

## PIAC speech

Thank you for the opportunity to speak to you today.

IPART and PIAC have had a long association. PIAC provides valuable input into our regulatory processes by advocating the interests and concerns of end-use customers, particularly low-income and disadvantaged customers. PIAC has helped us to identify groups of people who will be most affected by our pricing decisions, allowing us to recommend specific and well-targeted government actions to assist those groups.

Today I am going to talk about:

- ▼ Our recent review of regulated electricity prices, which provided for unfortunately large increases in average prices from 1 July 2011, and prompted us to make a range of recommendations for improving the affordability of electricity.
- ▼ The evolution of competition in the NSW retail electricity market, and the potential for effective competition to protect customers from unnecessarily high prices.
- ▼ Our views on how to enhance consumer engagement in regulatory and review processes.

## Recent review of electricity prices

IPART recently released the final decisions of our annual review of regulated retail electricity prices. These decisions mean that average regulated electricity prices will increase significantly across NSW from 1 July this year. More specifically, these prices will increase by:

- ▼ 17.9% for EnergyAustralia's customers
- ▼ 15.5% for Integral Energy's customers, and
- ▼ 18.1% for Country Energy's customers.

The decisions will mean that residential customers with average consumption will pay between \$4 to \$6 more for electricity per week, or between \$215 and \$315 more per year. Business customers with average consumption will pay \$6 to \$10 more per week, or \$300 to \$530 more per year.

We do not welcome these large increases, and are very aware that they will make life more difficult for everyone, but particularly the most vulnerable households in our community.

As part of our review, we provided a detailed picture of the effect that these increases will have on household disposable income. In Sydney and surrounding areas, some 6% of customers will spend more than 8% of their disposable income on electricity. In the rest of NSW, the proportion is much higher: around 14% of customers will spend more than 8% of their disposable income on electricity. This is because on average, customers in country areas consume more electricity (due to housing stock and climatic conditions) and pay higher prices for electricity (due to higher costs of supply).

We are concerned that low-income households with large consumption may have considerable difficulty in paying their electricity bills. PIAC has highlighted that some of these households already forego what most of us would consider non-discretionary consumption to manage their bills – for example, by not heating or lighting their homes properly.

Given the significant price increases this year, which come after large increases in previous years, we have made a number of recommendations to government that we hope will improve electricity affordability. These recommendations are targeted at both the policy settings that are contributing to higher prices, and the customer assistance measures currently available to help low-income households pay these prices.

### **Recommendations on policy settings**

The 2 drivers of the 1 July electricity price increases are:

- ▼ Higher network costs, which added 9% to retail prices.
- ▼ Higher retail costs associated with the various green schemes. Changes to the Federal Government’s Renewable Energy Target scheme added 6% to retail prices.

We consider that some of the policy settings related to these cost drivers are inappropriate, and are resulting in unnecessarily high prices. We made a number of recommendations on these policy settings, and are pleased to note that governments have responded positively on many of these.

**Starting with the policy settings that drive network costs**, we recommended a review of the National Electricity Rules to better enable the network regulator – the Australian Energy Regulator – to make balanced decisions that are consistent with the National Electricity Law’s objective – which is to promote efficient investment in, and operation and use of, electricity services for the long-term interest of consumers. We believe that the current regulatory framework is systematically biased towards delivering higher prices.

Encouragingly, last week the Australian Energy Regulator indicated that it intends to propose a Rule change to the Australian Energy Market Commission that will:

- ▼ allow the regulator to make unbiased forecasts of efficient capital and operating expenditure
- ▼ create strong incentives for the network businesses to spend no more than is necessary and efficient, and ensure that excessive expenditure is not rewarded
- ▼ establish a process for setting the cost of capital that properly reflects the cost of funds to ensure that consumers are not paying for excessive returns, and the businesses are able to receive a commercial return on efficient investment.

We also recommended that the Standing Committee on Energy and Resources (formerly the Ministerial Council on Energy) review the National Electricity Law to change the merits review process to deliver a more balanced review process.

In addition, we recommended that NSW review its network reliability standards to ensure that the higher reliability standards introduced by the previous government match what customers value and are willing to pay for. We are pleased that the NSW Government has committed to this review, and note that the Standing Committee on Energy and Resources has committed to a similar review at the national level.

If the reviews of network regulation and standards correct the currently inappropriate policy settings driving network prices, future electricity prices will be lower than they otherwise would be. However, we stress that the NSW review will need to be completed by mid-2012 to influence the pricing outcomes of the next regulatory determination to apply from 2014.

It will be extremely important for consumer groups to participate in these reviews, and I will talk about this later. Indeed, we recommended that the NSW Government provide additional funding to customer advocacy groups like PIAC to ensure that they can gain access to sufficient technical expertise to participate effectively in these reviews.

**Moving to the policy settings related to green schemes costs**, we recommended that the NSW Government close its Solar Bonus Scheme to new participants, and require retailers to redirect the financial gain they make from existing participants to the Government to help offset the costs of the scheme. We welcome the Government's decision to suspend its Solar Bonus Scheme, and to consider the retailer contribution at its second solar summit on 1 July 2011.

We also recommended that the Australian Government eliminate the solar credits multiplier under its Renewable Energy Target scheme, as this multiplier increases the costs of the scheme to retailers without increasing the renewable energy generated. We were pleased that after our draft report, the Australian Government announced that it would reduce this multiplier more rapidly than originally planned.

In summary, we are happy with the steps that governments have taken so far, but believe there is still some way to go to ensure that the policy settings influencing electricity costs are appropriate. We will continue to participate in these debates.

### **Recommendations on customer assistance measures**

To help low-income households manage the impact of the 1 July price increases we recommended the NSW Government take immediate steps to:

- ▼ make the Low Income Household Rebate available to otherwise eligible customers who reside in retirement villages and are separately metered, but whose bill is not in their name, and
- ▼ ensure that there are sufficient EAPA vouchers available to assist customers that find themselves in unexpected financial distress.

However, we also think that it is time to review the whole package of assistance measures available to energy customers in NSW. This review should develop eligibility criteria to ensure that customer assistance measures are well-targeted. In addition, it should consider a wide range of issues, including:

- ▼ What is the best way to gauge whether households face financial hardship due to the cost of energy bills?
- ▼ What are the patterns of energy consumption for households across a range of different household characteristics?
- ▼ What combination of measures is likely to best assist a range of different households across the state?

Therefore we also recommended that the NSW Government undertake a comprehensive review of the package of customer assistance measures to ensure that these measures are targeted, effective and efficient.

### **A social tariff**

One thing we did not recommend – which I know some members of the audience support – is the introduction of a social tariff. This is a tariff designed to allow certain disadvantaged customers to gain access to a discounted price that is commensurate with their financial circumstances.

We have previously considered the merits of a social tariff. We were concerned that the introduction of such a tariff will allow retailers to effectively segregate a group of customers that they might deem to be ‘unattractive’. In the absence of retail price regulation, these customers could see their prices increase as retailers argue that they are more expensive to serve because they may pay their bills late, pay their bills in installments, or default on their bills.

In our view, the objective of a social tariff is better achieved by leaving vulnerable customers on the same tariffs as other customers, and providing them with government rebates and other assistance to reduce the end price they pay for electricity.

If consumer groups are concerned about the adequacy of the level of Government assistance available through rebates, we note that this issue would not necessarily be solved by introducing a social tariff. Presumably, this discounted tariff would be made possible through Community Service Obligation payments from the Government to the retailers – which mean that for some customers the level of the discount funded by the CSO may not match their financial circumstances, as may be the case with the rebates that currently exist.

These issues need to be carefully considered in the continuing debate about social tariffs.

## **Competition in the NSW retail electricity market**

I would now like to turn to the issue of competition in the retail energy market.

Full contestability has been in place in NSW for 9 years now, and is continuing to evolve. When **effective** competition is established, this competition should limit price increases to efficient levels – without the need for regulation – so that prices are no higher than they need to be, given the Federal and State policy settings.

The Australian Energy Market Commission will conduct a review of the competitiveness of the NSW retail market in 2012, and will recommend whether or not it is sufficiently effective for the market to be deregulated. It will then be up to the NSW Government to decide whether it will deregulate the market. I do not intend to speculate on the findings of the AEMC's review.

Rather, I would like to discuss briefly:

- ▼ The evolution of competition in NSW to date, including the impact of the sale of the retail businesses of EnergyAustralia, Integral Energy and Country Energy.
- ▼ IPART's view on what features the retail market we would like to see to protect customers from unnecessarily high prices.
- ▼ Whether there are any steps that need to be taken to ensure the retail market continues to develop in the best interests of electricity customers.

## **The evolution of competition in NSW**

Since 2002, all small retail customers in NSW have been able to choose their electricity retailer and enter into a contract with this retailer to supply energy for a market-based price. In 2010, around 35% of these customers had done so. In many cases, retailers' market-based offerings are linked to the regulated tariff – for example, the prices may reflect the regulated tariff (which is set consistent with IPART's determinations) minus a specific discount, of say 5%. But the important point is that the effective price paid by these customers is not regulated.

As retail competition has developed in NSW, as in other regions, the regulatory framework has evolved. We have moved from a prescriptive form of regulation where IPART effectively sets individual prices, to a more light-handed form where there is significant discretion for retailers to set individual tariffs within an overall price cap. In our view, this move was appropriate in the context of the evolving retail market and complemented the development of the market. That is, we considered that a more light-handed form of regulation in the presence of a developing retail market was able to protect customers from unnecessarily high prices.

Earlier this year, the NSW Government sold the three State-owned retailers to TRUenergy and Origin Energy. Origin Energy bought both Integral Energy and Country Energy's retail businesses and TRUenergy bought EnergyAustralia's retail business. As a result, we now have three large vertically integrated energy businesses in the NSW market, alongside a number of stand alone generators and smaller new entrant retailers. How this market continues to evolve in terms of retailers entering or exiting the market, the extent to which customers switch retailers and ultimately the benefits that accrue to customers remains to be seen. However there are a number of steps that, in IPART's view, will help ensure that the competitiveness of the NSW retail market continues to develop in the best interests of customers. I will discuss these steps, however firstly I would like to outline the features of an effectively competitive market.

## **Features of a competitive market**

The main issue for the Australian Energy Market Commission in reviewing the competitiveness of the NSW retail market – and for the NSW Government in deciding whether to remove retail price controls, as the Victorian Government did in 2009 – is whether this market is (or will be) sufficiently competitive to rely on it alone to protect customers from unnecessarily high prices.

As I noted earlier, IPART considers that some of the current policy settings are contributing to unnecessarily high prices. But this is a different issue. Here, I am talking about the risk of retailers exercising market power to raise prices above efficient levels.

IPART supports the removal of retail price regulation where there is an effectively competitive market. We consider that in such a market, the scope for participants to exercise market power is restricted by the presence of competitors, or by the potential for competitors to enter the market. In other words, companies cannot increase their profits by raising prices above efficient levels – or by restricting services or reducing service quality – without risking losing customers to their competitors. We consider that this risk is sufficient to ensure that the market delivers outcomes that are in the best interest of customers.

Since full retail competition was introduced, we have examined the competitiveness of the NSW market as part of our price review process. Our purpose in examining this competitiveness was to determine how light-handed the regulatory framework should be – which is a lower threshold than the AEMC’s test for removing price regulation altogether. Nevertheless, the analysis involved is similar.

In our view, we would like an electricity market to have:

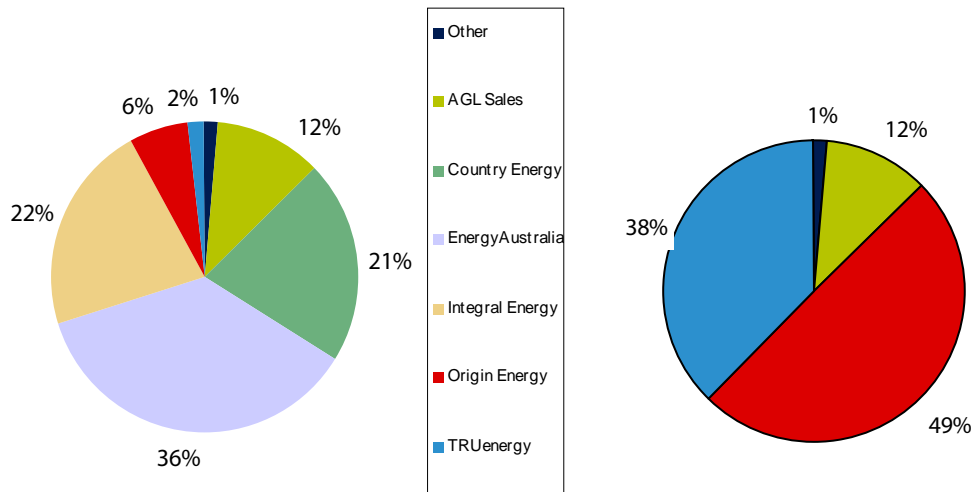
- ▼ a market structure that promotes competitive pressure – either through the presence of sufficient retailers competing for customers’ business, or the ability of retailers to enter the market and contest for customers
- ▼ market and retailer conduct that is conducive to customers negotiating deals that are in their best interest
- ▼ customer behavior and outcomes that lead to customers benefiting from their participation in the market

### Market structure

Several structural features of a market are likely to promote competitive pressure. These include the number of retailers and the market concentration (or the relative market share of the retailers), as well as the barriers to new retailers entering the market.

We note that currently, around half a dozen retailers are offering to supply small retail customers in NSW, which is fewer than when we last looked at this issue in 2010. This is partly due to the NSW Government’s energy reform strategy, which resulted in TRUenergy buying EnergyAustralia, and Origin Energy buying Integral Energy and Country Energy. As a result, the market concentration in NSW has increased (Figure 1.1 below). The market shares of these large retailers within their individual supply areas would also have increased.

**Figure 1.1 Retail market shares of small customers pre- and post- NSW market reforms, (customer numbers as at 30 June 2010)**



However, just because the market concentration has increased does not necessarily mean that the market is any less competitive. To understand this, the AEMC will need to examine whether there remain sufficient competitors, or there are any barriers to entry that may prevent new retailers from competing for small retail customers. In theory, low barriers to entry should ensure that current retailers' pricing decisions are constrained by the threat of entry by other retailers.

When we examined this issued in 2010 we concluded that there were low barriers to entry into the electricity market in Sydney and the surrounding metropolitan areas. In addition, the barriers to entry in the rest of NSW (Country Energy's supply area) were coming down as Country Energy continued to reduce its number of regulated tariffs.

### Market conduct

In an effectively competitive electricity market, the market information available and retailers' behavior should be conducive to customers negotiating deals that are in the customer's best interest.

When we considered this issue in 2010 we had concerns that the customers did not readily have access to simple and understandable information that allowed them to confidently negotiate deals that were in their best interest. This was partly due to the complex nature of the energy industry and retailer offers. However, it was also due to the quality and suitability of the information being provided by industry and aggressive marketing by their door-to-door agents.



We made recommendations to impose conditions on retailers to make it easier for customers to gain access to information about retail tariffs. We also made a recommendation that the NSW Government provide a price comparison service to make it easier for customers to determine if they were getting the most appropriate deal.

We are pleased that both these recommendations were implemented and we believe that they have improved market information.

Since the sale of the electricity businesses in March 2011 we believe that marketing activity has increased. Retailers have increased the level of advertising and discounting to customers. This is a positive development.

However, we remain concerned that aggressive marketing by door-to-door agents may lead to poor customer outcomes. We have stressed to the retailers the importance of them making sure that their agents do not mislead customers. We also remain concerned that some retailer offers purport to provide discounts to customers, but do not sufficiently disclose the benchmark price to which the discount applies, or how long the discount lasts. Retailers that are not being clear about this may be misleading customers, and this is a concern for us.

It is important that regulators, government and retailers ensure that customers are well-informed about their rights and the information provided as part of marketing activities is not misleading.

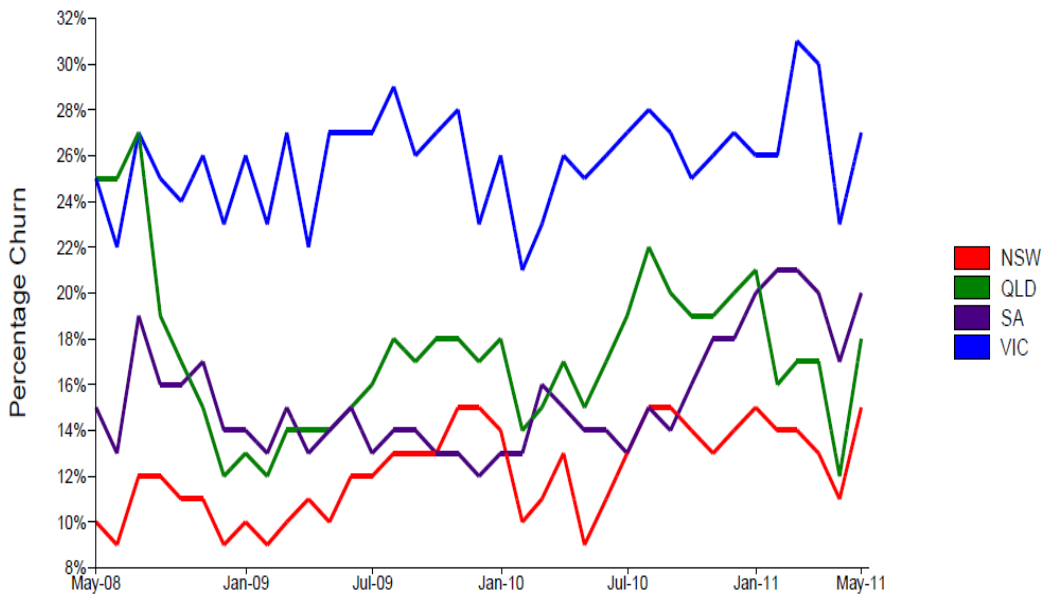
#### Customer behavior and outcomes

While appropriate market structure and market conduct are important conditions, we consider that, ultimately, for a market to be effectively competitive customers need to participate in it and this participation must lead to positive outcomes for them. Therefore, we also need to consider customer behavior and outcomes – including whether customers are effectively exercising choice and whether this choice is delivering outcomes that are in their best interests.

When we considered this issue in 2010, we cautioned against over-emphasis on customer switching rates. While switching rates may provide a good indicator of whether customers are active in the market, they are not necessarily a good measure of whether they are exercising choice effectively.

We note that in NSW, customer switching rates have been lower than in other jurisdictions (Figure 1.2).

**Figure 1.2 Historical annualised monthly transfer rates across jurisdictions**



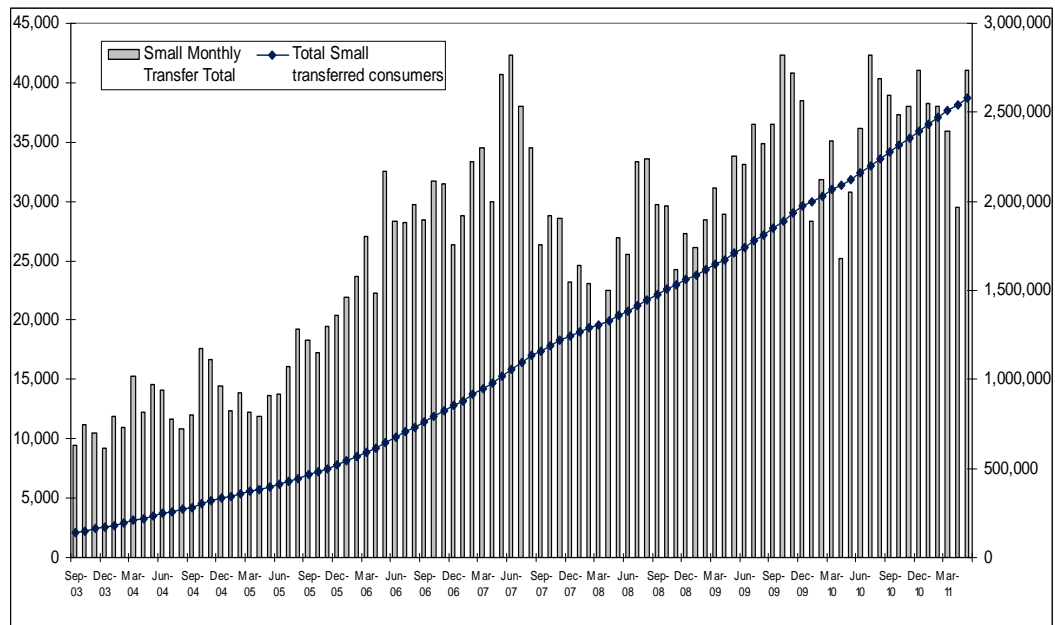
**Source:** AEMO, *National Electricity Market Monthly Retail Transfer Statistics*, May 2011, p 2.

The industry has typically suggested that this has been the result of IPART holding regulated prices low. However, we disagree with this view.

Historically, some regulated retail prices **were** set below the cost of supply. In 2004, we were so concerned about this under-recovery that we developed a regulatory regime that effectively determined a target retail price and forced retailers to move their under-recovering tariffs toward this target.

In our 2007 and 2010 determinations, we ensured that prices included an appropriate retail margin that was consistent with the risks and returns available in other retail electricity markets, and that the regulatory framework complemented the developing retail market. Over these determination periods, customers switching rates continued to grow steadily (Figure 1.3)

**Figure 1.3 Number of transfers for small customers in NSW, September 2003 to March 2011**



**Source:** Collated from AEMO, Retail Transfer Statistics - [http://www.aemo.com.au/data/retail\\_transfers.html](http://www.aemo.com.au/data/retail_transfers.html).

In making our 2011 determination we noted that because we were required to set prices based on the long run cost of new generation, rather than market-based costs, the effective margin provided to retailers is likely to be even higher than the margin we allowed for. Therefore, we are confident that the regulated prices we have set have provided retailers with ample scope to design attractive market offerings, and for customers in turn to exercise choice. It is too early to draw conclusions about the extent of customers exercising choice following the sale of the NSW businesses. We will need to observe behavior over a longer time frame.

In terms of customers exercising choice that delivers outcomes that are in their best interests, we found in 2010 that this was not necessarily the case, and we made recommendations to improve market information which have been implemented.

For future reviews, it would be worth considering customers' experience in markets that have already been found to be effectively competitive, such as Victoria and South Australia. What customer outcomes have resulted from these competitive markets? Is the deregulated Victorian market delivering the customer outcomes that were expected, and how could the transition process to a deregulated market be improved? What can we learn from South Australia's experience with a transitional approach, which links movements in regulated tariffs to market offers?

There may be important lessons that could be applied in NSW to help ensure that the retail electricity market here not only becomes more competitive, but also leads to outcomes that genuinely benefit customers. Therefore, we would encourage the AEMC to consider these matters as part of its 2010 review.

## **Steps to ensure the retail market continues to develop in the best interests of electricity customers**

In IPART's view, a range of steps are important to help ensure that the competitiveness of the NSW retail market continues to develop in the best interests of customers. These steps include:

- ▼ Ensuring that customers are well-informed about the offers being made, including how they compare to the regulated tariff, how long any discounts last, when prices can change, and what termination fees apply.
- ▼ Providing information to customers in a readily available and understandable format that allows them to easily compare offers. Consideration perhaps needs to be given to what aspects of retailer offers and the customer protection framework can be improved to deliver these outcomes.
- ▼ Ensuring that retailer marketers meet all marketing requirements, and that retailers ensure that agents acting on their behalf are exemplarily in their selling techniques so that customers have a positive experience and can benefit from the competitive market.

## **Enhancing consumer stakeholder engagement**

We understand and appreciate PIAC's interest in helping the most vulnerable people. As I mentioned earlier, we welcome PIAC's valuable input into our reviews, which help us to identify the key consumer issues.

Consumers and their representatives can play a vital role in regulatory processes. However, regulatory processes have become increasingly technical and impenetrable to outsiders. A simple indicator of this is the length of final reports. In 2004, our final report on prices for the NSW electricity distribution businesses was 287 pages long. The AER's 2009 report was 722 pages long, and its equivalent 2010 report on prices for the Victorian distributors ran to 1832 pages. It is no wonder that the regulatory and review processes are dominated by the well-resourced industry participants, who can effectively engage in matters of technical detail that are beyond the expertise and resources of consumer groups.

As a regulator, we would find it easier if consumer groups provided countervailing technical input to our review processes, as this would better enable us to weigh up the interests of the businesses and consumers, levelling the playing field. We understand that this would require additional resources. Therefore, in our recent annual report on regulated electricity prices we recommended that the NSW Government provide additional funding to consumer groups to help them participate in the very important network reviews.

However, the problem of consumer engagement goes deeper than this. It is a major issue that cuts across sectors and is getting greater attention from many regulators around the world. To stimulate discussion and debate on this issue in Australia, we commissioned a report from Cambridge Economic Policy Associates (CEPA) that looks at case studies on consumer engagement in regulation around the world. We will release the report this week.

In brief, CEPA found that there is growing disillusionment about the ability of traditional regulatory approaches to lead to effective consumer engagement. But while this is a difficult issue and there is no single answer or best practice, considerable innovation is occurring. For example, regulators are using a variety of tools to try to improve consumer engagement, including

- ▼ enhanced public consultation
- ▼ consumer panels and consultative groups
- ▼ consumer surveys, and
- ▼ constructive engagement between the utilities and consumers.

In many cases, the use of these tools requires additional resources and this will be a real and practical constraint. However, CEPA's work highlights 2 key points:

- ▼ consumer engagement should begin **before** the regulated business makes its submission, not after as is usually the case
- ▼ responsibility for initiating this engagement rests both with the regulator and the business.

For example, regulators are increasingly imposing stronger obligations on the regulated businesses to consult with their consumers in developing their proposals.

We note that prior to the review of their prices in 2010, State Water proactively engaged with each of its customer councils in developing the pricing proposals it subsequently submitted to IPART. State Water has established customer councils for each of the valleys that it services that includes representatives of the various water users in that valley. In our view State Water's decision to consult on its draft prices before they were submitted to IPART significantly improved the regulatory process. State Water's customers may still not have been enthusiastic about the outcomes – higher overall prices – but they had a better understanding of the drivers of price increases and their input was able to be reflected in aspects of the proposals submitted by State Water.

We appreciate your input into our current reviews and look forward to enhanced participation in our future reviews. Importantly, we also look forward to your input to the discussion about how we can enhance consumer engagement.

Thank you for your time today.