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03 January 2013

Dr Peter J Boxall AO
Chairman
Independent Pricing and Regulatory Tribunal of New South Wales
Level 8, 1 Market Street
Sydney NSW 2000

Via website:

[www.ipart.nsw.gov.au/Home/Consumer Information/Lodge a submission](http://www.ipart.nsw.gov.au/Home/Consumer%20Information/Lodge%20a%20submission)

Dear Peter

Review of regulated retail prices and charges for electricity 2013 to 2016
– Issues Paper

Lumo Energy welcomes the opportunity to comment and provide feedback on IPART's Issues Paper for its review of regulated retail prices and charges for electricity between 2013 and 2016.

Lumo Energy is one of the largest second tier energy retailers in the National Electricity Market. As such, it has a keen interest in the outcomes of the review and the extent it facilitates competitive entry into electricity retailing in New South Wales.

In summary, Lumo Energy supports:

- The full deregulation of electricity pricing in New South Wales
- A role for electricity price regulation until competition is effective in protecting the interests of consumers and full deregulation of electricity pricing, and
- An approach to regulating retail prices that facilitates the sustainable entry of new retailers.



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Lumo Energy looks forward to continuing to work with IPART and other stakeholders through the further stages of the review. As such, we would welcome the opportunity to meet with the Tribunal members and its staff to further discuss the issues raised in this submission.

If you require any further information, please contact Aneta Graham on (03) 8680 6439.

Yours sincerely

A handwritten signature in blue ink, appearing to read "Dean Carroll". The signature is fluid and cursive, with a horizontal line at the end.

Dean Carroll
Chief Executive Officer



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IPART Review of regulated retail prices and charges for electricity 2013 to 2016

Submission to Issues Paper

December 2012



Executive Summary

Lumo Energy strongly supports the objective of the full deregulation of prices for all electricity customers. Achieving this aim requires that competition be sufficiently effective to provide a credible source of protection for customers.

Regulators supporting retail prices that enable the sustainable entry of new entrant retailers is the best mechanism to facilitate competition.

Conversely, if regulated retail prices are set too low this will entrench the market power of the incumbents¹ and mean a reliance on price regulation will be necessary for the foreseeable future.

Cost assumptions for setting regulated price caps

Achieving a regulated price that facilitates sustainable retailer entry requires basing cost assumptions on efficient new entrant costs. This is a view that is well supported by regulatory practice in Australia and internationally.

In a number of areas the nature of costs for new entrant retailers differs from the costs of incumbent retailers, including:

- The ability to bear risk and the implications this has for the assumed hedge portfolio. New entrant and second tier retailers are unlikely to have the balance sheet of incumbent retailers to absorb the potentially detrimental impacts of a short hedge position. As such, these retailers are much more concerned about their likely exposure to extreme (rather than probable or historical) outcomes in the wholesale market.
- The smaller size of new entrant retailers means they have less scale than incumbents and a smaller customer base to spread fixed costs resulting in a higher Cost to Serve ("CTS") than incumbents
- Customer retention costs are higher for new entrant retailers given all of their customers have demonstrated a predisposition to switching retailer.

There are also a number of areas where Lumo Energy is concerned that IPART's proposed approach may not provide an adequate allowance even for incumbent firms. These include:

- The Frontier Economics' approach to estimating market-based costs seriously understates the pool price and peak demands risk and hence generates a so-called "conservative" portfolio that in reality would create an extreme and untenable risk for retailers.

¹ For the purposes of this paper the term incumbent is used to define those retailers that are Standard Retailer Suppliers for electricity and/or gas in the New South Wales market specifically Energy Australia, Origin and AGL.



- Using a 'point in time' to estimate market-based purchase costs does not reflect actual practice of prudent retailers.
- Should the carbon price be removed those retailers that rely on futures products as a hedge will hold futures with a carbon price inherent in them. A retailer would incur costs associated with managing this potential exposure that needs to be reflected in the regulated retail price.



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1 Introduction

Lumo Energy is pleased to have the opportunity to provide a submission to IPART's review of regulated retail prices and charges for electricity 2013 to 2016. As a second tier retailer, Lumo Energy has a keen interest in the outcomes of the review and the extent it facilitates sustainable competitive entry into electricity retailing in New South Wales ("NSW").

Lumo Energy is 100% owned by Infratil Limited ("Infratil"), a company listed on the New Zealand and Australian Stock Exchanges. Lumo Energy launched on the 5th July 2010 as the new brand for the former New South Wales Electricity. Lumo Energy currently sells gas and electricity in Victoria and NSW, and electricity only in South Australia and Queensland. Today Lumo Energy is the largest second tier energy retailer in the National Energy Market, (NEM), with around 470,000 customers. Strategically the business has strong growth aspirations and its plan is to continue to grow where the markets it operates in facilitate this.

While Lumo Energy sources the majority of its wholesale electricity from other parties, we own four peaking power stations in the NEM, totaling 164MW capacity, which are located in Angaston and Lonsdale in South Australia and the Hunter region in NSW.

IPART has identified a number of questions it is seeking a response for in its Issues Paper. This submission does not respond directly to those questions. The focus of this submission is on how regulated prices can be set to facilitate sustainable new entry into electricity retailing in NSW.

In this submission we identify a number of areas where second tier retailers may be different to incumbent retailers. Given its confidential nature, we have not provided quantitative data in this submission to support some of our views. However, we would welcome the opportunity to meet the Tribunal members and its staff to discuss this further.

The remainder of this submission is structured as follows:

- Section 2 demonstrates the effectiveness of competition in promoting the long-term interests of consumers, and draws out the key implication for setting regulated retail prices, which is that those prices should facilitate the sustainable entry of new retailers
- Section 3 considers the importance of IPART's approach providing retailers with certainty and predictability
- Section 4 addresses IPART's proposed approach to the cost assumptions for setting regulated price caps, and
- Section 5 considers the proposed opt-in mechanism.



2 Price deregulation is the ultimate objective

A core objective for IPART in setting retail price caps is to facilitate competition being used as the primary source to protect the interests of consumers as quickly as practicable.

Lumo Energy fully supports the deregulation of energy pricing in NSW and therefore IPART's objective.

The reason contestability was first introduced for all electricity customers in NSW was because it is well accepted that where effective competition is feasible, competitive markets can do a better job at protecting customers than regulation.² Indeed, it is the mainstream view in regulatory economics that

regulation is, at best, a second best solution and that even imperfect competition can be expected to deliver better outcomes than can be achieved through price regulation.

Lumo Energy is encouraged in this respect by the recent announcement by the South Australian Government that energy retail prices will be deregulated in that state in two years.³ In making this announcement the South Australian government has recognised that superior outcomes for customers can be achieved through market forces than can be achieved through regulation. Lumo Energy considers this announcement provides a positive signal to policy makers that a decision on price deregulation need not be dependent on the outcomes of the competition review by the Australian Energy Market Commission (AEMC).⁴ To that end, Lumo Energy recommends the NSW government follow the lead of South Australia and set a timetable for the deregulation of energy prices.

IPART's Terms of Reference identify that the continuation of price regulation is underpinned by two guiding principles:

1. to protect customers from retailers exerting market power where competition is ineffective or yet to be assessed, and
2. to facilitate competition in the electricity market.

Lumo Energy supports these guiding principles, and as such, a role for price regulation until such time as competition can be relied upon to protect the interests of consumers.

² It is worth noting in this respect that not all customers have to be 'active' on the market to benefit from competition. The mere fact that there are sufficient 'active' customers in the market (marginal customers) will often mean that those customers that do not make an active choice (inframarginal customers) will also benefit from the competitive activity of providers.

³ See: http://www.premier.sa.gov.au/images/news_releases/12_12Dec/energyprice.pdf

⁴ As IPART is aware, the AEMC has recently commenced its review of the effectiveness of retail competition in the electricity and gas markets in NSW. Details of the review can be found here: <http://aemc.gov.au/Market-Reviews/Open/nsw-retail-competition-review.html>



The focus of this submission, therefore, is primarily on how to achieve the second principle.

It is important to note, however, that pricing is only one part of the equation. It is also necessary that customers are provided with sufficient education about the choices before them and that appropriate non-price measures are in place to protect the interests of customers, particularly vulnerable customers. Indeed, ensuring these other matters are adequately addressed can assist in speeding up the process of competition by providing a safeguard to protect the interest of customers.

2.1 Price caps should be based on new entrant costs

It is vital for the long-term benefit of consumers that regulated retail prices at least accommodate the entry of an efficient new retailer. Through their sustainable market entry the efficiency benefits of competition can be achieved. Noting that IPART has made statements to this end, it is important that the decisions that are ultimately made match these statements. While there may be public and political pressure to take a short-term approach and set prices lower than what would facilitate competitive entry, this would be to the detriment of the long-term interests of consumers. If regulated prices are not assessed against the costs of new entrant participants, new retailers will not be able to enter the market, the existing market power of incumbents will remain entrenched, and prices will continue to need to be regulated for the foreseeable future.

For entry to be sustainable, new entrants must be able to foreseeably earn at least a reasonable return (that is, an efficient margin)⁵ while they are gaining scale, meaning that prices are at a level commensurate with the new entrant's existing, or prospective, cost base. While such a policy may permit incumbent retailers to earn economic profits in the short term, this will provide a strong signal for new entry, and enable those new entrants to achieve efficient scale.

With sufficient new entry and competitive rivalry the outcomes of competition, as identified above, would be expected to arise and deliver long-term efficiency benefits for consumers.

Conversely, if regulated prices are not sufficient to allow for the inherently lower scale economies of efficient new entrants, their entry would be foreclosed. This would mean that the market structure would never improve—only the incumbent retailers would make reasonable margins and new entrant retailers would not be able to survive in the market long enough to achieve scale efficiencies. The incumbents' dominances would be entrenched and the need for the regulation of retail electricity prices perpetuated.

⁵ An efficient margin in this context is one that compensates for the range of costs and risks that retailers bear.



In Appendix A we have provided a number of examples of regulatory precedent in Australia and internationally that demonstrate that it is mainstream practice when regulating a market transitioning to competition for regulators to recognise a new entrant's cost structure when setting prices.

What this reveals is that there is a common recognition that setting the lowest possible price in the short term is at odds with promoting competition. Indeed, setting regulated tariffs on the basis of a new entrant's costs would be highly consistent with good regulatory practice.

2.1.1 Support for the adverse consequences of setting regulated prices too low

The consequences of regulated prices that do not accommodate cost recovery for new entrant retailers are reasonably clear. As discussed above, if prices are insufficient to allow new entrants to recover their efficient costs (including compensation for risk), then firms will not enter the market.

The well renowned economist, Professor George Yarrow, investigated the impact of price regulation on electricity markets for the AEMC review of the effectiveness of competition in Victoria. Professor Yarrow's main finding was that the best outcomes are achieved when price regulation is removed. He also cautioned of the risks associated with setting a regulated price cap that is too low:⁶

Remembering that all regulators tend to come under political pressures to hold down prices in market conditions where costs are rising quickly, the risk of inadvertently setting prices too low is augmented by the risk of prices being set too low for reasons other than the pursuit of backstop protection for consumers against the exercise of market power.

If prices are set too low, the consequence will be restricted supply side incentives and consequential restrictions of competition: new entry will be discouraged, as will investment, innovation, and expansion of all competitors in the market, large and small alike.

Again, I would stress that these risks are real, and not just theoretical. The short commentaries in this Report on experience in Illinois and Maryland serve to illustrate at least some of the consequences identified, and, of course, there is also the experience of the greatest and most harmful "liberalisation" failure of modern times, the reformed Californian electricity markets, to consider. In each case, it is the combination of regulatory intervention and competitive pressures that is so difficult to manage. Price regulation limits the flexibility and adaptability of the market in the face of the various shocks that can occur. The actual consequences in a particular case will depend upon the particular types of shock that eventuate, but the risk exposure itself is caused by the restriction of the market's ability to adapt.

⁶ Yarrow, G., *Report on the impact of maintaining price regulation*, January 2008, p. 72



It can, of course, be slightly un-nerving to contemplate regulatory withdrawal in circumstances of upward pressure on costs/prices, and in the conditions of uncertainty and change that characterise today's energy markets. Particularly when considering impacts on consumers, can look 'safer' to maintain price regulation 'for just a little bit longer'.

The AEMC has previously focused on the more specific issue of which costs should be used for setting regulated prices. In doing so it identified that insufficient cost allowance for new entrants is a cause of ineffective competition. In its review of the effectiveness of retail competition in the Australian Capital Territory ("ACT") the AEMC stated:⁷

As a consequence, the actual margins available to second tier retailers may not be the same as those earned by ActewAGL Retail. Importantly, it appears that second tier retailers do not perceive the potential margins available to them to be a sufficient rate of return that is commensurate with the risks and uncertainties of operating in the market over the long-term. This perceived imbalance between the risk and reward of operating in the ACT has resulted in few retailers entering into (or expanding within) the market. Consequently, there has been very little retailer rivalry observed and there are currently limited offers available to small electricity customers in the market.

Specifically, the AEMC was critical of the regulator's approach of setting prices that reflect the cost structure of an incumbent rather than the efficient costs of new entrants. Indeed, it identified that this approach was a key driver of the lack of effective competition in the ACT.⁸

"Importantly, the potential competitor to ActewAGL Retail is likely to earn less than these effective margins. For example, the calculation of the TFT [transitional franchise tariff] is based on ActewAGL Retail's efficient costs. As a result, the costs are likely to incorporate an element of economies of scale and scope that a new entrant or stand-alone retailer may not be able to achieve. If this is the case, the effective margins set out in Table 7.2 are likely to be at the high-end of the possible margins that a new entrant or stand-alone retailer would be able to achieve."

Setting regulated prices too low also has impacts for those new entrant retailers that nevertheless do enter the market. In the first instance, inefficiently low margins mean that retailers are unable to innovate and invest in service quality and product differentiation. This is predominately because the inefficiently low margins would make the pay-off period for innovations too long relative to customer contracts. Further, low margins impact on the ability for new entrant retailers to gain a foothold in the market. Given new entrant retailers cannot have the brand awareness of incumbent retailers they are typically required to offer substantial discounts to customers in order to encourage them to switch retailer. Inefficiently low margins mean retailers are severely constrained in their ability to make offers that are attractive to customers in this context.

⁷ AEMC, *Review of the effectiveness of competition in the electricity retail market of the ACT, Stage 1 Final Report*, 24 November 2010, p.i

⁸ AEMC, *Review of the effectiveness of competition in the electricity retail market of the ACT, Stage 1 Final Report*, 24 November 2010, p. 59



It is notable that the experience of Lumo Energy to date in NSW aligns with the outcomes identified by the AEMC in the ACT.

3 Prices that provide certainty and sustainability

In addition to there being a sufficient allowance in regulated retail prices to provide an incentive for competitive entry, it is also important that the approach taken by IPART provides certainty about how it will update prices, to the extent this is necessary, within the determination period.

Lumo Energy is interested in establishing a long-term relationship with its customers. The ability to do this, however, is constrained where there is uncertainty about the likely approach to regulated retail price caps over the determination period.

Lumo Energy (like other retailers) has found that offering customers a discount to the regulated retail tariff is an effective way for them to be able to compare products and simplify the decision to switch retailer. Contracts in this respect may span multiple years of a price determination. However, this also means that the margin that is inherent in an offer is dependent on the level of the regulated retail price cap. As such, should the regulated retail price fall (or costs substantially increase without a change to the price) it can mean that a contracted offer is no longer commercially sustainable. This uncertainty shortens the payoff period required for innovations in product offers, making most innovations uneconomic to undertake. More severely, adverse changes to regulated prices can impact on the financial viability or sustainability of all retailers, including second tier retailers.

As many market offers by new entrants are referenced to regulated prices, it creates an imperative for certainty and predictability in the approach to setting regulated prices over the three year period. In particular, it means having confidence that contracts can be entered into with customers in the knowledge that, assuming prudent business practices, they will remain commercial over the period of the price determination. While this confidence can be facilitated by IPART providing clear ex-ante guidance on the circumstances that would cause a change in the price cap, the issue can also be addressed by taking a conservative approach to cost assessments to allow the price to accommodate flexibility and changes in circumstances throughout the determination period.

4 Cost assumptions for setting regulated price caps

As previously indicated, Lumo Energy supports price deregulation in NSW. However, before this is done we are concerned to ensure that the approach taken to set the regulated price cap is appropriately focused on ensuring that an efficient new entrant is able to recover their efficient costs. As demonstrated



by the evidence, setting a price cap on the basis of only incumbent type costs would foreclose on the prospects of sustainable new entry in the market and so entrench the current inefficient market structure.

In a number of areas the nature of costs for new entrant retailers differs from the costs of incumbent operators, including:

- The ability to bear risk and the implications this has for the assumed hedge portfolio
- The smaller relative size of new entrant retailers mean they have less scale than incumbents and a smaller customer base to spread fixed costs, and
- Customer retention costs might be expected to be higher for new entrant retailers given all of their customers have demonstrated a predisposition to switching retailers.

In addition to these areas where costs are higher for new entrant retailers, there are a number of areas where Lumo Energy is concerned that IPART's proposed approach may not provide an adequate allowance even for incumbent firms. These relate to the assumed hedge portfolio for a retailer and whether it is assumed that all contracts are entered into at a point in time for the wholesale cost allowance.

The remainder of this section expands on the points above and in doing so identifies a number of matters that Lumo Energy considers IPART should have regard to when considering the costs that form the basis for determining the regulated retail price cap.

4.1 Wholesale market costs

Where prices are regulated, Lumo Energy supports the overall approach of IPART to apply the weighted average of the long-run marginal cost of supply ("LRMC") and the market based wholesale purchase cost. Further, subject to the need for there to be more transparency about the approach taken, Lumo Energy generally supports IPART's approach to estimating the LRMC component of costs.

Lumo Energy's concerns, therefore, relate mainly to the approach that may be taken with respect to the estimate of market-based costs. These concerns relate to the following issues:

- The assumptions taken on the hedge portfolio of retailers and the risk taking that is implied by this approach



- The impracticality of determining the market price based on a marked-to-market approach. and
- The treatment of carbon uncertainty.

4.1.1 Assumed hedge portfolio for the market based wholesale purchase costs

Lumo Energy is concerned that if Frontier Economics' model as it has been applied in the past, and most recently in South Australia, is repeated for setting prospective prices in NSW, the portfolio of hedges assumed for wholesale purchase costs will understate the contracts that a prudent retailer would purchase. This would particularly be the case for new entrant or second tier retailers.

There are two critical flaws in Frontier modeling approach.

First, the model's inputs do not (and arguable cannot) capture the full set of possible price and volume outcomes that might arise and that influence hedging decisions.

Secondly, the Frontier model is na·ive in how it specifies the risk management objective of retailers, and in particular does not give proper regard to the need for retailers – particularly second tier retailers – to protect themselves against extreme price events.

Based on previous application, the Frontier Economics approach does not factor in a range of high demand and high price stress test scenarios due to their historical non-occurrence. Therefore, it understates the real pool prices and peak demand risks that a prudent retailer would consider when deciding on their hedging strategy. As a consequence, it generates a contract portfolio and expected purchase price that leaves an extreme and untenable risk position for retailers. Indeed, the approach taken in the original draft determination in South Australia has been strongly criticised by a number of retailers.⁹

Even if the Frontier model could include a full set of scenarios for price and volumes, the model would fail to predict the real-world hedging behaviour of prudent and efficient retailers (and new entrants in particular) and most likely understate the prudent and efficient level of contract cover. The reason for this is that the Frontier model assumes that retailers are concerned solely about the expected wholesale purchase price and the variance of the possible price outcomes (that is, the average spread of possible outcomes around the

⁹ See for instance: AGL, *Submission to 2011-2014 Electricity Standing Contract – Wholesale Cost Investigation*, 15 November 2012, p.22.



average price). In reality, retailers- and second tier retailers in particular- are also concerned about their likely maximum exposure, that is, their position under extreme outcomes, rather than merely probable or historical outcomes.

The concern with extreme outcomes reflects the fact that a single (even improbable event) – if it occurs – could bring the risk of bankruptcy. Thus, retailers will also conduct a "stress test" of their position under extreme market outcomes, and ensure that their hedging position protects their continued viability. Importantly, this additional objective for hedging may require a much higher level of contract cover than the Frontier model predicts.

A consequence of the discussion above is that the real-life hedging decisions cannot be represented fully and realistically in the highly stylised and assumption-driven modeling of the type performed by the Frontier model. Instead, risk management decisions of prudent and efficient retailers are the product of a far more complex exercise. The deficiency in the Frontier modeling is true for all retailers, but of particular importance for second tier retailers because the relative size of their balance sheet provides reduced capacity to absorb risks.

4.1.2 Point in time or rolling average

IPART has indicated that at this stage it prefers a point in time approach for estimating the market-based purchase costs. In order for retailers to implement this approach they would look to enter into all of their contracts on a single day, being the day that is assumed by Frontier Economics in its model.

Lumo Energy is concerned that this approach does not reflect actual practice. Indeed, it is our view that no prudent retailer would behave in this way. Instead, retailers manage risk by entering into a portfolio of contracts that is 'rolled over' continuously over several years. The level of coverage increases as the timing of electricity consumption, and the consequent purchase through the spot market, approaches. In doing so the wholesale cost to supply always reflects the average contract price over the preceding period.

Not only does a point in time approach not reflect actual or prudent practice it can also drive other perverse outcomes. For instance, it would likely promote short-term hedging outcomes. This in turn can lead to increased wholesale market volatility and price uncertainty for customers.

The impracticality of applying a single day to assessing such costs is a matter that recently has been identified with respect to the assessment of the cost of debt for setting the cost of capital for regulated network businesses in the NEM. In this instance there has been recognition that using a spot value for the



cost of debt does not reflect the actual practice of businesses and a trailing average approach might better approximate the debt costs incurred by an efficiently financed firm. The benefits of using a historical trailing average compared to a point in time approach have been recognised by numerous submissions to the AEMC's consideration of this issue as being a better reflection of the fact that efficient firms have portfolios that roll-over. NSW's own Treasury Corporation specifically commented on this matter noting that a historical average approach is consistent with a prudent debt management approach.¹⁰

In TCorp's opinion, the averaging period use for establishing the cost of debt should be consistent with a prudent debt management approach and stable prices. Prudent debt management will provide a smooth funding profile to at least a 10 year horizon. The averaging period for establishing the regulated cost of debt should therefore match the 10 year prudent financing period. The proposal would deliver secure funding, more stable regulatory prices and better allocative efficiency.

TCorp has a preference for the Ofgem framework. The Ofgem approach takes the ten year average of ten year debt, for both the risk free rate and the debt risk premium, updated annually. In TCorp's opinion, a mechanism that updates debt cost parameters within the regulatory period would closely reflect the model utility's benchmark funding costs, allowing prices to gradually adjust to any changes in market conditions. Further, it would remove the two sources of potential conflict between the Regulator and NSPs around short-term observation periods

Lumo Energy considers that the logic with respect to the cost of debt above holds with respect to the hedge costs of electricity retailers. As such, we urge IPART to reconsider its preferred position on this matter.

4.1.3 Carbon uncertainty

While the last time that retail price caps were determined in NSW there was uncertainty about the introduction of a carbon price, this time there is uncertainty about whether the introduced carbon price will remain in place or as is over the determination period. As IPART would be aware, the Federal Opposition has indicated that it will remove carbon pricing should it win the next Commonwealth election.

Lumo Energy is aware that an annual review of wholesale costs will accommodate any material cost changes that occur over the price determination period. To that end, in order to facilitate prudent hedging it is important that IPART provide ex-ante guidance regarding when it would expect such a change to be factored into the regulated retail price cap. This would assist retailers in better aligning their actual hedging approach to the approach taken by IPART.

¹⁰ NSW Treasury Corporation, *Response to Directions Paper on AERIEURCC rule change proposals*, 16 April 2012, p.3.



The uncertainty associated with whether a carbon price remains also creates costs for retailers today who need to manage carbon exposures inherent in futures pricing. IPART, therefore, needs to also ensure that it properly factors in the costs this uncertainty is creating for retailers.

Prudent retailers will look for ways to minimise exposure to this carbon uncertainty whilst maintain appropriate price protection for its customers. This will inevitably lead to further costs as retailers look for alternative products, such as call options on futures, to mitigate this risk.

4.2 Retail operating costs

There are a number of reasons why retail operating costs are likely to be higher for new entrant retailers than for incumbents, in particular, on a per customer basis. Without properly factoring in these cost differences into retail price caps the sustainable entry of new retailers will be constrained.

The most significant driver of the difference in retail operating costs is the size of incumbent retailers relative to new entrant retailers. The size of incumbents means that scale efficiencies can be achieved, particularly where fixed costs are spread across a larger customer base, but scale efficiencies means they will also achieve lower variable costs per customer. Over the long term if there is price deregulation or price caps are set at a level that enables new entrants to compete, new entrants will be encouraged to make their businesses as efficient as possible delivering the most competitive offer they can to customers.

The large customer base of incumbents means that even for those fixed costs that apply more or less equally between incumbents and new entrants, average costs per customer are lower for incumbents than for new entrants. A particular example in this respect is market fees.

Another cost that, to date at least, may not have been properly factored into retail price caps is the cost associated with bad debts. In the NEM retailers effectively hold the whole of the bad debt for the market. This is because retailers are still required to pay network businesses and the market operator for wholesale energy even when customers fail to pay their bills. It is important, therefore, that an appropriate allowance is made for this cost. While bad debt is also a substantial cost for incumbent retailers, it is relevant to note that the smaller customer base and balance sheet for new entrant retailers likely means again this is an issue that is even more problematic for new entrant retailers than for the incumbent retailers.

4.3 Customer acquisition and retention costs

The cost of acquiring customers is clearly an essential cost to include in order to facilitate competitive entry. It is important that IPART be aware, however,



that customer acquisition costs should be assumed to apply for the entire customer base and not just a percentage that is expected to churn. For a new retailer all of its customers have to be acquired from other retailers at a cost. While for the incumbent retailer, for its existing customers, customer acquisition costs are inherent in the purchase price paid for the business.

An important difference between incumbent retailers and new entrants might be expected with respect to customer retention costs. Demonstrated by the fact that the customers of new entrant retailers have switched retailer, it is more likely that new entrant retailers have customers that are predisposed to switch again. This means that new entrant retailers have to incur higher costs in order to retain a customer base than incumbent retailers. Indeed, the relative 'stickiness' of customers of the incumbents is reflected in the fact that so many remain on price cap prices while superior market offers exist in the market.

In addition, much like retail operating costs, the size of incumbent retailers means that any cost they incur in retaining customers will be lower on a per customer basis. A good example of this is the spend on advertising or brand development – a key component to retaining customers. An incumbent could spend much more in relation to this and still probably have a lower cost per customer than a new entrant – as the cost is spread over a much larger customer base.

5 Opt-in mechanism

In its Issues Paper IPART has again raised the option of an opt-in pricing model. Under this approach all existing regulated retail prices would become unregulated. Customers could then choose to opt-in to a regulated price.

As a general principle Lumo Energy has consistently supported customer choice. In that respect, customers already have the option to choose to opt-in to a market offer. Forcing customers onto a market contract with an option onto a regulated price is likely to create unnecessary and costly regulation. Further, there are a number of undesirable outcomes, including potentially entrenching incumbency depending on the approach taken. Indeed, the experience with smart meters in Victoria demonstrates that customers react poorly to decisions being forced upon them.

Given the costs involved in introducing regulation related to an opt-in mechanism, and the potentially significant risks, Lumo Energy urges IPART to instead rely on market forces to encourage customers to switch to market offers.

We consider in the absence of deregulation this is best facilitated by setting a regulated retail price cap that accommodates the sustainable entry of new entrant retailers.



Appendix A. Regulatory Precedent for setting prices based on new entrant costs

There are various examples in Australia and internationally of regulators having regard to new entrant costs when setting or otherwise influencing retail prices or margins. The common thread in these examples is recognition that setting the lowest possible price is at odds with promoting competition for the long term interests of consumers. These regulators have not seen this is a trade-off of inefficient entry for more competition. Rather, regulators have been clear that only efficient entrants should be able to enter and be viable but they should not be deemed inefficient by virtue of having inherently lower economies of scale upon entry.

We have found this approach used in a variety of contexts in the following jurisdictions.

ESCOSA, South Australia

In its 2004 determination¹¹ of electricity standing contract prices, ESCOSA established the principle that it was inappropriate to set prices based on the lowest possible number achievable by an efficient retailer in light of its objectives.

the Commission is required to have regard to a large number of factors in making a price determination, including the need to promote competition and facilitate entry into new markets. If the Commission was always to reduce the standing contract price to the lowest possible number achievable by an efficient retailer, then there would be no opportunity for another retailer to enter the market and compete on price.

Setting an appropriate level of "headroom" is clearly a matter of judgement, and the Commission has to balance and have regard to 15 different factors (set out in ...section 25 of the ESC Act) in coming to its decision.

If is not simply a matter of setting the lowest possible price...

In setting the appropriate cost allowance, ESCOSA noted that it may be set by reference to a number of benchmarks, such as:

1. *providing a 5-10% margin to allow competitors the opportunity to compete on price;*
2. *the overall returns available in equivalent markets such as Victoria;*

¹¹ <http://www.escosa.sa.gov.au/library/031128-2004EiecStandContPrice-IssuesPaper.pdf> - Dec 2003- Issues paper [most relevant]. Also: <http://www.escosa.sa.gov.au/library/031023-2004EiectStandingContractPrice-DiscPaper1.pdf> - Oct 2003 Discussion paper. <http://www.escosa.sa.gov.au/library/031231-2004EiecStandingContractPrice-Fina1Report.pdf> - Final Report



3. *historical costs and trends*¹²

ESCOSA stated that the determination of 'the cost of supplying the good or service' is only one factor the Commission is required to have regard to:

Other factors which might justify a higher price with "headroom" above the estimated "cost of supply" include:

4. *promoting competition [6(1)(b)(lj)];*
5. *facilitating entry into the market [6(1)(b)(iii)];*
6. *facilitating maintenance of financial viability and incentive for long term investment [6(1)(b)(vi)];*

Victoria

The AEMC reviewed the effectiveness of retail competition in Victoria in 2007. Part of its analysis was on the margins that retailers earned under the regulated retail price cap (standing offer tariff) and market offers. One of the key concerns of the AEMC in this respect was whether the regulated retail price cap provided an efficient margin for the profitable entry of new entrant retailers. The AEMC found that overall there was a sufficient allowance for new entrant costs in regulated prices, but there remained some concerns that the structure and level of the price for some customers was inhibiting competition.¹³

The Commission's margin analysis suggests that competition appears to have placed a sufficient discipline on retailers' market offers to limit margins to those expected in a competitive market. Similarly, margins available under the standing offer tariff, for electricity, appear not to have prevented efficient new entrants from being profitable, at least when considered on average across all customers in a distributor's service area. For gas, however, the results indicate that the scope to offer discounts off standing offer tariffs may have been more limited.

The Commission is mindful, however, that a reasonable margin for the average customer does not imply that all customers are profitable under the existing standing offer tariff, given that the cost of serving a customer can vary as a result of location, tariff type or levels of consumption. Accordingly, the Commission considers that, despite some comments to the contrary, there remains some risk that the structure and level of the standing offer tariff is inhibiting the further development of competition. However, the Commission would also like to reinforce the need for caution when interpreting estimates of margins and drawing inferences from them about the effectiveness of competition given the inherent imprecision in the exercise.

¹² On the specific facts of the case, ESCOSA did not ultimately set an explicit headroom margin, due to the availability of other sources of lower costs for entrants (i.e.

¹³ AEMC, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria, First Final Report*, 19 December 2007. p.146



Europe – approach to margin by regulators and the European Commission in telecoms

The principle and measurement of the appropriate margin for entrants in telecoms has been a prominent issue in Europe, in both ex ante regulatory and ex post competition law contexts. In essence, there is widespread recognition of the merits of using entrants' retail costs rather than incumbents', in order to take account of the inherently greater economies of scale enjoyed by the latter in pursuing the regulatory objective of promoting competition.

As far back as 1998, the European Commission¹⁴ recognised the appropriateness of an approach which sets a retail margin sufficient "to allow a reasonably efficient service provider in the downstream market to obtain a normal profit"¹⁵.

The official collective body of all EU telecoms regulators, BEREC¹⁶, has, in various policy documents, upheld this principle. It notes that there is no one test that is appropriate in all circumstances, and each has its pros and cons. However, it recommended the use of efficient entrants', rather than the incumbent's, downstream costs in the circumstance where:

if the market is mature and the main aim is to promote competition then there might be merit in using [the costs of entrants to measure the appropriate margin].¹⁷

BEREC went on to recommend an approach that explicitly takes account of incumbents' scale advantages, breaking the above-mentioned circularity as follows:

it might be reasonable to assume that the incumbent will attract, e.g., 20 or 25% of the downstream market and to use that assumption in the calculation of the minimum margin. This should in principle allow several competitors to enter and compete vigorously against the dominant provider for downstream business.¹⁸

¹⁴ [http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31998Y0822\(01\):EN:HTML](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31998Y0822(01):EN:HTML)

¹⁵ The EC also recognised the other main approach of using the incumbent's own downstream costs, which may be appropriate in some circumstances.

¹⁶ The Body of European Regulators (BEREC), formerly known as the European Regulators Group (ERG), represents all the EU telecoms regulators and formally advises the European Commission on regulatory policy.

¹⁷ Price consistency in upstream broadband markets - page 20 - http://berec.europa.eu/eng/document_register/subject_matter/berec/regulatory_best_practices/common_approaches_positions/1126-revised-berec-common-position-on-best-practice-in-remedies-on-the-market-for-wholesale-broadband-access-including-bitstream-access-imposed-as-a-consequence-of-a-position-of-significant-market-power-in-the-relevant-market

¹⁸ http://www.erg.eu/streaming/erg_06_33_remedies_common_position_june_06.pdf?contentId=542920&field=ATTACHED_FILE - ERG/BEREC- (this is the collective body of all the national telecoms regulators in the EU countries) Revised ERG Common Position on the approach to appropriate remedies in the ECNS regulatory framework -Annex: Margin squeeze



Incumbents' greater economies of scale is the basic rationale of BEREC for recommending an allowance for new entrant costs in the retail margin. Indeed, BEREC even sees merit in allowing for "inefficient operators" to enter in the short term, such are the long-run pro-competitive benefits:

...A number of [regulators] have suggested that where the market exhibits significant economies of scale and scope, learning curve effects or first mover advantages, then there might be a case for using the higher costs of the downstream competitor.

In a regulatory context, this reasoning may have merit where promotion of competition is the main regulatory principle. Specifically, regulators might find it justified to promote the entry of relatively inefficient operators in the short term in the expectation that they will become more efficient in the long run. Additionally, there might be efficiency benefits from having competitors in the market that although they might be less efficient may still be able to constrain the pricing of the [incumbent] operator.¹⁹

In terms of actual regulatory practice by regulators, BEREC carried out a survey of its constituent regulators to canvass the approach used to set the margin. It noted that regulators either explicitly used entrants' costs or, where using the incumbent's costs,

in half of the cases, the [regulators] admit that they on occasion modified the [incumbent]'s costs to take into account differences in economies of scale and scope or to take into account the inherent advantages enjoyed by the [incumbent] firm.²⁰

United States

In a paper for the AEMC²², Yarrow reviewed retail price de-regulation in a number of jurisdictions. He observes the downside risks for competition associated with freezing rates at too low a level and/or for too long in the crucial transition period between regulation and liberalisation. For example, for the state of Illinois, he notes

At various points in time during the rate freeze, the Illinois Commerce Commission highlighted the problem of the limited incentive for competing suppliers to enter the market during the rate freeze, which is one aspect of the general, 'case 2 problem': restriction of the supply side in consequence of the enforcement of price controls. The

¹⁹

[http://www.irg.eu/streaming/ERG \(09\) 07 Report on the Discussion of the application of Margin Squeeze tests to bundles.pdf?contentId=545844&field=ATTACHED_FILE](http://www.irg.eu/streaming/ERG%20(09)%2007%20Report%20on%20the%20Discussion%20of%20the%20application%20of%20Margin%20Squeeze%20tests%20to%20bundles.pdf?contentId=545844&field=ATTACHED_FILE) - ERG/BEREC - Report on the Discussion on the application of margin squeeze tests to bundles

²⁰ <http://www.irg.eu/template20.jsp?categoryId=260346&contentId=546068>

ERG Report on price consistency in upstream broadband markets - page 20 -

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[http://www.irg.eu/streaming/ERG \(09\) 07 Report on the Discussion of the application of Margin Squeeze tests to bundles.pdf?contentId=545844&field=ATTACHED_FILE](http://www.irg.eu/streaming/ERG%20(09)%2007%20Report%20on%20the%20Discussion%20of%20the%20application%20of%20Margin%20Squeeze%20tests%20to%20bundles.pdf?contentId=545844&field=ATTACHED_FILE) - ERG/BEREC - Report on the Discussion on the application of margin squeeze tests to bundles

²² <http://www.aemc.gov.au/Media/docs/Prof%20Yarrow%20Report-80834941-a50a-4bcd-8b0c-184b30791b18-0.pdf>



periodic reports published by the Commission during the transition process noted that any entry that occurred was fairly limited in scale and scope (up to a maximum of eight competitors), and that only some of those entrants had a sufficient number of customers to support a sustainable business in the longer term.

Crucially, Illinois appears to have been a market in which regulated prices had been held significantly below competitive market clearing levels. At the risk of becoming unduly repetitive, for all the reasons given earlier such price controls tend to have the effect of restricting supply, including by deterring new entry. Illinois experience confirms the earlier analysis, by showing some of the things that can go wrong with a transitional or precautionary price control when the cap is set at too low a level.

Yarrow makes a similar observation for the state of Maryland:

...regulated prices which were set below competitive market levels in the years when the rate freeze was in effect: [The incumbent] estimates ..that the prices in 2006 immediately prior to the expiration of the rate freeze were actually below prices in 1993.