Australian Power & Gas

10 May 2012

Dr Peter Boxall
Chairman
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

Dear Chairman

**RE: Changes in regulated electricity retail prices from 1 July 2012 Draft Report**

Australian Power & Gas (**APG**) welcomes the opportunity to provide comment on the Independent Pricing and Regulatory Tribunal (**IPART**) Changes in regulated electricity retail prices from 1 July 2012 Draft Report (**Draft Report**).

While this submission is made with respect to the Draft Report, it is important to begin by recognising the Draft Report should be considered within the broader objectives of national energy policy and the development of a consistent national regulatory framework. The scale and transformation taking place in the national energy sector dictates electricity prices reflect the efficient cost of supply in contestable markets. Accessible, reliable and competitively priced energy depends on this reflectivity. Energy price regulation distorts investment and the efficient use of energy, resulting in less competitive energy markets. Ultimately, customers pay for these regulatory inefficiencies.

In this respect, APG supports the recommendation of the Draft Energy White Paper 2011 to fully deregulate retail energy prices where effective competition exists, and welcomes the examination by the Australian Energy Market Commission (**AEMC**) of the competitiveness of the NSW retail electricity market. If however, price regulation were to remain, for reasons discussed in further detail below, APG is of the firm view that the methodology used to determine such prices should be reformed to better support effective competition in a complex and dynamic market.

Recent consolidation in the NSW retail electricity market, increasing vertical integration (both downstream and upstream) across the national electricity sector, and a rapidly developing regulatory regime, will impact on energy pricing for consumers regardless of their retailer. However, the costs incurred and risks faced by retailers operating in this market, and how each responds to such developments, will differ substantially.

Now, more so than ever, it is important for electricity retail prices to reflect the efficient cost of supply of a plurality of retailers (not just Standard Retailers) as the most effective way to ensure a retail market structure, with low barriers to entry, necessary to facilitate effective competition. As a stand-alone energy retailer, with access to efficient risk management wholesale arrangements, where regulated retail prices fully reflect the efficient cost of supply, APG is in a position to compete with larger integrated firms and deliver to customers the benefits of competition.

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APG is concerned that the determination of total energy cost allowances and the level of retail margin for the year starting 1 July 2012 contained in the Draft Report does not support effective competition in the market and that full cost reflectivity is not achieved under the regulated electricity retail prices. The failure to provide for full cost reflectivity in the revised total energy cost allowance and allow appropriate retail margin is undermining the ability of non-Standard Retailers to operate and compete in the NSW electricity retail market, and is effectively acting as a regulatory barrier to entry for other potential retailers. Artificially low prices in contestable aspects of the electricity market will only serve to undermine competition and reduce attention to longer-term consumer needs.

While we understand that IPART will not be opening up the methodology for the review of the retail components of the regulated retail price, we request that IPART also consider not changing the wholesale component of the energy purchase cost allowance, allowing it to remain at 2011-12 levels. While a short term solution, this would allow for a more sustainable determination of the total energy purchase cost allowance that more accurately reflects where retailers hedged wholesale costs. This would, of course, not affect the necessary pass through of carbon and green costs.

We discuss elements of these concerns further and other comments on the Draft Report in the Annex.

APG looks forward to discussing our submission with you further. In the meantime, should you have any questions or require any additional information regarding our submission, please contact me on (02) 8908 2714 or via email at hpriest@auspg.com.au.

Yours sincerely

**Hilary Priest**
Manager, Government Regulatory Relations and Compliance

ANNEX

## 1. Total Energy Cost Allowance

### 1.1. Methodology

IPART's regulated electricity retail prices directly apply to approximately one half of all residential and small business customers in NSW, being the prices charged by Standard Retailers to customers who have not signed a market contract either with them or another retailer. They also serve as an industry benchmark for other electricity customers, effectively imposing a ceiling on all electricity retail prices in NSW.

This means the regulated electricity retail price will impact on all electricity retailers and their customers. It also means that the methodology used to determine regulated electricity retail prices should incorporate a comprehensive market assessment of total energy costs of a diverse range or retailers and contain an appropriate retail margin. It's APG's concern that while retail energy cost allowances are based on the costs of Standard Retailers there will be a lack of recognition of the true efficient cost to supply consumers.

APG recognises that IPART is restricted by its Terms of Reference (**ToR**) in its review of regulated electricity retail prices to only allow Standard Retailers to recover the full, efficient costs of providing electricity to consumers who have not signed a market contract with them or another retailer. In doing so, the methodology used fails to account for the significant cost differences and different commercial risks faced by non-Standard Retailers versus Standard Retailers.

Under the ToR, non-Standard Retailers are also denied the opportunity to seek to apply for cost pass through with respect to their costs of compliance with regulatory and tax impositions beyond their control. This constrained methodology is particularly evident when reviewing the efficient energy costs of prudent retailers, for whom long term wholesale purchasing arrangements, including hedging undertaken in an increasingly constrained wholesale electricity market, and the cumulatively burdensome costs (for both administration and compliance) of regulation during a period of the unprecedented and rapidly developing reforms.

As a short term solution to the constraints of the ToR and the concerns about lack of true cost reflectivity, APG recommends that IPART not change the wholesale component of the energy purchase cost allowance from its 2011-12 levels. These levels would more accurately reflect hedged costs for wholesale electricity used by retailers and the lower energy purchase cost allowance to a more sustainable level to be absorbed by retailers in 2012-13. This would also allow for the NSW Government to reflect on whether changes to the ToR are necessary for the future.

### 1.2. LRMC and market-based purchase costs

APG supports any future ToR requiring retailer's energy purchase costs being based on the greater of Long Run Marginal Cost (**LRMC**) of electricity supply or the market-based purchase costs. Reasons for this can be illustrated by retailers' recent experiences in Queensland, where the immediate move to market-based energy cost allowance without consideration of LRMC has substantially eroded retail margins, particularly for those retailers with longer term wholesale purchasing arrangements.

If regulated electricity retail prices are to remain, and the NSW Government revises the ToR for IPART, we are concerned with IPART's recommendation that it be given greater discretion in making its determination. This is because the current ToR and the pricing methodology employed fails to result in fully cost reflective pricing for a competitive retail market with a diversity of retailers. Taking the higher of the LRMC and market-based purchase costs is a reasonable safeguard. Conversely, determining an energy retailer's purchase allowance to be the lower of LRMC or market-based purchase costs will compound the effects of regulated electricity retail prices which do not fully reflect the efficient costs of supply. The proposed approach will as a result undermine, rather than enhance, effective competition in the NSW electricity retail market, just as we have seen happen in Queensland.

### 1.3. Wholesale purchasing

APG occupies an important position in the NSW electricity retail market as a competitor to larger scale retailers. One of the most significant risks facing tier two electricity retailers, and the most significant barrier to entry into the NSW electricity retail market, is wholesale electricity price volatility. The primary mechanism by which stand-alone retailers manage this risk is by the use of price hedging contracts. It is therefore critically important to APG, other second tier electricity retailers, and potential new entrants, that the IPART pricing methodology for calculating the market-based energy purchase allowance accounts for a diversity of wholesale arrangements to enable stand-alone electricity retailers who face different purchase costs and security arrangements than Standard Retailers to operate in the market. An appropriate cost allowance would enable stand-alone retailers and new market entrants to manage price and volume risk efficiently in response to the requirements of the demand side of the market.

Given the recent consolidation in the NSW retail electricity market, and increasing vertical integration (both downstream and upstream) across the national electricity sector, it is no longer appropriate to make cost allowances for energy purchases based on an optimisation model combining contract cover and spot price exposure for given levels of risk for Standard Retailers. The costs incurred and risks faced by Standard Retailers for purchasing wholesale electricity to meet the regulated retail load is not representative of other retailers operating in the NSW retail electricity market. For example, vertically integrated market participants do not face the same level of pricing and cash flow risk as stand-alone retailers because the ownership of generating assets provides an alternative means of managing these risks. Standard Retailers are also able to manage their generation output for their own risk mitigation rather than making capacity available to the wider market, including through hedge contracts, driving up costs for stand-alone retailers.

APG also has concerns over IPART using a point in time estimate rather than a rolling average of contract prices. Wholesale electricity price hedge contacts are forward looking and vary in contract duration, which results in a rolling average of contract cover at different wholesale prices. While use of load following and other structured arrangements enable hedging arrangements to better reflect actual retail loads, this flexibility has its limits and attracts a cost premium. By adopting a point in time estimate, IPART makes allowances for future energy costs which do not reflect contractually fixed energy costs which will operate during the regulated price period. As a result, it is our view IPART underestimates the efficient energy purchase cost of a prudent retailer in doing so. This underestimation has greater impact for electricity retailers in circumstances where electricity consumption is decreasing (and the revenue otherwise earned from customers is reduced), which is a recent trend that is likely to continue under sustained electricity retail price increases and modest economic growth forecasts.

We note that the LRMC estimate of the wholesale energy cost is greater than the market based-energy purchase cost, and that the LRMC estimate is adopted in the Draft Report. Using a point in time estimate, rather than a rolling average of contract prices, to calculate the market based-energy purchase cost may, at least in part, explain this difference. This is a compelling reason to reform the pricing methodology to better support effective competition in a complex and dynamic market. It also serves to reinforce our concerns for the flexibility in any future ToR which would enable IPART to adopt the lower of LRMC or market-based purchase energy costs.

APG also has concerns with the LRMC estimation of the wholesale energy cost in respect of the carbon price. This estimation is based on a theoretical system in which investments in generation immediately respond to the carbon price, which, as is acknowledged in the Draft report, does not reflect the functioning of the market. This is particularly so given the current regulatory risk on carbon pricing and the impact we observe it is having on generation investment decisions. Consequently, an energy purchase cost allowances based on such methodology are lower than those experienced in the market and erodes retail margin. It also serves to reinforce our concerns for the flexibility in any future ToR which would enable IPART to adopt the lower of LRMC or market-based purchase energy costs.

### 1.4. Carbon price and green energy administration costs

We note that retail costs form part of IPART's ToR, and are to be based on "efficient costs" which take into account Standard Retailers' efficient costs and other available information on efficient operating costs for retailers. APG is concerned over the lack of clarity on how these costs were determined in the Draft Report. Carbon price implementation and administration costs are significant as well as compliance with other reform level changes in the energy regulatory environment. Such costs are often fixed costs in nature, and not readily scalable due to a retailer's size.

Assuming a 1% increase in Standard Retailers operating costs in supplying electricity customers is inadequate given the extent and pace of regulatory reform at present. A failure to allow for the full costs of administration to carbon price compliance will erode retail margin. It will also disproportionally impact on retailers without the scale of operations or size of customer base to absorb such costs while trying to maintain profitable margins.

We note that gas retailers other than APG recognise administration costs to carbon price compliance will be significant and, in the context of the gas market where there is scope to include such costs as part of the regulated default price, have sought to have their costs included as part of the retail component to default gas prices.

We also raise the same concern with respect to Green Energy compliance. Again, failing to allow for the full costs of administration to Green Energy compliance will erode retail margin and disproportionately impact on second tier retailers.

## 2. Retail margin

APG contends that there has been an erosion of the retail margin under the 2012-2013 regulated retail price. This is, in part, due to the administrative and compliance costs incurred by retailers for the implementation of major reforms in the energy industry including:

- Implementation of the National Energy Customer Framework (**NECF**) and NSW derogations, specifically around the maintenance of existing credit support regimes rather than transitioning to NECF 1 July 2012; and
- Cost of implementation of the price on carbon beyond the management of direct liability including requirements for bill messaging by the NSW government, education and support needs of customers, and increases in potential hardship of customers and risk of payment defaults.

However, as mentioned above, only Standard Retailers may apply for cost pass through for material, unforeseen changes in costs arising from eligible events, such as regulatory or tax change events. Retail margin is also being eroded, in part, by the total energy cost allowances not fully reflecting the cost of efficient supply in a competitive market for the reasons given above. The lack of reflectivity has flow on effects for retailer's margins.

The current Victorian retail electricity market is widely regarded as competitive. A manifestation of this competitiveness is that Victoria continues to record high levels of small customer switching between retailers in 2010-11. APG considers that the existence of robust stand-alone electricity retailers in Victoria contributes to this level of competition. We are concerned that regulated electricity retail prices and the existing methodology by which they are calculated reduces the ability of stand-alone retailers to compete in the market and attract new entrants to join the market because of insufficient pricing head room to operate. Ultimately, insufficient pricing head room will cause retailers to exit the market and result in a more oligopolistic market structure, less responsive to customers and the demand side of electricity market.

## 3. Recommendations to improve electricity pricing and affordability

We recognise and support IPART's interest in examining the efficiency of the NSW electricity network businesses. In our experience, the NSW network costs contribute a disproportionately large component of the total retail price, well in excess of those in other markets in which we operate. We support a detailed examination of the constraints and incentives within the regulatory framework applying to the NSW electricity network businesses, and reforms which will support productivity improvements in such businesses and appropriate cost effective investment in network expenditure by them.

We support pursuing cost effective opportunities in the deployment of time-of-use and/or smart meters by having installation at the discretion of the customer or their retailer. In our view, this is consistent with the original objectives of National Competition Policy (**NCP**), which separated markets into their natural contestable and monopoly parts. Based on domestic and international experiences in deploying such technology, this will better align commercial incentives to install and use such technology, which is essential to utilisation of the technology and the development of innovative retail products and customer services.

APG welcomed IPART's proposed framework in 2011 for reviewing NSW Green Schemes to ensure they are efficient and cost effective, and also supports the Commonwealth Government commitment to reviewing existing Green Schemes, with a view to removing or redesigning schemes that are not complementary to the carbon price. Disparate Green Schemes add significant compliance and administration costs for retailers, which undermines the cost effectiveness of such schemes and erodes retail margins. The decision by the Minister for Energy and Resources to end the NSW GGAS scheme effective 1 July 2012 is an appropriate rationalisation of Green Schemes in light of federal efforts to set a price on carbon.

We generally support IPART's recommendations concerning customer assistance measures and welcome explicit acknowledgement by IPART that their effectiveness "is not necessarily a case of throwing more money at the problem." Poorly designed amendments, unintended consequences of well designed amendments, or the introduction of new assistance schemes, will impose significant costs on retailers, which will further erode retail margin and ultimately be recovered from customers.

Through its customer hardship and credit programs, APG works with its customers to set payment plans for customers whose capacity to pay their energy accounts is challenged due to overall cost of living pressures. APG's experience continues to be that working with its customers to help them understand how to reduce their energy bills through energy efficiency coupled with financial support for those customers experiencing hardship is effective in helping customers pay for their energy consumption.