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Our Ref:

Fiona Towers
Independent Pricing and Regulatory Tribunal
PO Box Q290
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NSW 1230

10/4/02

Dear Fiona,

Re : Mid Term Review of Regulated Retail Tariffs

Please find attached to this letter our submission to the Tribunal's mid-term review of its determination of the regulated retail tariff. As always we will be happy to assist the Tribunal or the Secretariat by providing further information or comments should these be requested.

We look forward to discussing our views on the regulated tariff at the forthcoming public forum.

Of course, there is nothing in our submission we would wish to have treated as confidential.

Yours sincerely
Public Interest Advocacy
Centre

Jim Wellsmore
Policy Officer

1. Competition and consumer protection

PIAC repeatedly has expressed the view that those consumers who are not likely to receive direct benefits from full retail competition (FRC) should not be expected to bear the costs of its implementation. As the Tribunal will be aware, this concern has been focussed particularly on low-income and disadvantaged households in NSW.

From this position we see the assessment of the claims made concerning the appropriate level of retail margin within the current determination of the regulated or 'standard' electricity tariff as focussing on two main sets of issues. The first is the viability of second tier retailers seeking to undercut the standard retailers and the regulated tariff. The second is the legitimate costs incurred by the incumbents who supply energy at the regulated maximum price.

During the public consultations prior to the current determination a number of prospective second tier retailers proposed that the regulated tariff contain, in addition to an allowance for a standard retail margin, a 'retail headroom' or premium. This was conceived with the purpose of driving significant numbers of households to churn away from the incumbent suppliers.

Interestingly, demands for similar headroom have been aired more recently in Victoria in response to decisions by the State Government to hold increases in domestic tariffs below the levels sought by retailers¹. Assertions by some Victorian market participants of the need for significant increases in retail prices have coincided with predictions that the industry is on the verge of a period of consolidation. One senior industry executive has been quoted as stating that a reduction in the number of competing retailers, perhaps by half, is 'inevitable'². Yet, a number of submissions made to the Tribunal's mid-term review have based the proposals for the inclusion of greater headroom on the view that competition rather than regulation can be relied upon to provide the most effective protection for consumers.

Not surprisingly, the second tier retailers such as TXU and AGL again appear to be leading the argument. The doctrinaire Institute of Public Affairs also has commented on the development of retail competition being dependent on a larger retail margin within the regulated tariff. Unfortunately, the IPA has made a rather confused attempt to illustrate their point, arguing that a higher retail margin is necessary for the growth of competition while asserting that very tight profit margins are inherent to effective competition.

However, PIAC finds it astonishing that this argument has been taken up even by the publicly owned, standard retailers³ in disregard for both current NSW Government policy and one of the key purposes of the *Electricity Supply Act 1995*. For example, Integral Energy has quoted the view of the supposed architect of competition reform in the UK utilities industries, Professor Stephen Littlechild, that facilitating competition is so much more important than the prices paid by consumers that:

¹ Thomson, J. 'High-voltage hardship' in *Business Review Weekly* 28 February 2002

² Clegg, B. 'Energy shake-up on \$1.5bn sale' in *The Australian Financial Review* 5 February 2002

³ Australian Inland Energy and Water is the notable exception, having concentrated instead on their distinct cost base.

it may be more appropriate to set the initial price controls at a level that encourages new entrants into the market rather than at the estimated efficient cost level⁴.

The United Kingdom's national electricity markets regulator, Ofgem, has only recently decided to adopt the approach advocated by Professor Littlechild, announcing last February that it will remove the remaining direct controls over retail prices in that market. Yet, it is difficult to see why NSW should embrace a similar approach at what is a comparatively much earlier stage in the development of the local market. To date the vast bulk of NSW households have seen little in their new market other than demands for higher prices and uncertainty over the strength of competition.

It also needs to be understood that Ofgem has not embraced an open market entirely. Importantly, the regulator has announced that it will continue to investigate retail prices offered to low-income consumers and the relationship between these and the cost-to-serve⁵. Further, in order to continue to address 'fuel poverty' in the United Kingdom Ofgem have determined that retailers must target such households for a minimum of 50% of their spending on the mandated 'Energy Efficiency Commitment'.

2. Prices under competition

Despite the likelihood of fewer competing retailers in the near future the proponents of a larger retail margin and, hence, higher prices for the majority of residential users, rely on the claim that greater headroom will attract new entrant retailers. More importantly, these arguments ignore the fact that, irrespective of the level of competition or the rate of churn, a significant number of low-income, low-use consumers will remain with their incumbent retailer. This is because no retailer is obligated to offer a market-based retail product to any given consumer.

On one reading, then, these calls for a higher retail margin within the regulated tariff are an attempt to make the majority of small-volume consumers pay to make retail competition effective and to deliver benefits for the minority. That is to say, consumers are to be penalised because prospective second tier retailers are proving to be weak competitors for the incumbents. Consumers no doubt will be interested to make comparisons with new entrants in other major industries such as telecommunications or airlines. Neither Optus or Virgin, for example, sought to enter their respective markets on the back of the incumbents being forced to raise their prices. PIAC remains of the view that standard retail customers should not be used indirectly to fund the second tier retailers or smooth their path into the market by paying a premium price for their supply.

⁴ Integral Energy, *Submission to Mid Term Review : Regulated Retail Prices for Electricity to 2004*, March 2002 p.5

⁵ Office of Gas and Electricity markets (UK), *Review of domestic gas and electricity competition and supply price regulation : Conclusions and final proposals*, February 2002, pp.60-61

Another view of the proposals from the incumbents is that they are less interested in facilitating customer churn than maximising their revenue from those households remaining in a quasi-monopoly relationship with their respective standard retailers. The standard retailers accept that the majority of residential customers are not commercially attractive to their second tier competitors. Yet they appear unwilling to acknowledge that this is the reason for the introduction of a regulated standard supply tariff after significant efforts by organisations such as PIAC. It seems that what consumers regard as price exploitation is viewed by some businesses as a legitimate commercial strategy.

EnergyAustralia, for example, has proposed a double whammy of price increases aimed at achieving the current profit target and yet further rises to meet a revised target. PIAC can only wonder at the difficulties of explaining to the community the need for EnergyAustralia to raise its profit performance by some 400%.

A number of submissions have cited the level of customer transfers between retailers in NSW as if this alone demonstrates a link between the original determination and the extent of retail competition. In at least one case the data on churn rates has been misrepresented in order to support the assertion that retail competition is failing under the current regulated tariff.

The issue of cherry picking and its impact on the customer base of the incumbent retailers has been raised by EnergyAustralia. The claim is that the loss of wealthier, higher-volume customers from standard supply contracts needs to be addressed by increasing the revenue earned from the remaining low-income households. However, it is the understanding of PIAC that the significant activity in the new retail energy markets is not the movement of consumers to the second tier retailers but the attempts by the incumbents to secure the more commercially attractive of their existing customer base with their own long-term, market-based retail contracts. In other words, it is EnergyAustralia and the other incumbent retailers who are responsible for the bulk of the cherry picking in the NSW market.

Even with the knowledge of this internal cherry picking, Integral Energy has asserted that it is the current standard retail tariff which will restrict the churning of customers to second tier retailers to perhaps only 20% of the total customer base⁶. In truth, such a level of activity would compare favourably with international experience. However, PIAC long has held the view that this may be a generous estimate of the extent to which NSW households will embrace the concept of 'retailer of choice'. This arises from the structure of the local market and the realities of introducing competition to a commodity such as electricity. It was largely for these reasons that PIAC pursued the issue of a regulated tariff prior to the commencement of FRC.

PIAC has for over three years been expressing its concerns for the weakness of electricity retail competition and drawing attention to the problems of the majority of residential consumers being excluded from the new market. It is extremely galling to find now that these same weaknesses and flaws in FRC are being seized upon in an attempt to force low-income households to pay more for what is an essential service.

⁶ Integral Energy submission, p.9

The activity of the incumbent retailers in churning the wealthier of their existing customers will result in their existing customer base being divided into two classes – on the one hand the more commercially desirable group who are targeted to receive the benefits of FRC in product innovation and, perhaps, lower prices; and on the other hand the bulk of their existing standard customers who are expected to pay higher prices for electricity in order to fund the benefits enjoyed by the wealthy few.

There appears to be wide support from retailers for the standard tariff to reflect the prices being charged in other jurisdictions. Particular reference has been made to the higher retail margin allowed by the Essential Services Commission (formerly the Office of the Regulator-General) for the Victorian retailers. Once again, this argument ignores the realities of the residential consumer market NSW. In particular, it fails to recognise that the incumbent NSW retailers remain far more profitable than their privately-owned counterparts in Victoria. More importantly, it ignores the fact that Victoria does not provide for the existence of 'standard' retailers who are guaranteed a greater than 80% share of the small-volume market segment.

The industry needs to understand that the standard retail supply options for small volume users exist to protect poor and vulnerable consumers. Most importantly, the publicly owned retailers need to accept that they have been given this role not by the regulator but by the NSW Parliament. Rather than trying to divide their customers into winners and losers the standard retailers should note the responsibility given to them under the *State Owned Corporations Act 1987* to balance their apparent commercial instincts with a measure of social responsibility⁷.

3. Competition and retailer costs

The view of PIAC has been that the original determination made more than adequate allowance for the legitimate, efficient costs of the standard retailers. PIAC heard no complaints from the standard retailers about the allowance for costs immediately following the December 2000 determination. Yet we now are told that these present a major difficulty for the businesses. Perhaps the claim for retail headroom has provided a renewed opportunity for the retailers to pursue ambit in their cost claims. Certainly PIAC is mindful of the Tribunal having made the point in its original decision that the retailers' projections of costs were 'somewhat arbitrary'⁸.

The position of Australian Inland Energy and Water with respect to costs and the size of their customer base is deserving of particular attention. While accepting that AIEW may indeed have a much more costly customer base it is noted that they alone of the incumbents have not asked for greater retail headroom. However, the long term sustainability of AIEW is more a question for the Government than an issue of higher prices for customers in that part of the State.

⁷ *State Owned Corporations Act 1989* s.20E

⁸ IPART (2000), *Final Report : Regulated retail prices for electricity to 2004*, December 2000, p.46

More generally, however, PIAC does not accept that the issues of costs are as simple as the retailers are suggesting.

The Tribunal is undertaking separate work on the ROLR and FRC costs of the standard retailers and what further allowances should be made for these in the regulated tariff. The current allowance for FRC-related costs means that the majority of low-volume consumers already are contributing to the creation of an effective retail energy market while having little or no prospect of ever benefitting from these reforms. The explanation advanced by the Tribunal for including an allowance for FRC costs was that competition is intended to deliver benefits to small volume consumers who had been on the equivalent of default supply contracts⁹. An alternate view is that defraying these costs over the entire customer base has served only to make competitive 'market' supply options more attractive to the minority of consumers in a position to take them up.

To the extent that FRC costs are based on investment in capital assets rather than recurrent spending this component of the regulated tariff should fall over time rather than increase. It appears, then, that the current level of retail margin tends towards the generous.

The claim has been made that the transfer of commercially attractive customers to market based supply options offered by the second tier retailers is adding to the average cost of supplying the remaining standard customers. Once again it seems the advocates of a higher level for the standard tariff have confused cause and effect. The understanding of PIAC is that any impact of a constrained retail margin on the level of churn by consumers away from the incumbents will, in turn, constrain the rise in these average customer costs. That is, forcing less wealthy households to pay more for their electricity will result in a self-fulfilling prophecy whereby the average costs of supplying these consumers will rise.

On the other hand, if churn remains as low as some market participants have suggested, it will be difficult for consumers to accept that these costs have risen to an extent which necessitates a weakening of the current price protection.

Furthermore, under the current determination the incumbents are not required to reduce to the target levels established by the Tribunal those tariffs which are over-recovering. In effect, the businesses already are winners twice over through being permitted to increase charges to loss-making customers while retaining the profits they earn from over-charging other customers. No complaints have been made by the businesses about the operation of these 'cross-subsidies'.

PIAC also is very interested in the information held by the incumbents regarding the profitability of their second tier customers, those signed to market based contracts. The opportunities for such commercial tactics as offering 'loss leading' products in order to guard market share and the under-recovery from any market-based customers ought to be offset against claims of higher costs for standard customers.

⁹ *loc cit*

Country Energy has argued that their decision to maintain a more localised customer service, for example through the retention of depots, imposes greater costs which in turn should be recovered from their standard customers. Certainly PIAC welcomes the approach taken by Country Energy. It should be noted, however, that this service level equally has a commercial value for Country Energy in attracting or retaining second tier customers who would, judging by the proposal, be subsidised by their captive standard supply counterparts.

Integral Energy has seized on supposed differentials in the costs of processing bill payments by their standard and market customers¹⁰. PIAC finds it difficult to accept the claims of the retailers concerning these kinds of costs. Experience in recent years has shown that when called upon to demonstrate the costs underlying customer charges such as for 'account establishment' the businesses have produced little or no evidence to support their claims for certain levels of fee.

Since Integral have kept their cost information confidential PIAC is left to speculate that what is being proposed is a higher charge being levied on those customers using the more accessible payment methods. This would result in standard customers being charged more for using the same payment method they have relied on in the past. Yet, the basis for the claims about the benefits of FRC relied in part on innovation in areas such as bill payment methods allowing reduced costs and hence greater competitiveness of new retail supply options. PIAC cannot accept that the introduction of these alternative methods should result in higher costs or reduced access to mandated payment methods on the part of standard customers.

Similarly, the incumbents have sought to argue that the circumstances of FRC have led to increased levels of bad debt which necessitate a higher retail margin. This argument is based on an assumption FRC will see a greater proportion of low-volume, low-income households among the customer base of the incumbents and that this group are more prone to late payment or even non-payment of bills than their wealthier counterparts. PIAC believes the ability of the Tribunal to assess such claims would be assisted were the retailers to make public their internal data on 'bad debt'.

In fact, the total number of customers with unsatisfactory payment histories will not increase with FRC or as a result of the regulated tariff. It is our understanding that in cherry picking their own commercially attractive customers the standard retailers are 'selecting out' those who have such unsatisfactory credit performance. Given the development of an industry-wide credit reporting service it seems likely that the bulk of 'bad paying' customers will remain tied to the incumbent retailers who will continue to have resort to their current practices, including disconnection, for the recovery of unpaid debts.

¹⁰ Integral Energy submission p.4

4. Movements in CPI

PIAC notes that the usual treatment of CPI in economic regulation undertaken by the Tribunal generally has been directed at achieving incentives for regulated businesses to achieve ongoing reductions in costs and for these reductions to be shared, over time, with the wider community. While this goal was not explicit in the determination of the regulated tariff there is nothing inherent in the price-cap model of regulation which would rule out such an approach. Indeed, price setting in the metropolitan water industry in New South Wales embodies this very approach of incentive regulation.

In its original submission to the Tribunal regarding the regulated tariff PIAC argued that the great majority of residential consumers who would not be in a position to take advantage of market-based retail products ought to be assured that they, too, would see direct benefits from the introduction of retail competition. That such benefits could be shared was argued to be an indication of the effectiveness of the new retail energy market.

The treatment of retailer costs in the original determination failed to provide such incentives for the businesses or benefits for consumers. Similarly, the decision concerning CPI movements represented a missed opportunity for the majority of residential users to share some of the benefits of greater efficiencies in a more competitive retail environment. The view of PIAC, then, is that CPI-related increases in the target tariffs should not be permitted.

5. Side constraints

The use of side constraints continues to be supported by PIAC and a range of other community organisations. These limits provide long term certainty for consumers in relation to future prices and, more importantly, the continuing affordability of essential energy services. As such they are a vital element in protecting the interests of low-income consumers.

One concern over side constraints raised in this mid-term review relates to the speed with which the prices paid by all standard retail customers can be brought into line with the target tariffs established by the Tribunal in the original determination. The target tariffs are a useful mechanism which over time will see the rationalisation of the vast range of prices offered to residential and small business consumers. This is not only a sensible economic approach but satisfies the principle of horizontal equity within customer classes.

However, the impact of the regulated tariff on the affordability of electricity by low-income consumers continues to be more important than the often minor variations in the prices actually paid by households in different areas of the State. In other words, achieving this rationalisation of prices is less important than avoiding unsustainable price rises, particularly for low-income households.

Some submissions to the Tribunal have expressed the concern that the current determination might restrict the pass through of increases in the network component of final bills. However, it is our view that the appropriate response to this situation is not to loosen the side constraints but to clarify or amend the

determination so that they apply only to the fixed and variable retail components. This would allow for the full pass through by retailers of network costs (which are regulated separately by the Tribunal) while maintaining the integrity of side constraints in protecting vulnerable consumers from inappropriate price rises being introduced by the businesses.

Country Energy complain that side constraints remove the flexibility of the businesses to move prices in response to commercial circumstances¹¹. Yet, in our view this is precisely the value of side constraints to consumers – the provision of a mechanism whereby commercial imperatives and appropriate flexibility for the businesses is balanced by the interests of customers.

PIAC understands the argument that price movements need to track changes in the costs of supply. The gap between the costs of supply and the revenue recovered might widen should side constraints impose too great a restriction on the ability of the business to move prices. However, in this sense the ‘risk’ of tariffs falling behind costs would seem greatest in those cases where an individual customer is consuming a large amount of energy. If FRC is to be a success then the structure of the retail energy market in NSW and the dynamics of competition will see many of these consumers take up market-based retail products and thus move outside the regime of price regulation and restrictions on price movements. Those consumers with low-volumes of consumption pose a lesser risk individually and yet they continue to have the greatest need for the protection of side constraints.

The proposal from Country Energy that individual side constraints be negotiated between the retailers and the Tribunal is unacceptable to PIAC and to consumers generally. The variable outcomes which would result simply offend the principle of horizontal equity. We do not believe there is sufficient merit in the argument to unbundle the marginal ‘cross-subsidies’ between customers representing varied costs-to-serve. More importantly, such an approach to side constraints necessarily will increase the complexity by which they are determined which would not only greatly compromise the ability of consumers to participate in these decisions but undermine the transparency of the decision making process.

EnergyAustralia has made a specific proposal in relation to the current side constraints applied to off-peak hot water tariffs. It is argued that permitting the retailers to implement a substantial increase in the level of these tariffs will produce a higher uptake of solar hot water products and thus positive environmental outcomes. Given that many households lack the financial ability to finance the up-front acquisition of expensive new solar water heaters perhaps this proposal should more correctly be seen as an attempt by the retailers to redress historical decisions for pricing off-peak energy so far below cost.

¹¹ Country Energy, *Electricity Mid Term Retail Review : Public Submission to the Independent Pricing and Regulatory Tribunal*, March 2002, p.13

6. LRMC of generation

PIAC expressed strongly to the Tribunal its views concerning the long run marginal cost of generation in connection with the original determination of the regulated retail tariff. In particular, PIAC focussed on the concerns that the initial calculation of LRMC undertaken for the Tribunal was directed at the facilitation of full retail competition and would result in windfall profits accruing to the generators. The first of these concerns was informed by the apparent desire on the part of prospective second tier retailers to establish a 'retail headroom'. The second concern arose from the initial calculations of LRMC being based partly on an unreasonably high allowance for the rate of return for investment in new generation.

Following these concerns PIAC welcomed the final determination by the Tribunal regarding the regulated tariff. This not only facilitated future investment in new generation without building in a producer surplus but ensured consumers not attractive to second tier retailers would not be disadvantaged when forced to remain outside the competitive market.

PIAC does not believe that in the short period since the initial determination of regulated retail tariffs that circumstances have developed which require the Tribunal to revise its allowance for the LRMC of generation. Rather, what we have seen is that practical experience with the new retail energy markets has borne out our earlier analysis. The household energy sector provides a very poor base for a competitive market. Retail competition is likely to remain weak and the majority of residential consumers will remain in a quasi-monopoly relationship with their incumbent retailers.

NSW households should not be expected to bear the costs of the creation of an effective retail energy market.

In any event, the profitability of several of the second tier retailers is grounded as much in their investment in new generation capacity as it is in a retail headroom. On the one hand this investment suggests that some retail businesses have positioned themselves to benefit from predicted future rises in wholesale market prices. This runs counter to the arguments that the viability of the retailers depends on a higher level for the regulated tariff. On the other hand, it is clear that these investment decisions are not being affected adversely by the current allowance for LRMC within the regulated tariff.

7. 'Green energy' costs

The allowance made in the original determination for the cost of future energy purchases by the standard retailers included both the LRMC of generation and 'green' energy needed for the businesses to meet existing greenhouse gas benchmarks. Given the importance of other developments related to the enforcement of the greenhouse benchmarks PIAC believes it is appropriate to consider the 'green' component of the costs of future energy purchases separately from LRMC for the purposes of this mid-term review.

The Ministry of Energy and Utilities recently published a proposal for the future enforcement of the standard retailers' greenhouse emissions targets. This proposal has been the subject of public consultation. The cost of compliance with the proposed new regime is calculated by the Ministry to range as high as an additional \$2/MWh in energy costs for the businesses¹². This appears to challenge the allowance for energy costs, including green energy, of \$1/MWh determined by the Tribunal. PIAC has supported the greenhouse compliance regime proposed by the Ministry. However, we do not believe that this forecast price impact should automatically pass through to the regulated tariff.

The upper end estimate of the price impact is dependent on a range of factors such as the adoption of similar benchmark targets throughout the national electricity market (NEM). The likelihood of a national or cross-border approach to achieving these targets is arguably low at the present time. More importantly, these compliance costs are forecast across the duration of the proposed regime – full compliance will only be required in 2006-07 which is well past the lifespan of the Tribunal's current regulated tariff determination.

Finally, it is noted that compliance costs and their impact on energy prices passed through to consumers will depend on the mixture of capital investment (for example in new sustainable sources of generation) and demand management or foregone sales. The Ministry's modelling of the proposal suggests that demand management will be the more significant contributor to the retailers achieving the benchmarks. This is the case particularly in the early years of the proposed regime and under the 'NSW only' case¹³.

A reliance on demand management and foregone sales appears even more likely given the data reported by the Tribunal in its most recent electricity licence compliance report. It is clear that the retailers have not been relying to any significant degree on renewable and other 'green' or low-emissions energy sources. On average for 2000/2001 the NSW retailers obtained only 3% of their total energy needs from such sources¹⁴.

¹² Ministry for Energy and Utilities, *NSW Government Position Paper : Greenhouse-related licence conditions for electricity retailers*, December 2001 p.82

¹³ *ibid.* pp.63-64

¹⁴ IPART (2002), *Electricity distribution and retail licences : Compliance report for 2000/01*, October 2001, p.33

Similarly, while there are sound reasons for clarifying the grounds on which the standard retailers may provide 'green power' tariffs to their customers it is difficult to see how these tariffs should be significantly different from the regulated tariff established by the Tribunal. Again, data published by the Tribunal indicates that as few as 0.46% of all retail sales are based on one of the existing 'green power' options. This is strongly suggestive of such tariffs not being commercially viable, nor achieving very much in the way of environmental outcomes.

In response, the Tribunal should focus on the greenhouse gas related benchmarks proposed for the retailers and their impact on final prices paid by consumers.

Having considered the Tribunal's published information and the modelling undertaken by the Ministry, PIAC believes there are no grounds for increasing the allowance in the regulated retail tariff for the costs of energy purchases within the term of the current determination.

Finally, PIAC concurs with Country Energy in its response to the suggestion that the Tribunal should amend its determination to provide for the introduction of additional 'green energy tariffs'. One of the major thrusts of the determination is to rationalise the number of residential tariffs being offered. New tariffs offering 'green' options to customers are able to be developed by the retailers among their other competitive market products. The competitive market remains the appropriate place for these new tariffs.

8. Retailer-of-last-resort (ROLR) costs

PIAC has always been very clear that the ROLR fee should cover the costs and benefits of performing the ROLR function and that the retailers have to justify the costs they believe will be imposed on them.

As the retailers have not publicly justified the costs involved, PIAC is unable to provide any comment, at this stage, on the level, if any, of a ROLR fee.