

## **Early Termination Fees**

Regulating the fees charged to small electricity customers in NSW

**Electricity — Issues Paper**  
August 2013





Independent Pricing and Regulatory Tribunal

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## Invitation for submissions

IPART invites written comment on this document and encourages all interested parties to provide submissions addressing the matters discussed.

**Submissions are due by 9 September 2013. Late submissions will not be accepted.**

We would prefer to receive them electronically via our online submission form <[www.ipart.nsw.gov.au/Home/Consumer\\_Information/Lodge\\_a\\_submission](http://www.ipart.nsw.gov.au/Home/Consumer_Information/Lodge_a_submission)>.

You can also send comments by mail to:

**Early Termination Fees**

Independent Pricing and Regulatory Tribunal

PO Box Q290

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Our normal practice is to make submissions publicly available on our website <[www.ipart.nsw.gov.au](http://www.ipart.nsw.gov.au)>. If you wish to view copies of submissions but do not have access to the website, you can make alternative arrangements by telephoning one of the staff members listed on the previous page.

We may choose not to publish a submission—for example, if it contains confidential or commercially sensitive information. If your submission contains information that you do not wish to be publicly disclosed, please indicate this clearly at the time of making the submission. IPART will then make every effort to protect that information, but it could be disclosed under the *Government Information (Public Access) Act 2009* (NSW) or the *Independent Pricing and Regulatory Tribunal Act 1992* (NSW), or where otherwise required by law.

If you would like further information on making a submission, IPART's submission policy is available on our website.



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# 1 Introduction

In the competitive market, electricity retailers can offer small customers market contracts with a fixed term, or a fixed benefit period (typically between 1 and 3 years). Under the terms and conditions of these contracts, they can require a customer who terminates the contract before the end of this term or period to pay an 'early termination fee'.

Currently, this fee is unregulated: retailers decide whether or not to charge an early termination fee, and how much to charge.<sup>1</sup> However, the NSW Government has decided to impose requirements on retailers in relation to early termination fees under the new National Energy Retail Rules (NSW),<sup>2</sup> which will come into effect on 1 March 2014.<sup>3</sup> The Premier of NSW has asked the Independent Pricing and Regulatory Tribunal (IPART) to conduct a review of the maximum amount of early termination fees for small customers under market contracts for electricity, or the electricity component of dual fuel contracts.

## 1.1 What has IPART been asked to do?

The Premier has provided detailed terms of reference for this review. These terms of reference 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.

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

<sup>2</sup> 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).

<sup>3</sup> While these arrangements are currently due to come into effect on 1 January 2014, the Department of Trade & Investment has advised that the regulations will be updated to commence on 1 March 2014.

Under the legislation, this maximum *base* amount cannot be charged 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 Scheme voucher.<sup>4,5</sup>

The terms of reference also 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 must represent the monetary costs to the retailer of any up-front inducements offered to the customer, calculated on a pro-rata basis.

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 1.1). For clarity, we refer to this component as the '**base early termination fee**' (**base ETF**).

In making our decision on the maximum level of the base ETF (or the base ETF cap), 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 will balance the policy intent of providing protection to customers with the impact that regulating ETFs may have on consumer prices and the competitive market, including the level and diversity of product offerings.

We are also required to review the base EFT cap every 2 years.

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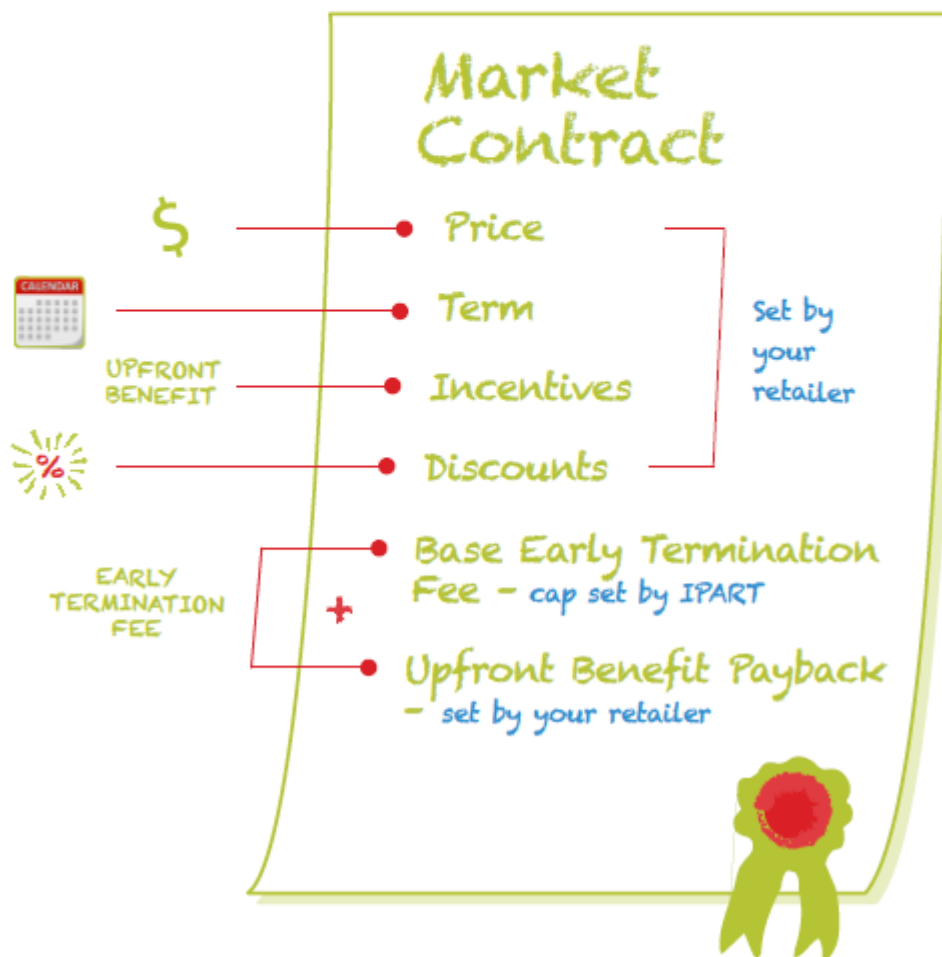
<sup>4</sup> Clause 73A, *National Energy Retail Law (Adoption) Amendment (Early Termination Charges and Site Specific Conditions) Regulation 2013* (NSW).

<sup>5</sup> A retailer is *not* required to waive the recovery of upfront inducements to these customers.

### Box 1.1 IPART's role in regulating market contracts

NSW households and small businesses can choose between a standard electricity supply contract where the maximum average price is regulated by IPART, or a more competitive market contract where the prices and other terms and conditions are set by retailers according to various consumer protection requirements.

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.



## 1.2 How do we propose to approach this task?

To make our decision, we will use an approach designed to ensure that we consider all the matters that we are required to consider and make a decision that is consistent with our terms of reference. In broad terms, our proposed approach includes the following steps:

1. Consider the types of costs that retailers typically seek to recover through current unregulated ETFs,<sup>6</sup> 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, 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 cap, 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.

## 1.3 What are our preliminary views on implementing this approach?

To implement this approach, we will need to use our judgement to balance the matters for consideration specified in the terms of reference. In particular, we will need to consider how to exercise our discretion in applying the terms of reference by:

- ▼ Considering the policy intent of providing protection to customers by constraining the regulated base ETF. This includes excluding some costs from the regulated base ETF that retailers typically seek to recover through the currently unregulated ETFs (Step 2), and
- ▼ Considering the impact this may have on consumer prices and competition. This includes considering the potential responses of customers and retailers to the introduction of a regulated base ETF, 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 have provided preliminary views where we have them to assist stakeholders to comment on the issues we have raised.

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<sup>6</sup> Subject to Rule 49A of National Energy Retail Rules.

We need to take account of the impact on the competitive market of constraining ETFs at a low level; that is, at a level that does not allow the recovery of a reasonable proportion of the costs retailers would avoid if the customer had either completed the contract term or had not signed the contract. Specifically, we need to consider the detrimental impact that a low **base ETF** cap may have on the products offered to customers over time, including the level and diversity of prices and service quality.

We note that if we were to set a base ETF cap that recovered a reasonable proportion of these costs, there is less risk of detrimental impacts on electricity prices and competition. However, Government, retailers, consumer groups and IPART would need to engage with customers to ensure they understand that this amount is a cap, and that they can shop around to find a product offering that best suits their needs (including products that include no ETF).

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.

#### **1.4 What review process will we follow?**

Our review process will include public consultation and analysis. This issues paper is the first step in this process. It explains the key steps in our proposed approach in more detail, and sets out the issues we will need to consider and our preliminary views. It also seeks submissions from interested parties, which are due by 9 September 2013. (See page iii for information on how to make submissions.) Please note that as the timeline for this review is very tight, we will not be able to consider submissions received after the specified dates.

After considering the information and comments we receive in submissions, we will make draft decisions and explain these in a draft report. We expect to release the draft report in mid-October. We will also hold a public forum and will seek submissions on our draft report. We will consider the comments made at the public forum and in submissions in response to the draft report before making our final decisions in December 2013.

Table 1.1 provides an indicative timetable for this review. This timetable will be updated on our website as the review progresses.

**Table 1.1 Indicative review timetable**

<b>Key tasks</b>	<b>Timing</b>
Release Issues Paper	15 August 2013
Submissions on Issues Paper due	9 September 2013
Release draft report	Mid October 2013
Public forum	Early November 2013
Submissions on draft report due	Mid November 2013
<b>Release final report</b>	<b>Mid December 2013</b>

In addition to the formal steps set out in Table 1.1, the Secretariat will undertake workshop meetings with key stakeholders in developing our approach to assessing the relevant costs.

## 1.5 How the rest of this paper is structured

Chapter 2 of this paper provides more information on the context and scope of this review. Chapters 3 to 5 discuss the remaining steps in our proposed approach, including the issues we will need to consider and our preliminary views.

## 1.6 What submissions should address

The issues on which we particularly seek information and comment from stakeholders are highlighted throughout this paper. There are 4 key questions that we seek stakeholder comment on:

- 1 The types of costs that retailers typically seek to recover through their current ETFs? 11
- 2 Which costs, consistent with the terms of reference, can be included in the base ETF cap? 20
  - Which costs would a retailer avoid if the customer had not signed the contract? 20
  - Which costs would a retailer avoid if the customer completed the contact term? 20
  - Of these costs, which (if any) relate to lost supply and lost profit? 20
- 3 The level and range of the costs reasonably associated with giving effect to early termination? 27
  - The range of customer acquisition costs (excluding upfront inducements) that retailers could reasonably avoid if the customer had not signed the contract? 27

- The range of investments made on behalf of customers, such as incurring energy-purchase related costs, that retailers could reasonably avoid if the customer had not signed the contract? What energy-purchase related costs do retailers face in adjusting their portfolio if a customer terminates early? 27
- The range of administrative costs that retailers could reasonably avoid if the customer had not signed the contract? What is the range of costs for closing an account and what proportion relates to early termination? 27
- 4 The impacts of the introduction of a base ETF cap for consumer prices and the competitive market in terms of 33
  - The potential responses of customers and retailers to the introduction of a regulated base ETF? 33
  - The potential impacts these responses will have on electricity prices and the level of competition in the retail electricity market? 33
  - The implications of setting the base ETF cap either ‘too low’ or ‘too high’? 33
  - The experience in other jurisdictions where ETFs are regulated 33

## 2 ETFs: What is the role of customers, retailers and Government?

As Chapter 1 indicated, the NSW Government has decided to impose requirements on retailers in relation to early termination fees for the supply of electricity to small customers under the new National Energy Retail Rules (NSW). These charges must not exceed the sum of:

- ▼ the amount specified by IPART (the '**base early termination fee**' (**base ETF**)) 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*, and
- ▼ the inducement costs of the retailer.

The purpose of this review is to investigate and decide the appropriate amount for IPART to specify for the purpose of these sub-rules.

To provide the context for this review, the sections below discuss the role of early termination fees in competitive markets, the ETFs included in energy retailers' current market offers in NSW and the regulation of ETFs in other states. Box 2.1 provides more information on rules 49AA(2) and 49AA(3) and the definition of inducement costs.

### 2.1 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.<sup>7</sup>

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.

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<sup>7</sup> 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.

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.<sup>8</sup> In short, ETFs act as a deterrent to early contract termination, while also allowing retailers to recover some of the contract establishment 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 consumers 'walking away' from the contract by terminating it before the end of this term.<sup>9</sup>

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<sup>8</sup> 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).

<sup>9</sup> 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.

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**Box 2.1 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)”.

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## 2.2 What can we observe in the NSW retail electricity market?

The first step in our approach is to consider the full scope of costs energy retailers incur in contracting with small retail customers. These costs may result from a range of functions associated with negotiating and establishing contracts, and the costs more directly associated with the early termination of these contracts. In the absence of regulation, it may be reasonable for retailers to recover some or all of these costs through ETFs.

The section below discusses our understanding of the broad cost categories that energy retailers may seek to recover through ETFs (in the absence of regulation). It also outlines some preliminary observations from the competitive energy retail market in NSW.

The subsequent chapters consider the ‘reasonableness’ of including these costs within the base ETF (Chapter 3), including the guidance within the terms of reference, our preliminary approach and the information required for establishing the level of these costs (Chapter 4) and the potential impact on prices and competition (Chapter 5).

### 2.2.1 Costs of establishing the contract

Our understanding is that retailers can incur a range of costs in establishing service contracts with customers. These are costs that businesses would typically not incur if a customer did not enter into a contract with them. These costs can be significant, and are usually recovered through the terms and conditions – usually the price – over the term of the contract. However, where a customer terminates within this term, retailers seek to recover some of these costs through ETFs.

Our preliminary view is that electricity retailers’ costs of establishing market contracts may include:

- ▼ customer acquisition and marketing costs, including the costs of inducements and/or sales channels
- ▼ investments made on behalf of the customer (eg, purchasing assets, entering into energy purchase portfolio positions, organising services)
- ▼ the administrative costs for negotiating and preparing the contract and processing the customer transfer from another retailer.<sup>10</sup>

### 2.2.2 Direct costs of terminating the contract early

Retailers may also incur direct costs associated with terminating the contract before the end of the agreed term. Our preliminary view is that these costs could include:

- ▼ the costs associated with adjusting the energy purchase portfolio to account for the loss of a customer
- ▼ the administrative costs associated with bringing forward the closing of a customer account, including those of final bills, transferring customers out of their systems, as well as the higher payment delinquency rates for final bills.

IPART seeks comment on

- 1 The types of costs that retailers typically seek to recover through their current ETFs?

<sup>10</sup> They can also include upfront inducement costs, but as noted above, these must not be included in the base ETF cap.

### 2.2.3 ETFs included in current electricity market offers in NSW

In most areas of NSW, a wide range of market contracts are currently on offer. We reviewed a sample to see whether they include ETFs and whether there is a relationship between these fees and the other features of the offer.

As Table 2.1 indicates, our sample of 25 included 14 that had no fixed term. However, 6 of these included a fixed benefit period and an ETF if the customer switches contracts within the first year. The remaining 11 had fixed terms of 1 to 3 years, and 9 of these included an ETF.

Of the 15 offers that included an ETF, the level of this fee varied significantly. For example, if the contract is terminated in the first year of the term, the fee ranged from \$40 to \$90. This variability was observed both between retailers, and between product offerings by the same retailer.

**Table 2.1 Overview of current market offers and ETFs**

Contract type	No.	Offers with ETF (first year)	Offers with upfront inducements	Offers with ongoing discounts
<b>No fixed term</b>	14	6 (\$48 – \$70)	4	13 (1% - 16%)
<b>1 year</b>	5	3 (\$40 – \$83)	1	4 (11% – 15%)
<b>2 years</b>	3	3 (\$75)	3	3 (5% - 7%)
<b>3 years</b>	3	3 (\$90)	0	3 (11%)
<b>Total</b>	25	15	8	23

Source: [www.energymadeeasy.gov.au](http://www.energymadeeasy.gov.au)

We did not find a clear relationship between the level of the ETF and other features of the offering, such as upfront inducements or ongoing discounts.

We recognise the challenges in trying to capture a representative sample of market offers and to draw conclusions from this sample. While we cannot be definitive, the high degree of variability in our sample is consistent with ETFs in other service contracts. This most likely reflects that:

- ▼ The costs of supplying particular customers, or offering particular contracts, can be higher or lower than those for other customers, or other contracts. For example, it may be that customers acquired through different sales channels – such as through door-to-door knocking or through brokers– involve different costs.
- ▼ Some retailers have higher or lower cost structures than other retailers.
- ▼ In a competitive market, retailers will respond to their competitor’s behaviour by offering products with a range of prices and term and conditions.

### 2.3 What is the role of Government in regulating ETFs?

Governments have an active role in facilitating competition and effective consumer engagement across all markets. For example, the Australian Consumer Law (ACL) was implemented in January 2011 as single, national law concerning consumer protection and fair trading across all markets in Australia. It is enforced by all Australian courts and tribunals and is administered by the ACCC and each State and Territory's consumer law agency.<sup>11</sup>

Some governments have taken a more active role in specific markets by regulating key aspects of contracts that are signed between businesses and customers, such as prices and/or key terms and conditions within contracts, and regulating key aspects of business behaviour. For example, the credit market in Australia is subject to the National Credit Code<sup>12</sup> under which customers and credit providers have certain rights and responsibilities.<sup>13</sup>

While the context for these regulations varies across markets, they are typically designed with the intent to:

- ▼ Improve the ability of customers to engage in the market – for example through measures designed to improve the transparency of market offers, reduce the complexity of offers facing customers,<sup>14</sup> and reduce barriers to customer switching.
- ▼ Protect consumers from 'unreasonable' terms and conditions - for example regulating key terms and conditions, such as banning fees and charges for specific customers groups (such as electricity customers on hardship programmes in NSW<sup>15</sup>) or regulating the price of key fees and charges.

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<sup>11</sup> [http://www.consumerlaw.gov.au/content/the\\_acl/downloads/ACL\\_an\\_introduction\\_November\\_2010.pdf](http://www.consumerlaw.gov.au/content/the_acl/downloads/ACL_an_introduction_November_2010.pdf)

<sup>12</sup> The National Credit Code is part of the *National Consumer Credit Protection Act 2009*.

<sup>13</sup> Under the National Credit Code a court can annul or reduce an exit or pre-payment fee if the court determines it exceeds a reasonable estimate of the lender's loss arising from early termination or pre-payment. The Australian Securities and Investments Commission (ASIC) provides guidance that sets out how provisions in the National Credit Code and unfair contract terms law apply to mortgage early termination fees (exit fees). ASIC, Media Release - *ASIC sets out expectations of lender practices on mortgage early termination fees*, 10-234MR, 10 November 2010, <http://www.asic.gov.au/>

<sup>14</sup> For example, Ofgem have made recommendations in the UK energy market to reduce the number of tariffs and products that energy retailers can offer customers. Ofgem consider that these measures will improve the ability of customers to engage in the market. <http://www.ofgem.gov.uk/Markets/RetMkts/rmr/consumers/Pages/index.aspx>

<sup>15</sup> Retailers are prohibited from charging an early termination fee to customers in their hardship programs, who on their last bill either received an energy rebates or used and EAPA voucher . *Clause 10A, National Energy Retail Law (Adoption) Amendment (Early Termination Charges and Site Specific Conditions) Regulation 2013* (NSW).

### 2.3.1 Why is the NSW Government regulating ETFs for electricity contracts in NSW?

The NSW Government has made amendments to the NECF by regulating ETFs or exit fees to customers wanting to exit their electricity contracts in NSW. This includes regulating the levels of ETFs and prohibiting the imposition of the base ETF amount to:<sup>16,17</sup>

- ▼ 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,<sup>18</sup> improve customer engagement and participation in the market, and reduce barriers to switching retailers.

### 2.3.2 Have electricity ETFs been regulated in other states?

In Victoria, early termination fees have been regulated under the Energy Retail Code for the past 5 years. The Code provides for a maximum of ETF of \$20 plus any unamortised upfront inducement cost.

The \$20 ETF was established in an Essential Services Commission (ESC) review of early termination fees in 2006.<sup>19</sup> The ESC found that the relevant costs to be recovered through this ETF are the incremental administrative costs relating to terminating a contract, and 'hedge book imbalance' costs. It considered that these costs were 'small and uncertain'. However, to provide a small deterrent to early termination, the ESC considered a reasonable allowance for these costs would be \$20 (irrespective of when the contract is terminated). The ESC also recognised that retailers amortise their upfront inducements to customers over the period of the contract, and considered that they should be able to add these unamortised costs to the \$20 ETF. Note that in Victoria the \$20 applies to each account, so for a dual fuel account this amounts to \$40.

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<sup>16</sup> Clause 73A, *National Energy Retail Law (Adoption) Amendment (Early Termination Charges and Site Specific Conditions) Regulation 2013* (NSW).

<sup>17</sup> A retailer is *not* required to waive the recovery of upfront inducements to these customers.

<sup>18</sup> 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.

<sup>19</sup> Essential Services Commission, *Final Decision: Early Termination Fees*, December 2006. This review was initiated as part of the ESC's compliance activities, in particular in response to the wide range of ETFs observed in the market. During the review, the ESC found that it did not have a basis for determining whether a retailer's ETF represented a 'fair and reasonable estimate' in accordance with the regulatory requirements. After undertaking a consultation process, the ESC amended the Energy Retail Code (Code) to give clearer guidance to retailers on what constitutes a fair and reasonable ETF.

Like NSW, other states have only recently moved or are currently moving to regulate ETFs. For example, in Queensland the *Electricity Act 1994* (Qld) was amended in July to prevent electricity retailers charging early termination fees to small customers who exit their market contract with 20 days of a price increase above notified prices. Likewise, in South Australia, a bill<sup>20</sup> was recently introduced which sets out broadly similar provisions to those in place in Queensland. Also in South Australia, recent amendments to energy legislation introduced a requirement that all electricity (and gas) retailers offer a market contract without an early termination fee for small customers in that State.<sup>21</sup>

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<sup>20</sup> Electricity (Early Termination) Amendment Bill 2012 (SA).

<sup>21</sup> *Electricity (General) Regulations 2012* (SA), reg 44C.

### 3 What type of costs should be included in the base ETF cap?

As Chapter 2 discussed, retailers incur costs associated with a range of functions including negotiating and establishing contracts with customers and the costs more directly associated with the early termination of these contracts.

It may be reasonable for retailers to recover these costs through the base ETF, other than those costs specifically excluded by the terms of reference. The second step in our proposed approach is to decide on what type of costs should be included in the base ETF cap.

The terms of reference provide some guidance on this, indicating that the base ETF cap we set must reflect “a retailer’s reasonable costs of giving effect to the early termination of a market retail contract”. They also require us to consider the potential impact on electricity prices and competition.

The key issue in this step will be to decide how we interpret this guidance. We consider there are several legitimate views on this:

- ▼ One is to include some of the costs that a retailer would avoid if the customer **had not signed the contract**.
- ▼ Another view is to include those costs that a retailer would incur if the customer did not **complete the contract term**.

The sections below discuss this and also our understanding of which costs the terms of reference exclude from the base EFT cap.

#### 3.1 Costs excluded by the terms of reference

The terms of reference explicitly prevent us from including 2 types of costs in setting the base ETF cap. The first is the costs of lost supply and lost profit. We consider that prevents us from including amounts that reflect the expected margin over the remainder of the contract term (lost profits).

The second is the costs related to any up-front inducements that retailers offer to win customers – such as a discount on the first bill, an upfront allocation of reward points, or a magazine subscription. However, retailers **will** be able to recover these costs. As Chapter 2 noted, under the National Energy Retail Rules (NSW),<sup>22</sup> 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.<sup>23</sup>

### **3.2 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.

As Chapter 2 discussed, retailers would typically recover these costs over the full term of the contract (and thus risk losing them when the customer terminates the contract early). In this case, the test for whether a type of cost, or what proportion of a cost, should be included in the reasonable range we consider in setting the base ETF would be whether the cost incurred by retailer would vary as a result of the customer signing the contract. If the costs do not vary, then they may not fall within the set of costs that we must take into account.

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<sup>22</sup> The *National Energy Retail Law (Adoption) Regulation 2013* is referred to as the National Energy Retail Rules (NSW).

<sup>23</sup> Rule 49AA(2) or (3) of the National Electricity Retail Rules (NSW), as applicable.

3 What type of costs should be included in the base ETF cap?

Table 3.1 summarises our preliminary view of which of the costs would be included in the reasonable range if we used this interpretation. It shows that this would lead to a broader range of costs as it would include some of the costs of establishing the contract, as well as the costs of completing the early termination.

**Table 3.1 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, marketing costs).
Investments made on behalf of customer	Yes	These costs are incurred as a result of the customer signing the contract.
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 costs of entering into energy purchase arrangements for a period based on the length of the contract do not vary if the customer terminates early. However, those of rebalancing the energy purchase portfolio to account for the reduced load when a customer terminates early do and so are costs of giving effect to the early termination.
Administrative costs of finalising a customer account, including increased payment delinquency rates	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.

### 3.3 Costs a retailer would incur if the customer did not complete the contract term

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 other words, the test for whether a type of cost, or what proportion of a cost, should be included in the reasonable range we consider in setting the base ETF 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 3.2 summarises our preliminary view of which of the costs would be included in the reasonable range if we used this interpretation. It shows that this would result in a fairly narrow range of costs, as it would predominantly exclude those costs associated with establishing the contract.

**Table 3.2 Costs 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 require 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 costs of entering into energy purchase arrangements for a period based on the length of the contract do not vary if the customer terminates early. However, those of rebalancing of the portfolio to account for the reduced load when a customer terminates early do and so are costs of giving effect to the early termination,
Administrative costs of finalising a customer account, including increased payment delinquency rates	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.

We are interested in stakeholders’ comments on how we should interpret the costs of giving effect to early terminations, and to what extent the cost categories outlined above should be considered the costs of lost supply and lost profit.

We note that in other markets, including the market for non-residential loans, it is considered ‘reasonable’ for ETFs to recover the costs associated ‘unrecovered establishment costs’.<sup>24</sup>

<sup>24</sup> ASIC considered that an ETF “is unconscionable” if it exceeds a reasonable estimate of the lender’s loss (including unrecovered establishment costs) arising from the early termination. ASIC, *Early termination fees for residential loans: Unconscionable fees and unfair contract terms*, November 2010, p 10.

3 What type of costs should be included in the base ETF cap?

We note that the issues associated with this interpretation overlap with those we need to consider in setting the base ETF cap within the reasonable range of costs (discussed in Chapter 5). In particular, we consider that whether a narrower or a broader interpretation of the costs of giving effect to early determinations is preferable is likely to depend on which definition will result in a base ETF cap that has minimal detrimental or distortionary effects on retail prices and competition in the retail market.

IPART seeks comment on

- 2 Which costs, consistent with the terms of reference, can be included in the base ETF cap?
  - Which costs would a retailer avoid if the customer had not signed the contract?
  - Which costs would a retailer avoid if the customer completed the contact term?
  - Of these costs, which (if any) relate to lost supply and lost profit?

## 4 What is the level and range of relevant costs?

As Chapter 3 discussed, the terms of reference provide some guidance on the type of costs to be recovered in the base ETF cap. The third step in our approach is to consider the level and range of these costs. The section below discusses our understanding of the nature of these costs, and our preliminary approach and information required for establishing the level of these costs.

### 4.1 Costs of establishing the contract

Retailers can incur costs in establishing service contracts with customers, including:

- ▼ customer acquisition and marketing costs
- ▼ investments made on behalf of the customer (eg, purchasing assets, entering into energy purchase portfolio positions, organising services)
- ▼ the administrative costs for negotiating and preparing the contract and processing the customer transfer from another retailer.<sup>25</sup>

These are costs that businesses would typically not incur if a customer did not enter into a contract with them. These costs can be significant, and are usually recovered through the terms and conditions – usually the price – over the term of the contract. However, where a customer terminates within this term, retailers often seek to recover some of these costs through ETFs.

#### 4.1.1 Customer acquisition and marketing costs (excluding inducement costs)

Retailers incur costs in attracting customers in the competitive market. In addition to general marketing costs, retailers will incur acquisition costs that are specific to an individual customer. These are costs that retailers could reasonably avoid if the customer had not signed the contract. These can include costs incurred in enticing the customer on to a contract (of which inducement costs are specifically excluded from the base ETF cap), as well as upfront costs associated with sales, including payments made to sales agents.

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<sup>25</sup> They can also include upfront inducement costs, but as noted above, these must not be included in the base ETF cap.

#### 4 What is the level and range of relevant costs?

These costs, including the balance between upfront and ongoing 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 fuel.<sup>26</sup>
- ▼ The level of competition in the market (ie, how challenging it is to acquire new or retain customers in the market).

As part of our recent electricity review we considered current estimates of upfront customer acquisition and retention costs by reviewing the information provided to us by the NSW Standard Retailers, reviewing information provided by retailers to the market, and reviewing other regulators' decisions.

Table 4.1 summarises our estimates of the upfront costs associated with the acquisition of new customers.<sup>27</sup> These estimates vary widely, reflecting differences in retailer types and methods used to acquire customers. They could also include some upfront inducement costs (attributable to the customer), which need to be excluded from the base ETF. Nonetheless, they suggest the upfront costs of acquiring a new customer can be significant.

**Table 4.1 Summary of estimated upfront customer acquisition cost (\$2012/13)**

Source of estimate	\$ per new customer	\$ per customer per annum
Retailer information submitted to IPART	182	48
Other regulatory decisions	-	43
IPART 2010 determination	-	40
Market information (acquisition costs only)	129-193	34-51

**Note:** Converted to \$ per customer per annum using a discount rate of 9.7% and a period based on a churn rate of 20%.

As part of our retail review, EnergyAustralia submitted that there are other costs such as advertising and market and sales staff that should be considered customer acquisition costs, but which are not attributable to acquiring a specific customer.<sup>28</sup>

<sup>26</sup> Bell Potter, *Australian Power & Gas (APK), Electrifying and energising*, September 2011, p 8.

<sup>27</sup> IPART, *Review of regulated retail prices and charges for electricity - Final Report*, June 2013, p 116.

<sup>28</sup> EnergyAustralia submission, May 2013, p 32.

Based on the above information, we consider it reasonable to conclude that retailers incur an upfront acquisition cost in the range of \$150 to \$190 per new customer. In our view, given that inducement costs can often be a substitute to direct sales acquisition costs, this amount may capture the costs of any upfront inducements attributable to customers, commissions to sales agents as well as advertising and other marketing costs. We are interested in identifying the costs that retailers would avoid if the customer had not signed the contract, including the range and level of customer acquisition costs at a disaggregated level.

#### **4.1.2 Investments made on behalf of the customer**

Retailers also 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.

One of the major costs retailers incur is the cost of purchasing energy – particularly the cost of managing their exposure to volatile spot prices in the wholesale market. Retailers buy energy in the wholesale market and bundle the costs of that energy with the other costs that they face in supplying their customers (eg, the costs of transporting the energy across the poles and wires, meeting green scheme obligations and providing retail service). Retailers typically bill customers at a pre-specified price, although they face some uncertain costs, particularly in relation to the wholesale market.

To supply their customers, retailers may invest in a range of physical or financial assets. At the time of entering into a contract with customers, retailers often enter into energy purchase portfolio positions by purchasing financial instruments from generators or derivative markets (including futures markets).

We are interested in what other services retailers may invest in or organise to be able to supply their customers. For example, in the future, retailers may become more increasingly involved in investing in metering technology or metering services as these functions become increasingly contestable. Retailers may be able to offer customers products (such as time of use or critical peak tariffs supported by appropriate metering technology) that benefits both the customer and retailer. Investments in these assets or metering services on behalf of the customer could be costly, as could disposing of or transferring these assets or services if customers were to terminate their contract early. How metering services are to be operated, owned and funded is being considered by the NSW Government.<sup>29</sup>

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<sup>29</sup> <http://engage.haveyoursay.nsw.gov.au/smartmetertaskforce>

### 4.1.3 Administrative costs for negotiating and preparing the contract and processing the customer transfer

When a customer engages with a retailer in relation to arranging a contract for the supply of electricity, the retailer may incur a range of costs. These are the costs involved in:

- ▼ Designing the product, negotiating and preparing the offer then finalising the contract and other documentation (eg, the corporate overhead costs – call centre staff time, equipment, telephone, lease of premises etc), net of costs captured in the acquisition costs.
- ▼ Establishing and processing the customer transfer with the Australian Energy Market Operator (AEMO).<sup>30</sup>

We are interested in understanding the size and nature of these costs, and whether they can be considered incrementally. We also seek stakeholder view on the extent to which these costs are considered part of upfront acquisition costs (and the extent to which they are captured in the estimates in Table 3.1) or are a general operating expense that is recovered from all customers through retail prices.

Some of these customer transfer costs are incurred by AEMO and are funded through a levy on market participants. Typically, AEMO related costs are recovered from all customers through retail prices. Other costs may be incurred by retailers.

## 4.2 Direct costs of terminating the contract early

Retailers may also incur direct costs associated with terminating the contract before the end of the agreed term. Our preliminary view is that these costs could include:

- ▼ the costs associated with adjusting the energy purchase portfolio to account for the acquisition and loss of a customer
- ▼ the administrative costs associated with closing a customer account, including those of final bills, transferring customers out of their systems, and the higher payment delinquency rates for final bills.

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<sup>30</sup> Delivering retail competition requires systems to process transfers of customers between retailers in the NEM. These systems are operated and managed by the AEMO.  
<http://www.aemo.com.au/About-AEMO/Services/Market-Development>

### 4.2.1 Energy purchase costs

As discussed above, when a retailer wins a customer, it is likely to incur energy purchase-related costs in establishing a fixed term account with a customer. If the customer terminates its account early, then the retailer could adjust its energy purchase portfolio position. But this adjustment is likely to impose costs on the retailer. The customer's actions could impose 2 broad categories of costs on the retailer - gains or losses on the energy purchase portfolio position, and transactions costs of trading this position. The section below discuss these categories and our proposed approach for estimating these costs.

#### Gains or losses on the energy purchase portfolio position

The financial contracts that the retailer enters into when it establishes a customer account can be generally be sold prior to the quarter to which they relate. Therefore, if a customer terminates its contract early and the retailer holds a financial position in relation to the energy purchase risk, then the retailer can trade that position.

The cost of a forward contract for a specific period (for example Q1 2014) can vary over time. If a retailer were to enter into a contract today for a unit of energy for Q1 2014, the price of that contract might be different to what it was last year.

Forward contract prices for a defined quarter can move up or down in the period leading up to that quarter. It is possible that a customer is more likely to terminate a fixed-term contract early where they can obtain a better deal in the market. This is more likely in a period of falling wholesale prices (as other retailers can sign the customer up at the lower prices reflecting the current market conditions). This could lead to a systematic bias of the contracts being 'out of the money' (or below the purchase price) at the time that the retailer loses the early terminating customer. However it could also be argued that customers are more likely to focus on their electricity bills and consider shopping around when prices are rising (contracts could be 'in the money').

Accounting standards require retailers to mark-to-market their financial contracts. Therefore, as the wholesale prices decline, they are required to adjust their financial statements to reflect the lower value of their contracts. This may suggest it is the movement in the contract price, rather than the early termination, that results in the detrimental financial outcome for the retailer.

Nevertheless, we consider that it is likely that recovering gains and losses on their contract position resulting from the early termination through an ETF is likely to be a feature of a competitive retail market. If retailers were not able to recover the gains and losses on their contract position resulting from early termination through an ETF, it is possible that retailers might not offer fixed term contracts. Without an ETF, the expected return to a retailer of entering into a

contract would be reduced: the retailer would still face the financial losses if the market moved against the retailer, but would be less likely to receive the financial benefits if the market moved for the retailer.

#### Transactions costs of trading the energy purchase portfolio position

When the retailer loses a customer and needs to adjust its energy purchasing portfolio, it involves transactions costs. These costs include the costs of the trading team undertaking its functions and any brokerage or commission costs or fees payable in relation to that trade.

While these costs are likely to be relatively small, we consider that the transaction costs of trading the energy purchase position to be a cost of giving effect to early termination.

#### Proposed approach for estimating energy purchase adjustment costs

To assist us in assessing the energy purchase portfolio costs, we intend to engage a consultant to provide us with expert advice. We will require the consultant to develop a draft methodological approach that assesses the 2 categories of costs identified above. We will undertake informal consultation on that approach prior to the draft report.

#### 4.2.2 Administrative costs of terminating a contact within the fixed period

When a customer switches retailer, there are a range of costs that a retailer faces in closing the account and sending a final bill. Under current practices in NSW, customers tend to charge retailers at the next meter reading, reducing the range of costs to finalise an account. For example, the final bill will be the next scheduled bill. There is scope to request a special meter reading to transfer the customer in a more timely manner, as well as provision to charge a separate fee for that meter reading.

We are interested in understanding to what extent these costs are considered an incremental cost to be recovered from customers terminating their contract, or a general operating expense that is recovered from all customers through retail prices.

IPART seeks comments on the following

- 3 The level and range of the costs reasonably associated with giving effect to early termination?
  - The range of customer acquisition costs (excluding upfront inducements) that retailers could reasonably avoid if the customer had not signed the contract?
  - The range of investments made on behalf of customers, such as incurring energy-purchase related costs, that retailers could reasonably avoid if the customer had not signed the contract? What energy-purchase related costs do retailers face in adjusting their portfolio if a customer terminates early?
  - The range of administrative costs that retailers could reasonably avoid if the customer had not signed the contract? What is the range of costs for closing an account and what proportion relates to early termination?

## 5 How should we balance our requirements in setting the base ETF cap?

The fourth step in our proposed approach is to set the base ETF cap, taking account of the range for the costs of giving effect to early termination discussed in Chapter 4, the potential impacts on consumer prices and competition, and any other relevant matters. The main issues we will need to consider in this step are:

- ▼ the potential responses of customers and retailers to the introduction of a regulated base ETF
- ▼ the potential impacts these responses will have on electricity prices and the level of competition in the retail electricity market, and
- ▼ the implications of setting the base ETF cap either ‘too low’ or ‘too high’.

The sections below summarise our preliminary views and then discuss these issues in more detail.

### 5.1 Summary of preliminary view on setting the base ETF cap

As Chapter 1 noted, we are still at an early stage in understanding the role played by ETFs in the competitive market, the costs they typically recover and the implications of regulating these fees for retail prices and competition. However, we consider it important that our preliminary views are clear so that stakeholders can meaningfully comment on the issues we have raised.

We need to take account of the impact on the competitive market of constraining ETFs at a low level; that is, at a level that does not allow the recovery of a reasonable proportion of the costs retailers would avoid if the customer had either completed the contract term or had not signed the contract. Specifically, we need to consider the detrimental impact that a low **base ETF** cap may have on the products offered to customers over time, including the potential for reduced product diversity, higher average prices and/or lower service quality.

We note that if we were to set a base ETF cap that recovered a reasonable proportion of these costs, there is less risk of detrimental impacts on electricity prices and competition.

However, Government, retailers, consumer groups and IPART would need to engage with customers to ensure they understand that this amount is a cap, and that they can shop around to find a product offering that best suits their needs (including products that include no ETF). This may better balance the requirements in our terms of reference.

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.

Finally, we note that in developing its policy in relation to smart metering the NSW Government will need to consider the impact of regulating ETFs on the incentives for retailers to facilitate an efficient deployment of smart metering technology.

## 5.2 Potential customer responses

As Chapter 2 discussed, in the competitive market, ETFs act as a deterrent to early contract termination, while also allowing retailers to recover some of the contract establishment costs they would otherwise recover over the term of the contract. Given this, regulating the base ETF may remove a barrier to switching for some customers, particularly if the base ETF cap is set at a low level. It may also mean that for most customers, the potential short-term benefits of switching contracts or retailers may exceed the costs they impose on retailers. This may lead to increased levels of customer switching.

The extent to which any increase in the level of customer switching leads to better customer outcomes in the longer term will depend on retailers' response (discussed below). It will also depend on the extent to which customers actively 'shop around' to identify the best available offer for them before switching. Regulating the base ETF – or any of the terms and conditions of market contracts – may make it less likely that customers actively consider the different offers available to them. In particular, it may lead them to assume 'all ETFs are the same anyway'.

## 5.3 Potential retailer responses

Given the guidance in the terms of reference, regulating the base ETF has the potential to constrain retailers' ability to recover some of the costs they incur in relation to fixed-term market contracts. The lower the base ETF cap is set (or the more conservatively we estimate the costs of giving effect to the early termination of contracts), the more significant this constraint. The risk to retailers may be magnified if regulating the base ETF leads to increased levels of customer switching.

Potentially, retailers may respond to this constraint by:

- ▼ **Reducing the level of their marketing and retailer sales activity**, so they don't incur costs in acquiring customers that they can't recover.
- ▼ **Continuing to market to customers**, but choose to recover the contract establishment costs previously recovered through ETFs through higher prices (or reduced ongoing discounts) for some or all customers.
- ▼ **Reducing the level of their product diversity**, including reducing any customer-specific investments (such as investments in smart meters or metering services),<sup>31</sup> or enticements offered to customers that may not be able to be recovered.<sup>32</sup>

In addition, regulating the base ETF – or any of the terms and conditions of market contracts – may make it less likely that retailers will compete based on the terms and conditions in their offerings. For example, it may encourage them to include an early termination fee in line with base EFT cap in all fixed-term contracts, particularly if this cap is relatively low.

#### 5.4 Potential impacts on electricity prices and the competitive market

The impact of regulating base ETFs on retail prices and competition in the retail market will depend of the actual responses of consumers and retailers.

As we have previously stated, we consider it is in the long-term interests of customers for retailers to compete and offer products that customers' value. We also consider that competition is more effective than regulation in driving prices towards efficient costs, and in reducing costs and increasing innovation over time.

To gain some indication of the possible impacts of regulating ETFs, we are interested in the experience in other jurisdictions, including Victoria, where ETFs are subject to regulation.

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<sup>31</sup> Retailers in the future may play a key role in encouraging some customers to pay for energy on a time-of-use basis. This could involve retailers investing in smart metering assets or metering services, and sharing the benefits with customers. Restricting the ability of retailers to recover the costs associated with establishing a contract with a customer may reduce the incentive retailers have to invest in new products and inhibit the efficient deployment of new technologies.

<sup>32</sup> This could include ongoing price discounts. We note that the ESC does not consider price discounts to be an inducement that should be considered when evaluating ETFs. The ESC considers up-front inducements to play a fundamentally different role (related to attracting customers away from other retailers) to ongoing price discounts (relating to the cost of ongoing supply of energy). (See ESC, 2006, pp 11-12.)

## 5.5 Implications of setting the base ETF cap ‘too low’

As Chapter 2 discussed, there are currently a wide range of EFTs. If we were to set the base ETF cap towards the lower end of the feasible range, it would reduce the flexibility retailers have to set the ETF within the overall product offering.

This may reduce the complexity for customers in assessing the offers available in the competitive market, and may lead to higher levels of customer switching (as discussed in section 5.2). In addition, by reducing ‘unreasonable barriers’ to switching, it may stimulate competition among retailers to attract customers by offering better pricing terms.

However, it is not clear that a regulatory regime that attempts to provide greater transparency through reduced product choice, or ‘better’ prices and conditions to all or some customers is in the interests of all customers. Studies across a range of industries have suggested that attempts to protect customers by restricting retailers’ product offerings or by regulating key terms and conditions in market contracts may not actually benefit consumers.<sup>33</sup>

We are concerned about the impact of constraining ETFs to a low level on the competitive market, and ultimately on the level of prices and quality of services offered to customers over time. Reducing retailers’ flexibility in setting ETFs may have a number of detrimental effects on customers in general and the competitive market. For example, in our view, setting the base EFT cap ‘too low’ creates a risk of:

- ▼ **Reducing product diversity**, meaning those customers that value and are willing to commit to longer term contracts may miss out on the benefits associated with these products (in terms of new services and technologies, upfront inducements, subsidised products, and ongoing price discounts).
- ▼ **Reducing the level of marketing and retailer activity**, as retailers are unable to recover a proportion of their contract establishment costs. While retailers may turn to lower cost marketing channels (ie, move away from door-to-door sales), we consider it reasonable to assume this is likely to lead to reduced competitive activity.

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<sup>33</sup> For example, Stephen Littlechild suggests that Ofgem’s recommendations to improve competition in the UK retail energy market may be having detrimental effects on the market. <http://www.cornwallenergy.com/Latest-news/Blog/Ofgem-and-the-Philosopher-s-Stone> Further, Mayo suggests that in the U.S, regulation of key terms and conditions such as ETFs in telecommunications contracts may leave consumers ‘worse off’, such that the proposed “cure” is likely to be worse for consumers than the identified “ailment.” John W. Mayo, Regulating Early Termination Fees: When “Pro-Consumer” Legislation Isn’t, Georgetown University - School of Business, January 2010.

- ▼ **Increasing retail prices for all customers**, as retailers cannot distinguish between those customers that are more/less likely to terminate their contract early (and lead to higher/lower cost to serve). Higher average costs recovered from all customers involves a cross-subsidy from customers who are less likely to switch to those who are more likely to switch.
- ▼ **Reducing the incentives for retailers to compete by setting ETFs below this cap**, meaning the base ETF cap becomes a default ETF.

## 5.6 Implications of setting the base ETF cap ‘too high’

If we were to set the base ETF cap towards the higher end of the feasible range, this would provide retailers with more flexibility in setting ETFs within their overall product offerings. It would ensure that retailers can recover a high proportion of costs of establishing fixed term contracts through these fees.

This would expand the potential for retailers to design product offerings to attract new customers and to invest in innovative customer acquisition channels to attract new customers. Thus, it would enable retailers to distinguish themselves in the market by the particular products they provide – including whether or not they charge an ETF, and if so, the level of this fee.

However, providing retailers with higher levels of flexibility by setting the base ETF cap ‘too high’ also creates risks. For example, customers may mistakenly assume that ‘ETFs are regulated and therefore are all the same anyway’ and may end up paying in a contract with a higher ETF even if they do not value the other elements of the product. Unreasonably high ETFs may create an unnecessary barrier to switching, reducing the benefits that competition can provide.

Our preliminary view is that if we were to set a base ETF cap that recovered a reasonable proportion of the costs retailers would avoid if the customer had either completed the contract term or had not signed the contract, the Government, retailers, consumer groups and IPART would need to engage with customers to ensure they understand that this amount is a cap, and that they can shop around to find a product offering that best suits their needs (including products that include no ETF). The AEMC is currently developing their final advice to the NSW Government on competition in the NSW energy market and how to assist customers in engaging effectively in the market.

IPART seeks comments on the following

- 4 The impacts of the introduction of a base ETF cap for consumer prices and the competitive market in terms of
  - The potential responses of customers and retailers to the introduction of a regulated base ETF?
  - The potential impacts these responses will have on electricity prices and the level of competition in the retail electricity market?
  - The implications of setting the base ETF cap either ‘too low’ or ‘too high’?
  - The experience in other jurisdictions where ETFs are regulated

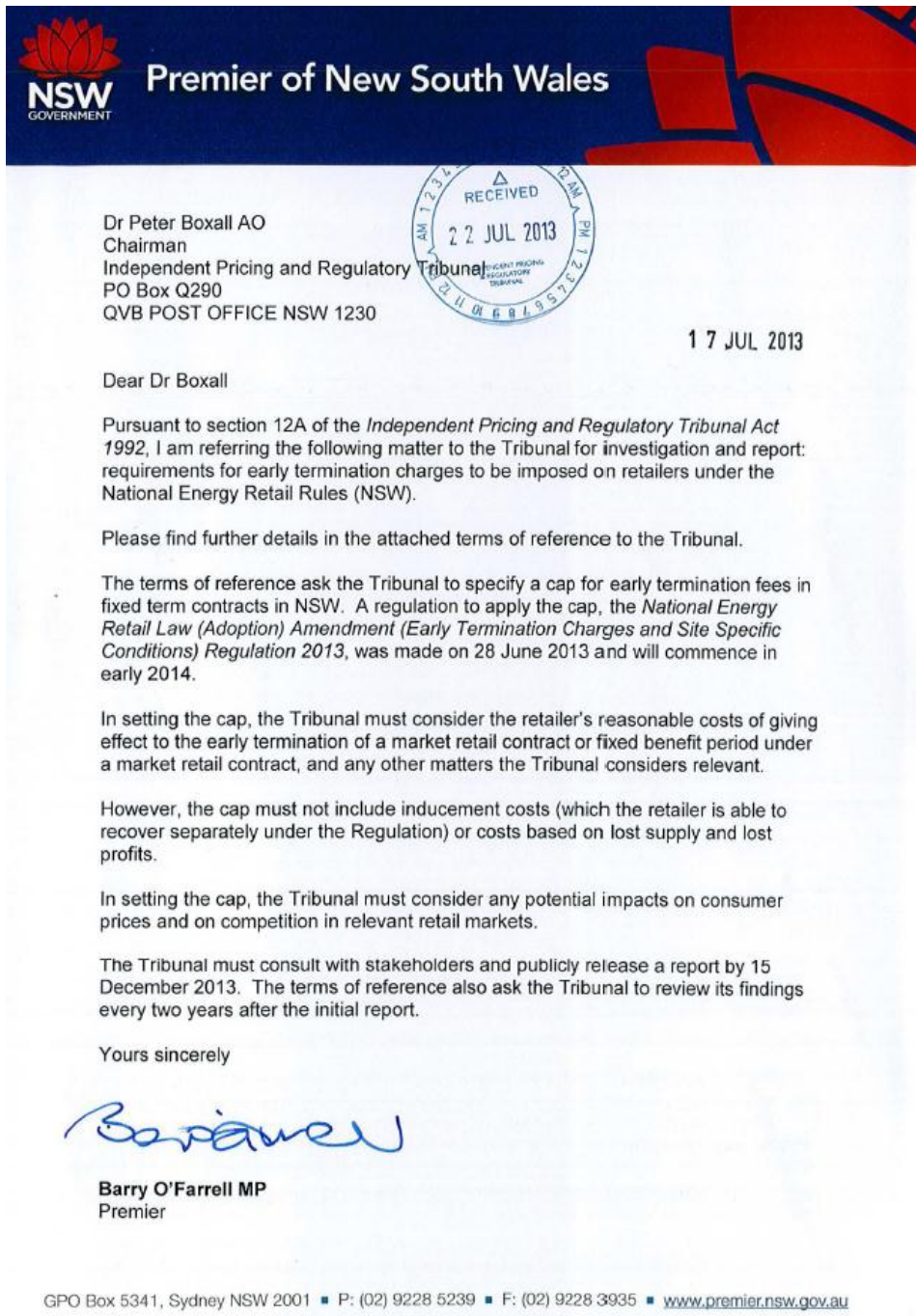




## **Appendices**



## 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.

