness of assistance that is available to customers, or helping them choose an offer that is more suitable (such as a zero ETF offer). Making a requirement for retailers to provide a zero ETF offer would need to be made under the National Electricity Retail Rules (the responsibility of the AEMC) or the NSW Government through a regulation. Extending eligibility arrangements and other forms of additional customer protection are matters for government policy and outside the scope of IPART's review.

6.5 Updating the base ETF caps

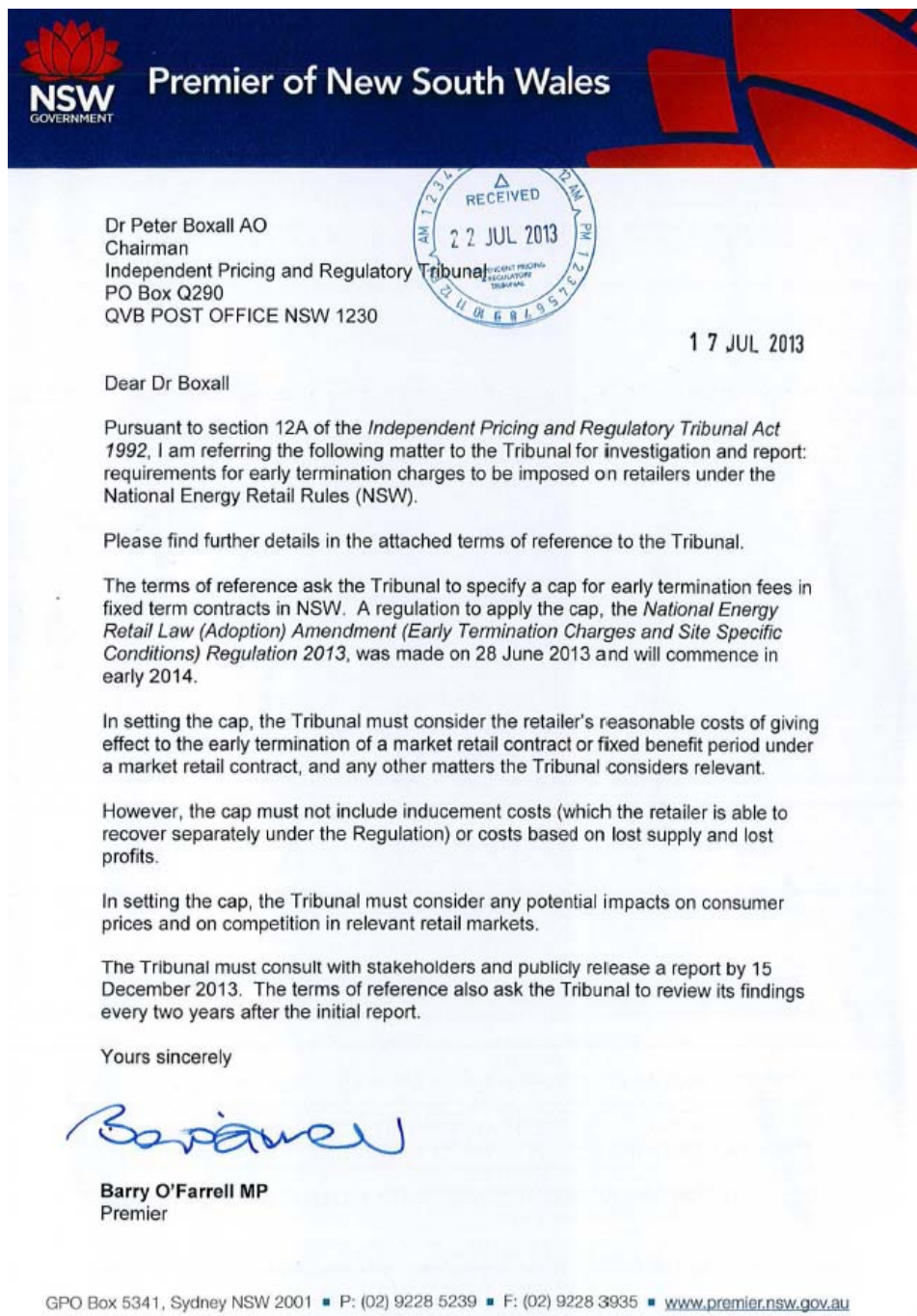
We do not propose indexing our base ETF caps for inflation until we next review these amounts.

Our terms of reference require us to review the base ETF caps within 2 years of our final decision. To do this we propose to conduct a similar process to the one we followed for this review. This will involve obtaining updated cost information and inviting stakeholder comment. We will also assess how the market responded to our decision.



Appendices

A Terms of reference



TERMS OF REFERENCE

Investigation and report on requirements in relation to early termination charges to be imposed on retailers under the National Energy Retail Rules (NSW)

I, Barry O'Farrell, Premier of New South Wales, under section 12A of the *Independent Pricing and Regulatory Tribunal Act 1992 (Act)*, refer the following matter to the Independent Pricing and Regulatory Tribunal (**Tribunal**) for investigation and report:



1. The Tribunal is to specify an amount or amounts for small customers for the purposes of rules 49AA(2) and 49AA(3) of the National Energy Retail Rules (as modified by the *National Energy Retail Law (Adoption) Regulation 2013 (National Energy Retail Rules (NSW))* and which apply in NSW in accordance with the *National Energy Retail Law (Adoption) Act 2012 (NSW)*).
2. The Tribunal may specify a different amount for the early termination of:
 - (a) a fixed term market retail contract for the sale of electricity;
 - (b) a fixed term dual fuel contract in relation to the sale of electricity; and/or
 - (c) a fixed benefit period of:
 - (i) a market retail contract for the sale of electricity; and/or
 - (ii) a dual fuel contract in relation to the sale of electricity.
3. In deciding the relevant amount or amounts to be specified, the Tribunal must take into account the following matters:
 - (a) the amount or amounts must reflect a retailer's reasonable costs of giving effect to the early termination of a market retail contract or fixed benefit period under a market retail contract (as the case may be);
 - (b) the amount or amounts must not include an estimate of costs based on lost supply and lost profits; and
 - (c) the amount or amounts must not include an estimate of inducement costs (as defined in rule 49AA(4) of the National Energy Retail Rules (NSW)).
4. In deciding the amount or amounts to be specified for the purposes of rules 49AA(2) and 49AA(3), the Tribunal must consider any potential impacts on consumer prices and on competition in the relevant retail markets.
5. The Tribunal may take into account any other matters the Tribunal considers relevant, including possible regulatory impacts.
6. The Tribunal must consult with stakeholders and publicly release a report no later than 20 December 2013 which sets out:
 - (a) details of the Tribunal's investigation; and

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- (b) the amount or amounts specified for the purpose of rules 49AA(2) and 49AA(3) of the National Energy Retail Rules (NSW) and the basis for its decision.
- 7. The Tribunal must review the amount or amounts specified for the purposes of rules 49AA(2) and 49AA(3) of the National Energy Retail Rules (NSW) within two years of:
 - (a) its initial decision under paragraph 1; and
 - (b) a subsequent review conducted under this paragraph.
- 8. The Tribunal must carry out any review under paragraph 7 in accordance with paragraphs 2 to 5.

B National Energy Retail Rules

IPART is to specify a base ETF cap for the purpose of sub-rules 49AA(2) and 49AA(3) of the *National Energy Retail Law (Adoption) Amendment (Early Termination Charges and Site Specific Conditions) Regulation 2013*. Box B.1 provides more information on rules 49AA(2) and 49AA(3) and the definition of inducement costs.

Box B.1 Rules 49AA(2) and 49 AA(3), *National Energy Retail Law (Adoption) Amendment (Early Termination Charges and Site Specific Conditions) Regulation 2013*

Rules 49AA(2) and 49AA(3) apply to electricity contracts, that are (i) a market retail contract for the sale of electricity; or (ii) a dual fuel contract to the extent that a term or condition of such a contract applies to the sale of electricity under that contract.

Rule 49AA(2) applies to fixed term retail contracts and provides that:

A term or condition of a fixed term retail contract has no effect to the extent that it provides for payment of an early termination charge (however described), unless the charge is an amount that does not exceed the sum of the amount specified for the purposes of this subrule by the Independent Pricing and Regulatory Tribunal pursuant to a referral under section 12A of the *Independent Pricing and Regulatory Tribunal Act 1992* and the inducement costs of the retailer.

Rule 49AA(3) applies to market retail contracts with fixed benefit period and provides that:

A term or condition of a market retail contract that is not a fixed term retail contract has no effect to the extent that it provides for the payment of an early termination charge (however described), unless

- (a) the early termination charge is payable due to the early termination of the fixed benefit period; and
- (b) the charge is an amount that does not exceed the sum of the amount specified for the purposes of this subrule by the Independent Pricing and Regulatory Tribunal pursuant to a referral under section 12A of the *Independent Pricing and Regulatory Tribunal Act 1992* and the inducement costs of the retailer.

In both these rules, the **inducement costs** of a retailer are defined as “the monetary costs to the retailer of any up-front inducements offered to the customer to induce the customer to enter into the market retail contract, calculated on a pro rata basis (according to the period for which the contract was in force)”.

C WACC parameters

The real post-tax WACC for our final decision on early termination fees is 7.5% (equivalent to a real pre-tax WACC of 10.1%). This is 0.1% higher than our early termination fee draft decision. The increase is mainly due to small increases in the 40-day average of the risk-free rate (from 3.9% to 4.1%) and market risk premium (from 7.3% to 7.5%).

The table below summarises the WACC parameters for our final decision.

Table C.1 WACC parameters for the final decision

	Current market data	Long-term averages
Averaging period	40 days	10 years
Nominal risk-free rate	4.1%	5.1%
Inflation	2.8%	2.7%
Debt margin	1.2 to 2.3%	2.4%
Market risk premium	7.5% ^a	5.5 to 6.5%
Gearing	20%	20%
Equity beta	0.9 to 1.1	0.9 to 1.1
Real pre-tax cost of debt	2.5 to 3.6%	4.8%
Real post-tax cost of equity	7.9 to 9.3%	7.2 to 9.3%
Real post-tax WACC	6.8 to 8.2% (midpoint 7.5%)	6.7 to 8.4% (midpoint 7.5%)
Real pre-tax WACC	9.2 to 11.0% (midpoint 10.1%)	9.0 to 11.2% (midpoint 10.0%)

^a The 40-day average of Bloomberg's MRP.

Note: Real pre-tax WACC calculated using an effective tax rate of 30%. Data as at 26 November 2013.

Source: Bloomberg and IPART analysis.

Our final decision on the WACC for this review represents the midpoint of the WACC range established using the midpoints based on current market data and long-term averages (Table C.1). This approach is consistent with the interim WACC methodology applied in our draft decision on early termination fees and our 2013 electricity retail price determination.⁵³

⁵³ IPART, *Review of regulated retail prices for electricity 2013-2016 – Final Report*, June 2013, pp 177-211.

D Final decision

Final decision – pursuant to a referral under section 12A of the *Independent Pricing and Regulatory Act 1992 (NSW)*

1. For the purposes of sub-rule 49AA(2) of the *National Energy Retail Rules* (as modified by the *National Energy Retail Law (Adoption) Regulation 2013 (NSW)* and which apply in NSW in accordance with the *National Energy Retail Law (Adoption) Act 2012 (NSW)*) (**National Energy Retail Rules (NSW)**), the Independent Pricing and Regulatory Tribunal specifies the following amounts:

- a) \$130, where the early termination of the fixed term retail contract occurs less than 12 months from the date on which the retailer commenced selling energy to the customer under the contract; and
- b) \$45, where the early termination of the fixed term retail contract occurs 12 months or later from the date on which the retailer commenced selling energy to the customer under the contract.

2. For the purposes of sub-rule 49AA(3) of the *National Energy Retail Rules (NSW)*, the Independent Pricing and Regulatory Tribunal specifies the following amounts:

- a) \$130, where the early termination of the fixed benefit period of the market retail contract occurs less than 12 months from the date on which the retailer commenced selling energy to the customer under the contract; and
- b) \$45, where the early termination of the fixed benefit period of the market retail contract occurs 12 months or later from the date on which the retailer commenced selling energy to the customer under the contract.

3. In paragraphs 1 and 2 above, the 'date on which the retailer commenced selling energy to the customer under the contract' means the date on which the first supply of energy which is sold under the contract was made to the customer.

4. The amounts specified in this decision continue to apply until this decision is replaced pursuant to a referral under section 12A of the *Independent Pricing and Regulatory Tribunal Act 1992 (NSW)*.

5. The amounts specified in this decision do not include GST (as defined in the *A New Tax System (Goods and Services Tax) Act 1999* (Cth)).

Interpretation

In this decision, unless the contrary intention appears:

- a) a reference to an Act, legislation or law includes regulations, rules, codes and other instruments under it and consolidations, amendments, re-enactments or replacements of them; and
- b) a term defined in the National Energy Retail Rules (NSW) has the meaning given to that term in the National Energy Retail Rules (NSW).

E More information on costs of early termination

This appendix responds to stakeholder submissions and provides more detailed information on how we have estimated the costs of early termination that are used in our financial model.

As discussed in Chapter 6, we received information from retailers on the costs of early termination. We went through a process to ensure each cost was relevant to our framework, and that the level of the cost was reasonable.

Customer acquisition costs

The customer acquisition cost we have incorporated in Table 6.1 represents a weighted-average cost across a range of different acquisition channels (for example third-party brokers, on-line acquisitions and internal referrals).

Consumer representatives stressed 2 main points in relation to customer acquisition costs:

- ▼ That these are costs of doing business and not specifically related to early termination.
- ▼ In setting market prices retailers may not be fully ‘competing away’ the customer acquisition and retention cost (CARC) allowance included in regulated prices. Therefore, they may already receive an allowance for customer acquisition costs and including this in an ETF would be ‘double-dipping’. PIAC cite evidence that average discounts of 5% to 6% are lower than the 8% assumed by IPART in setting the CARC allowance. Similar comments were made by NCOSS and CPSA.⁵⁴

In section 5.2 we outlined why we consider customer acquisition costs to be relevant to giving effect to early termination. We do not agree that retailers are not fully competing away the regulated CARC allowance in setting their market prices. Firstly, the discounts PIAC refer to are not on a comparable basis. The 5% to 6% discounts PIAC cite are discounts off an entire bill. However, in setting the CARC allowance we assumed an 8% discount off the usage component

⁵⁴ PIAC submission, November 2013, pp 4-5; NCOSS submission, November 2013, pp 2-3; CPSA submission, November 2013, p 5.

only.⁵⁵ (8% off usage only would be a lower percentage when applied to the total bill). In addition, the 5% to 6% discounts incorporate information from financial year 2011. However, we noted in our 2013 electricity determination that the level of discounting has increased in 2012/13,⁵⁶ therefore we expect this would bring down the average discount that PIAC has referred to.

Secondly, the NSW electricity market has recently been found to exhibit 'robust competition'.⁵⁷ In such markets, retailers cannot expect to win customers without offering good deals to customers. As part of this review we examined market offers available in NSW and found many examples of offers where discounts were in excess of 8% off regulated usage prices.

Based on the comments above, we don't consider there is strong evidence that retailers are deliberately pricing their market offers about their efficient costs and double-dipping on customer acquisition costs. We do expect that retailers would recover customer acquisition costs over a period of time. However, this is consistent with both how we estimated the CARC allowance (where we assumed retailers would recover this cost over 4 years) and our framework for the ETF review (where we assumed retailers would recover this cost over 2 years).

Bad debt costs

PIAC submitted that even under our framework for estimating the base ETF caps, bad debt is not a legitimate inclusion. It notes one possible exception where the imposition of the ETF results in the final bill being unpaid (that otherwise would have been). It requested evidence that customers who terminate early are more likely to leave a bad debt than any other customer.⁵⁸ Similar comments were made by NCOSS.⁵⁹

We consider that bad debt is a relevant cost of early termination. This is because some customers, including some early terminating customers, will leave bad debt on their final bill. Under our framework discussed in Chapter 5, had a retailer not signed a contract with a customer it would avoid this cost of bad debt. The amount we have included is an average cost of bad debt for all final bills (including early terminating final bills). This average amount accounts for the fact that some customers do pay their final bill, but some do not. We expect that retailers would recover the average cost of bad debt over a period of time (and for this review we have assumed that retailers would recover this average cost over 2 years for a customer on a fixed term contract).

⁵⁵ IPART, *Review of regulated retail prices and charges for electricity – From 1 July 2013 to 30 June 2016 – Final Report*, June 2013, p 118.

⁵⁶ *Ibid*, p 34.

⁵⁷ AEMC, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales – Final Report*, October 2013, p i.

⁵⁸ PIAC submission, November 2013, pp 5-6.

⁵⁹ NCOSS submission, November 2013, p 3.

PIAC suggests we should only include any incremental costs of bad debt on a final bill. However, as discussed in Chapter 5, we do not consider that including only incremental costs is appropriate as this would mean some costs of early termination would need to be recovered from all market customers. This would increase prices for these customers.

We did benchmark costs associated with bad debt for final bills to information we had as part of our electricity determinations. We considered that some estimates were unreasonably high, so we decided to exclude this data in setting an average cost of bad debt.

Accounting for profit in our calculations

PIAC and CPSA submitted that we have over-compensated retailers for the risk of losing customers, while giving them the reward of profits during the term of the contract. In contrast, consumers bear the risk of prices rising at any time during their contract and face a barrier to accessing better offers. They submit that if we take our current approach we should also take account of profit in our calculations (ie, reduce the base ETF caps).⁶⁰

In our view, it is reasonable for retailers to be able to earn a return on investment during the time they serve a customer. The ability to earn return on investment should be considered like any operating cost which retailers should not need to repay if a customer breaks a contract. We do not consider that this is over-compensating retailers for risk, but recognises the risks that retailers faced for the time that it served the customer.

Energy purchase adjustment costs

The energy purchase adjustment cost was estimated by AGL and EnergyAustralia using a 'swaption premium' approach.⁶¹ We engaged Frontier Economics to provide advice on the cost of rebalancing a hedge position using options. Based on this advice we consider that the average cost proposed by AGL and EnergyAustralia is reasonable. More information on this approach is available in Frontier's report.⁶² As no stakeholders commented on Frontier's draft report, these costs have remained unchanged from our draft decision.

⁶⁰ PIAC submission, November 2013, p 6.

⁶¹ AGL submission, September 2013, p 3; EnergyAustralia submission, September 2013, p 12.

⁶² Frontier Economics, *Estimating energy purchase adjustment costs – A final report prepared for IPART*, December 2013.