Looking forwards, not counting backwards: PIAC submission to IPART's Draft Report, *Early termination fees—Regulating the fees charged to small electricity customers in NSW*

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Introduction

The Public Interest Advocacy Centre

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit law and policy organisation that works for a fair, just and democratic society, empowering citizens, consumers and communities by taking strategic action on public interest issues.

PIAC identifies public interest issues and, where possible and appropriate, works co-operatively with other organisations to advocate for individuals and groups affected. PIAC seeks to:

- expose and redress unjust or unsafe practices, deficient laws or policies;
- promote accountable, transparent and responsive government;
- encourage, influence and inform public debate on issues affecting legal and democratic rights; and
- promote the development of law that reflects the public interest;
- develop and assist community organisations with a public interest focus to pursue the interests of the communities they represent;
- develop models to respond to unmet legal need; and
- maintain an effective and sustainable organisation.

Established in July 1982 as an initiative of the (then) Law Foundation of New South Wales, with support from the NSW Legal Aid Commission, PIAC was the first, and remains the only broadly based public interest legal centre in Australia. Financial support for PIAC comes primarily from the NSW Public Purpose Fund and the Commonwealth and State Community Legal Services Program. PIAC also receives funding from Trade and Investment, Regional Infrastructure and Services NSW for its work on energy and water, and from Allens for its Indigenous Justice Program. PIAC also generates income from project and case grants, seminars, consultancy fees, donations and recovery of costs in legal actions.

Energy + Water Consumers’ Advocacy Program

This program was established at PIAC as the Utilities Consumers’ Advocacy Program in 1998 with NSW Government funding. The aim of the program is to develop policy and advocate in the interests of low-income and other residential consumers in the NSW energy and water markets. PIAC receives policy input to the program from a community-based reference group whose members include:

- Council of Social Service of NSW (NCOSS);
- Combined Pensioners and Superannuants Association of NSW;
- Park and Village Service;
- Ethnic Communities Council NSW;
- Rural and remote consumers;
- Retirement Villages Residents Association;
- Physical Disability Council NSW; and
- Affiliated Residential Park Residents Association.

1. Introduction

PIAC thanks the NSW Independent Pricing and Regulatory Tribunal (IPART) for the opportunity to comment on its draft report, 'Early Termination Fees: Regulating the fees charged for small electricity customers in NSW' (the Draft Report). This review is seeking to set a cap on base early termination fees (ETFs) for market retail contracts for electricity and gas (the base ETF cap). The cap excludes the cost of any contract inducements, the prices of which are unregulated. Retailers will be able to set their ETF at any level below the cap, or indeed to have no ETF at all.

PIAC supports the policy intent of this review on the part of the NSW Government, which PIAC understands is to offer consumers protection from excessive ETFs. PIAC also notes that the NSW Government has introduced measures that prevent retailers from charging ETFs to customers receiving certain energy rebates, on retailer hardship programs or who have paid any part of their last bill using an Energy Accounts Payment Assistance scheme voucher.

PIAC will argue in this submission that the majority of the costs that IPART has included in its proposed base ETF cap are costs of doing business and are not intrinsically related to the early termination of the contract. Accordingly, PIAC takes the view that these costs should not be included in the base ETF cap. The letter from the NSW Premier to the Chairman of IPART, which accompanies the Terms of Reference (ToR) for this review, states that IPART should consider two issues: the base ETF cap's impact on prices, and the impact on competition.[1] PIAC's comments in this submission outline the negative impact that IPART's proposed cap on the base ETF will have on both prices and competition.

PIAC takes the view that IPART should re-consider its approach to determining the costs that retailers should recover through an ETF. IPART states that an ETF should reflect the costs a retailer would have avoided if the customer had not signed a contract. This means the costs of acquiring the customer and closing the account are included in their base ETF cap. PIAC has previously argued that any ETF cap should be based on the direct costs of giving effect to the early termination, as this more closely reflects the ToR for this review. The ToR state that the base ETF cap must reflect 'a retailer's reasonable cost of giving effect to the termination of a market retail contract'.[2]

IPART has proposed a cap on base ETFs of $130 per year in the first year and $45 per year thereafter.[3] This is well in excess of the $20 cap allowed in Victoria, excluding a pro rata amount to allow retailers to recover the cost of any inducements offered to consumers at the time they sign up to a contract. PIAC takes the view that this cap has not had a negative impact on product diversity or competition in Victoria.

PIAC wishes to emphasise that it is appropriate to compare the Victorian market with that in NSW. This is especially the case given that ETFs will only apply to contracts that offer energy at an unregulated or 'market' price. Victoria is considered by many observers to be the most competitive retail energy market in the world. Competitive activity in the NSW market has

1 O'Farrell, B, *Terms of Reference – Requirements for early termination charges,* (as supplied in letter to Dr Peter Boxall), 17 July 2013, 1. Available at: http://www.ipart.nsw.gov.au/Home/Industries/Electricity /Reviews/ Retail_Pricing/Review_of_requirements_for_early_termination_charges/22_Jul_2013_-_Terms_of _Reference /Terms_of_Reference_-_Requirements_for_early_termination_charges, as at 6 November 2013.

2 Ibid, 2.

3 IPART, *Early Termination Fees: Regulating the fees charged to small electricity customers in NSW—Draft report,* 2013, 21.

increased significantly in recent years, to the extent that it is appropriate to compare the small retail energy market to that in Victoria.

2. Impact of IPART's decision on energy prices

2.1 Reasonable cost of early termination

The ToR for this review state that the amount determined as a base ETF cap 'must reflect a retailer's reasonable cost of giving effect to the early termination' of the contract.[4] In its initial Issues Paper for this review, IPART noted that there were two possible approaches that could be taken to setting the cap: calculating the costs of establishing the contract (and set the cap to compensate retailers for these costs); or, setting the cap to allow retailers to recover the direct costs of terminating the contract early.[5] In its submission in response to the Issues Paper, PIAC took the view that it would be more appropriate for IPART to calculate the base ETF cap with reference to the costs the retailer faced in terminating the contract early,[6] as this more closely reflected the intent of the ToR given to IPART.

IPART's draft decision is that the base ETF cap should be calculated using 'the costs a retailer would avoid if the customer had not signed the contract'.[7] On this basis, IPART calculates the cost of termination as being divided into three categories, and assigns a dollar value to each cost (see Table 1). The total cost of $161 is then translated into a fee of $130 within the first 12 months and $45 thereafter.[8]

Table 1 – IPART's average benchmarked figures for costs to retailers from early contract termination.[9]

Cost category	Example of costs	Value of costs
Customer acquisition	Sales commissions Establishing new account	$83
Losing customer	Managing bad debt	$61
Energy purchase adjustment	Changes to future purchase agreements with electricity generators.	$17

IPART also states that, according to data provided by retailers, the two most significant costs were 'sales channel costs relating to acquiring customers and the cost of bad debt (related to losing customers)'.[10]

PIAC submits that IPART has erred in taking this approach. PIAC believes that a base ETF cap calculated with regard to the direct cost of terminating a contract early is more aligned with the ToR for this review, which refer to 'reasonable costs of giving effect to the early termination of

4 Ibid, 2.
5 IPART, *Early Termination Fees – Regulating the fees charged to small electricity customers in NSW: Issues paper*, 2013, 21-24
6 PIAC, *A friendly goodbye: PIAC submission to IPART's Issues Paper, 'Early termination fees—regulating the fees charged to small electricity customers in NSW,* 2013, 3. Available at: www.piac.asn.au/publication/2013/09/friendly-goodbye.
7 IPART, above n 3, 17.
8 Ibid, 21.
9 Ibid, 22.
10 Ibid.

retail market contract'.[11] Further, PIAC takes the view that costs associated with customer acquisition and most costs associated with finalising a contract early are costs of doing business. After all, there are administrative costs and a risk of bad debt associated with the end of any contract, not simply those that are terminated early.

In addition, PIAC notes that the benchmark regulated price contains a Customer Acquisition and Retention Cost (CARC) allowance.[12] As discussed below, there is a risk that in compensating a retailer for customer acquisition via the ETF, that the retailer will be compensated twice for the same cost.

2.2 Customer acquisition costs

As noted above, the Victorian Essential Services Commission (ESC) has previously determined that ETFs should be capped at $20, plus a pro rata amount to recover the cost of up-front inducements.[13] The ESC notes that costs such as those related to marketing, contract processing and sales commissions are 'general costs that any retailer would incur on entering into any new contract with a customer and, as such, can not be directly attributable to a contract breach'.[14]

PIAC shares the view of the ESC that such expenses are costs of doing business, rather than being specifically related to early termination. PIAC submits that these costs should, therefore, not be counted as 'reasonable costs of giving effect to the early termination', as per the TOR given to IPART. Accordingly, PIAC recommends that these costs not be included in the base ETF cap that is the subject of this review.

Recommendation 1

PIAC recommends that IPART not include customer acquisition costs in the base ETF cap, and that the final cap be reduced accordingly.

2.2.1 Existing mechanism for recovering customer acquisition costs

PIAC opposes including customer acquisition costs in the ETF. However, it also takes this opportunity to assert that IPART has over-estimated how much of these costs should be included in an ETF calculated using IPART's preferred methodology (ie, to compensate retailers for the costs they incurred in obtaining a customer).

In particular, PIAC notes that in its recent price determination for electricity, IPART included a CARC allowance of $22 per MW/h.[15] This level of CARC allowance is based on IPART's calculation that retailers incur indirect costs through discounting of around 8% of the regulated price.[16] Unlike in Victoria, market discounts in NSW are offered off the regulated price. This means that elements of the regulated price are included in many offers. Further, in its recent examination of the effectiveness of retail competition in NSW, the Australian Energy Market Commission (AEMC) found that over the last two years average discounts in NSW have been 5%

11 Ibid, 30.
12 IPART, *Review of regulated retail prices and charges for electricity from 1 July 2013 to 30 June 2016—Final report,* 2013, 110.
13 ESC, *Early termination fees compliance review—supplementary report,* 2009, 11.
14 Ibid 11.
15 IPART, above n 12,119.
16 Ibid, 117.

in the Essential Energy network area and 6% in the Endeavour Energy and Ausgrid network areas.[17]

While the base ETF cap that is the subject of this review will apply to market contracts, PIAC submits that where market contracts are not discounted by an amount equal to the entire value of the CARC for a particular customer, retailers have already received some allowance for customer acquisition. PIAC believes this needs to be taken into consideration to ensure that 'double dipping' does not occur. The AEMC has found that average levels of discounting in the NSW retail energy market are 2-3% lower than those used by IPART in determining customer acquisition costs. PIAC, therefore, recommends that even if IPART does not adopt PIAC's recommendation to classify customer acquisition costs as costs of doing business rather than early termination, IPART should re-examine the value of those costs included in the base ETF cap.

Recommendation 2

PIAC recommends that, if IPART retains its current model for calculating the base ETF cap, it nevertheless should re-examine the level of customer acquisition costs that need to be recovered through the ETF and reduce the cap accordingly.

2.3 Cost of bad debt

At the public forum for this review, the IPART secretariat noted that there is a higher rate of payment delinquency associated with the final bill for an account.[18] PIAC would have welcomed the inclusion of more information on this analysis in the Draft Report. However, PIAC submits that these costs are potentially a feature of any final bill and are unrelated to whether the account was terminated early or otherwise. PIAC, therefore, takes the view that bad debt is a cost of doing business, rather than a 'reasonable cost of giving effect to the early termination'.[19] Even if one accepts IPART's preferred method of calculating the base ETF cap, PIAC does not believe that this is a legitimate inclusion in costs attributed to an individual customer signing a contract. As such, PIAC argues that these costs would be recovered by retailers across their entire customer base and should not, therefore, be imposed on customers who terminate their contract early.

IPART's position is that the broader costs of early termination should be borne by those customers who break their contract early (IPART has set a cap it believes will ensure prices 'do not need to increase due to the introduction of the base ETF cap'[20]). IPART has not been able to show that customers who terminate their contract early are more likely to leave bad debt than any customer who changes supplier. PIAC, therefore, argues that to impose extra costs related to bad debt on consumers who have not necessarily imposed it on retailers is inconsistent with IPART's broader approach.

PIAC notes that there is one possible exception to bad debt being a cost of business, rather than a cost of early termination. This is if the imposition of a high ETF, such as that proposed by IPART, results in customers who would otherwise pay their final bill failing to do so. However,

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17 AEMC, *review of the effectiveness of competition in the Retail Electricity and Natural Gas Markets in New South Wales,* 2013, 27.

18 Merrell Corporation, *IPART review of Early Termination Fees for Electricity Contracts: Public* Hearing, 2013, column 20 (comment by John Smith).

19 O, Farrell, B, above n 1, 1.

20 IPART, above n 3, 17.

PIAC would still not support a high cap on base ETFs to allow retailers to recover any bad debt associated with that high ETF.

As previously stated, the Draft Report notes that retailers submitted that the cost of bad debt was one of the two most significant costs associated with early termination. Given bad debt should rightly be considered a cost of doing business, removing this amount from the base ETF cap would result in a significant reduction in the fee.

Recommendation 3

PIAC recommends that IPART exclude the cost of bad debt from the base ETF cap and reduce the cap accordingly.

2.4 Risk and reward for retailers and consumers

PIAC submits that the proposed base ETF cap over-compensates retailers for the risk of losing customers, while giving them a reward in the form of profits from the supply of energy until the contract is terminated. Conversely, consumers bear the risk of the price increasing at any time during their fixed-term contract, while also facing potential barriers to accessing the benefits of lower prices available from other suppliers. PIAC argues that this is an inequitable division of risk and reward between retailers and consumers.

While PIAC does not support IPART's proposed method of calculating ETFs, PIAC argues that it would be consistent with that approach to take account of some of the reward retailers have earned from consumers. IPART proposes to use the base ETF cap to compensate retailers for the costs they have incurred in acquiring the customer. PIAC submits that if IPART adopts this counting back approach, it would also be appropriate to take account of the profit that retailers have earned during this period. At the public forum for this review, a representative of AGL stated that 'profit is a return on risk'.[21] If consumers bear all the risk from early termination (due to the requirement to pay an ETF), retailers should not be able to retain all the reward.

Recommendation 4

PIAC recommends that IPART take account of the profits that retailers have earned from customers before early termination, and reduce the base ETF cap accordingly.

2.5 Cost impact of the two approaches

As previously stated, the Draft Report notes that IPART's proposed approach 'means that electricity prices do not need to increase due to the introduction of a base ETF cap'.[22] The Draft Report also states that PIAC's preferred approach—namely, basing an ETF on the direct costs of early termination—would see prices increase on market contracts.[23] However, at the public forum for this review, EnergyAustralia noted that the costs it incurs from early termination are 'essentially higher' than IPART's proposed ETF cap.[24]

PIAC anticipates that the competitive pressure of the market will force Energy Australia to increase its efficiency in other areas, or offer consumers new and innovative products, rather than

21 Merrell Corporation, above n 18, column 33 (comment by Meng Goh).
22 IPART, above n 3, 17.
23 Ibid, 20.
24 Merrell Corporation, above n 18, column 12 (comment by Melinda Green).

increase its prices above those of its competitors. In this way, PIAC believes that a lower cap would more effectively focus the power of the competitive market in a way that benefits consumers. Further, PIAC submits that this logic could be extended to the market as a whole by setting a lower base ETF cap. This could be achieved either through using PIAC's preferred 'direct costs of termination' approach or through removing/reducing the costs of doing business currently included in IPART's draft base ETF cap. PIAC argues that the competitive pressure of the market would force retailers to increase their efficiency or innovate in order to attract or retain customers, rather than simply increase prices.

3. Impact of IPART's decision on competition

In the letter accompanying the ToR for this review, the Premier of NSW also instructed IPART to consider the impact of its decision on competition.[25] As previously stated, PIAC believes that a valid comparison can be made between the section of the NSW energy market where prices are not regulated and the Victorian energy market. In Victoria, a cap of $20 plus a pro rata amount to recover the cost of initial inducements has not stopped that market becoming what is often described as the most competitive in the world.

In addition, the low ETF cap has not stopped high levels of product diversity from developing. PIAC takes the view that setting the base ETF cap at the level proposed by IPART will act as barrier to competition. Finally, PIAC believes that there is a risk that retailers will start to compete on the basis of fees, rather than price. This would be a negative outcome for competition and the market, as well as consumers.

3.1 Impact on product diversity

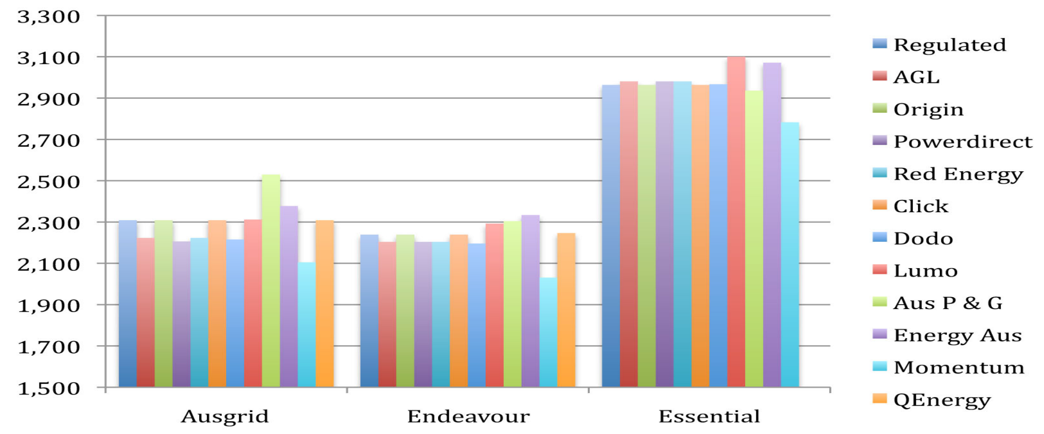
IPART has stated that setting the base ETF cap at the proposed level will benefit competition through product diversity. Specifically, IPART argues that if the base ETF cap was set at zero, retailers would be forced to increase prices to recover the costs of early termination.[26] In contrast, with a cap at a higher level, retailers have the option of recovering these costs through an ETF, higher prices, or a combination of both. IPART argues that these arrangements would have a positive impact on product diversity.[27] However, PIAC notes that despite the $20 cap on ETFs in Victoria (excluding inducements), product offerings in that state have a greater diversity than is available in NSW, excluding time of use offers. This is shown in Figures 1 and 2, on page 8, illustrating the different offers available in NSW and Victoria. PIAC, therefore, cannot agree with IPART's assertion that the proposed base ETF cap, which is $110 higher in year one of a contract than that available in Victoria, is necessary to safeguard a diversity of product offerings in the market. If IPART retains that position, PIAC would welcome the inclusion of the supporting analysis in IPART's Final Report for this review.

In addition, PIAC takes the view that product diversity must be assessed across all the various components of an energy offer. PIAC submits that in a competitive market, such as the NSW small retail electricity market, suppliers will work within the constraints of any regulation to offer as diverse a range of products as possible. This is borne out in Victoria, where an appropriately low ETF cap has not stopped the evolution of a more diverse set of product offerings than those

25 IPART, above n 3, 29.
26 Merrell Corporation, above n 18, column 9 (Comment by Dr Peter Boxall).
27 Ibid, column 10, (Comment by Dr Peter Boxall).

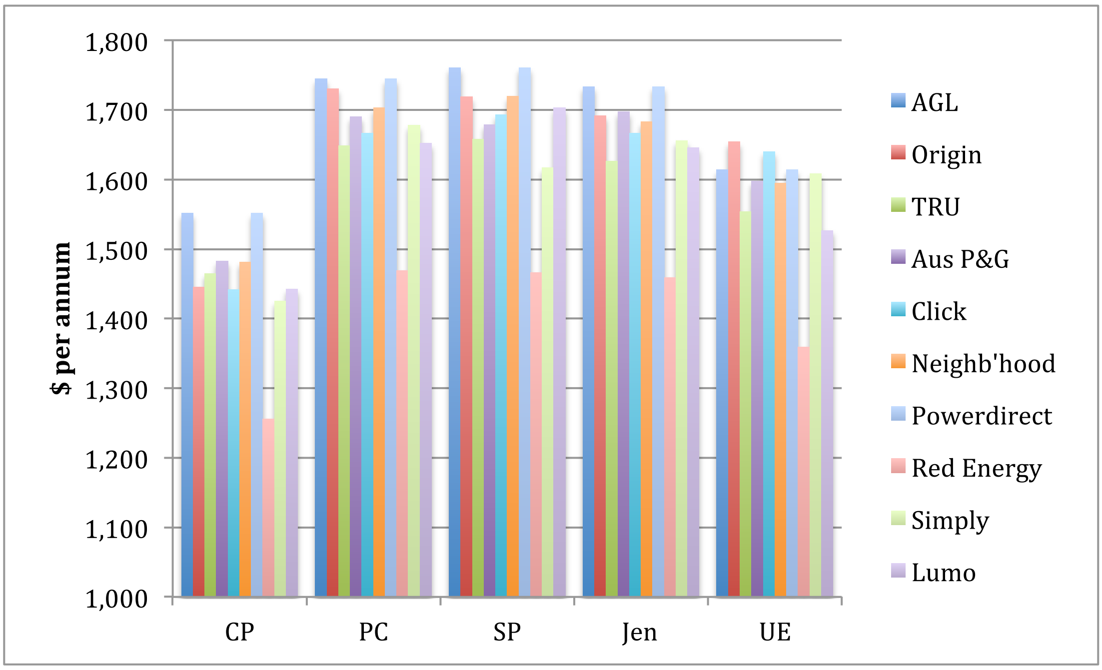
available in NSW. PIAC supports product diversity that provides consumers with genuine options, rather than diversity for diversity's sake.

Figure 1: Tariff shapes in NSW by network area, 2013, excluding discounts[28]



Price in dollars per annum for 7,200 kWh per year, single rate.

Figure 2: Tariff shapes in Victoria, 2013, excluding discounts[29]



Price in dollars per annum for 4,800 kWh, single rate.

28 Dufty, G, *Creating fairer energy and water markets for all, Presentation to PIAC conference,* 2013, 8. Available at: http://www.piac.asn.au/news/2013/10/capacity-crowd-hears-how-energy-and-water-markets-could-be-fairer

29 Ibid, 10.

3.2 ETFs as a barrier to competition

In its Issues Paper for this review, IPART noted that 'unreasonably high ETFs may create a barrier to switching, reducing the benefits that competition can provide'.[30] PIAC submits that because IPART's proposed base ETF cap includes costs of doing business, such as those associated with customer acquisition and bad debt, fees at or near the cap would represent a barrier to customer switching. For example, if a customer faces a fee of $129 for terminating a two-year contract after six months,[31] they would need to be sure that they will be better off by at least that amount under any alternative contract.

This assertion is supported by the recent supplementary report to the AEMC's review of the effectiveness of competition in NSW. The report found that, while customers were generally strongly motivated by the possibility of saving money (76% of residential customers said they would switch in order to save),[32] there remained uncertainty and confusion about whether significant savings could be made by engaging in the competitive market.[33]

PIAC submits that consideration of an ETF versus any savings contributes to this effect—fostering confusion among consumers, which in turn leads to disengagement. Consequently, PIAC recommends that IPART reduce the proposed base cap on early termination fees, in order to ensure that such fees do not have a negative impact on competition.

PIAC also understands that many retailers are moving their activities from a focus on customer acquisition to customer retention. In this environment, it is potentially in the interests of a retailer to include a large ETF that 'locks in' customers, making them less likely to switch suppliers. This raises concerns that retailers are likely to set exit fees close to the cap, rather than significantly lower. As such, it is important the cap is appropriately and fairly set. PIAC would like to see retailers provide customers with offers that are too good to miss, rather than making the customer consider the penalties of leaving.

3.3 Competition on the basis of fees

PIAC has long-standing concerns about the possibility that retailers will increasingly compete on the basis of fees, rather than price. PIAC considers that this would be a negative outcome for consumers, as such a market would be more difficult for customers to understand and, therefore, engage in effectively. Price is the most important indicator of the likely cost of a contract and in PIAC's experience is the primary basis for people's decisions about which supplier to use.

Competition on the basis of fees could see more generic base prices with differences expressed in fee levels. This offers little benefit to those consumers who do not terminate contracts early and consequently do not impose any associated costs on retailers.

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30 IPART, above n 5, 32.

31 IPART, above n 3, 29.

32 AEMC, *Supplementary report: Increasing consumer engagement. Review of Competition in Retail Electricity and natural gas markets in NSW,* 2013, 12.

33 Ibid, 13.

4. Conclusion

PIAC supports the policy intention of the NSW government in setting a cap on base ETFs for market energy supply contracts in NSW. However, PIAC takes the view that IPART's chosen method of calculating a base ETF cap will not benefit consumers or enhance competition in the market. PIAC submits that IPART should not calculate the cap based on the costs that the retailer incurred in obtaining a customer who has terminated a contract early. This approach includes costs related to customer acquisition and bad debt, which PIAC argues are costs of doing business, not costs of early termination. PIAC further argues that most consumers already pay customer acquisition costs and that any customer who changes supplier represents a bad debt risk. To recover bad debt costs specifically from customers who have terminated their contract early is not consistent with IPART's intention of trying to recover any costs to the retailer from the customer who imposed those costs.

PIAC recommends that IPART calculate the base ETF cap with reference to the 'retailer's reasonable costs of giving effect to the early termination of the market contract',[34] consistent with the NSW Government's ToR for this review. PIAC also notes that the equivalent cap in Victoria is $20. PIAC argues that given the strong similarities between the NSW and Victorian energy markets (and not withstanding the differences), this is a more appropriate level for the base ETF cap in this state.

34 O'Farrell, B, above n 1, 1.