

Submission to the Independent Pricing and Regulatory Tribunal on the Review of Regulated Retail Tariffs for Electricity

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Introduction

The Public Interest Advocacy Centre (PIAC) seeks to promote a just and democratic society by making strategic interventions on public interest issues.

PIAC is an independent, non-profit law and policy organisation that identifies public interest issues and works co-operatively with other organisations to advocate for individuals and groups affected.

In making strategic interventions on public interest issues PIAC seeks to:

- expose unjust or unsafe practices, deficient laws or policies;
- promote accountable, transparent and responsive government;
- encourage, influence and inform public debate;
- promote the development of law—both statutory and common—that reflects the public interest; and
- develop community organisations to pursue the interests of the communities they represent.

Established in July 1982 as an initiative of the 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 Centre Funding Program. PIAC generates approximately forty per cent of its income from project and case grants, seminars, consultancy fees, donations and recovery of costs in legal actions.

Utility Consumers Advocacy Program

The Utility Consumers' Advocacy Program (UCAP) was funded in 1998 by the NSW Government to develop policy and advocate in the interests of residential consumers, particularly low-income consumers, in the NSW energy and water industries. The project is based at the Public Interest Advocacy Centre. UCAP staff receive broad policy direction from a community based Reference Group. This includes representatives from the following organisations/population groups:

- Council of Social Service of NSW (NCOSS);
- Tenants Union;
- Combined Pensioners and Superannuants Association of NSW (CPSA);
- Australian Consumers' Association (ACA);
- Park and Village Service;
- Rural and remote consumers; and
- Institute of Sustainable Futures, University of Technology.

1. Retailer hardship programs

PIAC acknowledges the efforts of the incumbent energy retailers, and those of some new entrant businesses, over recent years to develop and implement effective programs for assisting customers in financial hardship. We have campaigned over a number of years to have the retailers accept their responsibility in this area and reduce their previous reliance on disconnections to deal with customer indebtedness. It is reasonable that the incumbent retailers should seek to highlight their progress in this regard.

Further, given the likelihood of significant price rises following this review of standard tariffs it is pleasing that the retailers have anticipated the impact on customers facing difficult financial circumstances. In our view it is deeply disappointing that this consideration was not allowed for by the NSW Government in setting the terms of reference for the review.

A central concern for PIAC is the interests of low-income households with respect to utility services. We expect the outcomes of this review to impose extra burdens on these households in particular.

It is important, however, that the Tribunal understands that the operation of these hardship programs by the individual retail businesses is not a justification for increase in the level of regulated prices. These programs operate to mitigate the impact of price rises for an essential service. They do not imply that such price increases are reasonable or appropriate.

The view taken by our community-based stakeholders is that to promote retailer hardship programs as part of a case for higher tariffs leads to the suggestion that these schemes operate merely to assist customers to pay those higher prices. This would be a cynical approach to hardship programs and we believe it is unfortunate that such an implication might be drawn from the submissions made by the energy retailers.

The increases in standard tariffs will affect the great majority of NSW consumers. Protecting low-income households from the worst of these impacts is an important aim. However, the policies behind these price increases and their size involve a much wider range of public interest considerations. The views we express in the course of this review seek to deal with a number of those wider issues.

Our concerns at the likelihood of increases in the price of electricity are not assuaged by reference to retailer hardship programs.

2. Phase-out of retail price regulation

We note that the NSW Government has determined to phase out retail price regulation for small users of energy. However, we also note that the jurisdictions have agreed to a process whereby the abolition of price protection is to follow a series of reviews to be conducted by the Australian Energy Market Commission (AEMC) into the effectiveness of energy retail competition.¹

Those reviews are to be conducted using a set of criteria that have been subjected to wide public consultation. We note that this level of consultation was not provided by the NSW Government when formulating the terms of reference for this review.

Furthermore, those criteria are broadly based and, with some minor amendments as have been proposed by stakeholder submissions, will bring a diverse set of information to be considered in a decision about the effectiveness, or otherwise, of retail energy competition.

The terms of reference provided to the Tribunal for this determination seem to us to be inappropriate in that they represent a decision to abolish price controls before any review has been conducted into the capacity for retail competition to deliver the supposed protections needed by a large number of residential consumers. The strong view of PIAC is that the terms of reference given to the Tribunal do not in any way permit a decision to be made about the current effectiveness of retail competition in NSW or to assess the likely impact of the move towards deregulated prices on NSW households.

This view is strengthened by the Tribunal having indicated it will base its assessment of FRC on the views of the energy retailers and the information they make available. The likely exclusion of consumers and community organisations such as PIAC from the review of FRC is a serious flaw in the Tribunal's approach. Moreover, given the likelihood that the retailers will provide their information only on a confidential basis, consumers will have no reason for relying on the results of such an assessment.

We draw the attention of the Tribunal to:

- the low rate of customer churn in NSW, evidenced by the data submitted by the incumbent retailers;
- recently published research² showing the poor distribution of gains and losses by consumers under FRC in Victoria;
- the correlation between higher rates of churn in South Australia and massive price rises introduced at the commencement of FRC;
- research in the United Kingdom³ which suggests that even with churn rates as high as 50% many customers are paying prices as much as 33% above the 'competitive level'.

¹ Ministerial Council on Energy, *Communiqué* 19 May, 2006

² Consumer Law Centre Victoria (CLCV) and Centre for the Study of Privatisation and Public Accountability, *Electricity Reform in Victoria: Outcomes for Consumers*, February 2006

³ Waddams Price, C. et al, 'Consumer Choice And Competition Policy: A Study Of UK Energy Markets' in *The Economic Journal*, 115 (October 2005)

However, as we have noted above, a valid assessment of the effectiveness or the extent of retail competition in NSW will require a wider range of information than crude (possibly inaccurate) data about customer churn.

Thus, it is difficult for PIAC to comment on an appropriate form of regulation for retail prices looking forward to the abolition of price controls. We note, however, the preference expressed by many consumers for simple, basic tariffs. This has been expressed by PIAC's community-based stakeholders. It is echoed in research published by the Essential Services Commission of South Australia (ESCOSA). We believe it also is reflected in the recent decision of Country Energy to re-design their residential distribution tariffs with the removal of the distinction between 'urban' and 'non-urban' customers.

PIAC supports the continuation of a price ceiling or cap determined by the N+R formula. We accept that this does not provide anything like simple and transparent prices and is a long way from postage stamp pricing supported by the NSW Government in the metropolitan water industry. However, given the cumulative effect of a series of policy and regulatory decisions, we believe this is the best that can be done for household consumers in the next determination.

We note this would be in line with the terms of reference provide for this review insofar as the Tribunal has been asked to consider simplifying the regulated tariff structures.

PIAC does not support calls for the introduction of a weighted average price cap (WAPC) for regulated retail prices. The effect on prices of a retail WAPC in addition to the WAPC for distribution charges is difficult to predict but clearly it would have the potential to create an increasing divergence in the prices faced by residential customers. This approach would remove much of the remaining transparency of pricing decisions for electricity and mean individual customers would have almost no chance of understanding their prices. Any price signal supposedly created under this form of regulation would be interpreted by customers as little more than a crude rise in the total price.

3. ETEF and cost-reflective tariffs

The strong preference of PIAC is for the effect of the phasing out of the Electricity Tariff Equalisation Fund (ETEF) to be applied to standard tariffs gradually over the course of this next determination. That is, any increase in customer prices for electricity which result from the phase-out of ETEF ought to be implemented through changes to the price path which mirror the step changes in the support for retail load from the Fund.

In practice this will be easier to implement if these changes are achieved on an annual basis, with the steps in any one year being aggregated into a single change in the price path. This would avoid the problem of intra-year price increases. It may be appropriate for the price path to implement these price increases at the start of each financial year, in advance of the steps in the roll-off of the ETEF to be achieved during that year.

PIAC is opposed to consumers being exposed to the full effect of the ETEF phase-out at the beginning of the next regulatory period largely because of the potential this will have for contributing to price shocks. Already NSW households are seeing significant rises in cost of electricity due to increases in distribution charges approved by the Tribunal (including as a result of

licence changes mandated by the NSW Government). We expect the next determination to add further significant increases in costs for many NSW households apart from those associated with the phase-out of ETEF.

A further concern with the rate at which these costs are passed on to consumers is that retail competition, so often suggested as mitigation for rises in the cost of electricity, will increase only slowly (if at all) throughout the period of the next determination. This means that a large majority of residential users in NSW will have few (or no) opportunities to offset the overall rise in electricity prices by exercising choice of supplier.

PIAC understands the policy problem that lies behind the question of cost reflective tariffs in relation to the phase-out of ETEF. However, we see this discussion as pointing to the poor thinking behind the NSW Government's policy of seeking to drive more dynamic retail competition. The cost of hedging, then, is of particular interest to residential consumers. We will make further comment on this below.

4. Roll-out of ToU meters

Time-of-use (ToU) meters are not mentioned explicitly in the terms of reference for this review. PIAC believes the Tribunal needs to clarify why it has chosen to raise questions about these meters.

It is true that ToU metering may have demand management benefits. Certainly this is the claim put forward by some proponents of this technology. It also is a proposition being tested by a series of trials of these meters currently being undertaken, or soon to be commenced, by the NSW distribution businesses. Some parties in the debate about metering have been eager to make claims about the preliminary results of trials already underway. However it remains to be seen whether these claims are, in fact, justified by the actual results and the extent to which demand management may result from the introduction of ToU meters.

In the absence of rigorous information from trials we assert it is too early to base regulatory decisions on the assumption that ToU metering as a generic concept will result in positive demand management outcomes. Likewise, it is too early to tell whether ToU metering can deliver benefits for consumers generally, rather than a minority of households with the opportunity and the capacity to take advantage of the tariff structures.

More to the point, analysis undertaken by PIAC⁴ indicates that the case for ToU metering can be as much about cost-recovery as demand management.

For these reasons we believe it is preferable for the regulator to defer any critical decisions on tariff design intended to extend the offering of ToU tariffs to residential users.

We are aware of the decision by the Council of Australian Governments (CoAG) to pursue the development of policy and regulation, which would facilitate the more widespread introduction of ToU meters. Again, that process is far from being completed. In such circumstances the appropriate role for the Tribunal would be to collect information and views of relevance to the task of the CoAG working party. For example, the role of retailers is a critical question to the more widespread introduction of tariffs based on ToU meters and information about their willingness, or

⁴ PIAC, *Paying for what?: the impact of utility tariff structures*, UCAP Occasional Policy Paper No.8, March 2006

preparedness, to use ToU pricing would be of greater value than an attempt by the Tribunal to dictate tariff structures it might hope would facilitate the uptake of new meters. It is not necessary that this task of assessing the stance of retailers be undertaken in conjunction with a review of regulated retail prices in NSW.

Short of a compelling case being established that there are clear customer benefits from the introduction of ToU structures to regulated prices, the view of PIAC is that ToU tariffs remain appropriate in the contestable segment of the market but are not consistent with the needs of the community in relation to standard retail supply of electricity.

We also would appreciate the Tribunal clarifying its view on demand management as a policy aim. That is, whether demand management is central to economic regulation or is instead rooted in the pursuit of environmental benefits. PIAC does not object to the Tribunal seeking to capture important elements of the public interest by considering and encouraging appropriate demand management measures by the electricity supply industry. On the other hand, we note that at times the Tribunal has been firm in the view that matters of non-economic regulation are outside its responsibility. For example, the Tribunal has been reluctant to place much weight on matters of social equity, relying instead on a claim that these concerns more rightly fall into the domain of Government policy.

Demand management clearly can have a place in economic regulation. There is good evidence that appropriate demand management can result in economic benefits for the electricity supply industry and for its customers. Despite this we observe there has been only a slow introduction of demand management in the NSW electricity industry, due largely to the reluctance of the supply businesses.

PIAC takes the view that if demand management, and particularly the widespread introduction of ToU metering, is to be pursued on economic grounds then it is imperative that proposals for meter roll-outs are assessed on economic grounds – that is, for their costs and benefits. At this point there has been no definitive assessment of the costs and benefits to consumers from ToU metering nor, indeed, a policy decision by governments in NSW or the Commonwealth to mandate these tariffs.

To this end we oppose the notion that the standard retailers should be have the discretion to move standard customers on a regulated tariff to a time-of-use tariff. This clearly would have the effect of undermining the current policy of providing all electricity consumers using less than 160MWh per year the choice of a regulated, non-market tariff for their electricity.

5. Options for the form of regulation

As noted above, PIAC supports the retention of the N+R form of regulation for standard retail tariffs. This approach is consistent with the role of standard tariffs since it:

- offers a less complex or ‘vanilla’ tariff for consumers who do not choose or are unable to enter the competitive market;
- provides protection for customers who do not wish or are unable to enter the competitive market;
- allows for the pass through to customers of costs not derived from energy retail functions; and
- enables a clearer identification of tariffs that are under-recovering or over-recovering by comparison with the target tariffs.

We note that the terms of reference are intended to promote a transition away from the provision of the standard tariff. That is, it is envisaged that soon after the conclusion of the next regulatory period NSW consumers will cease to be offered any regulated price protection.

The view of PIAC is that accomplishing this transition will be complex given the many elements that need to be taken into account in the design of standard tariffs. Moreover, this process needs to be based on more than simply exposing consumers to tariffs which are believed to be more reflective of the tariff structures which might be chosen by electricity retailers in the future.

Tariff innovation may lead to a greater exercise of consumer choice on the part of some NSW households. Our view, however, is that the strongest incentives for customers to exercise choice in the competitive market will come price signals in the form of significant price rises. Certainly price pressures will affect a larger number of consumers than, for example, innovative tariffs being offered by competing retailers. We believe there is evidence for this view in research into FRC (including that commissioned in the past by the Tribunal and more recently by the retailers) and in observation of jurisdictions which are experiencing higher rates of churn than NSW (the best example being South Australia).

Furthermore, this view is implicit in the terms of reference established for this review since these primarily are focused on introducing higher retail costs and bringing price headroom to the NSW retail energy market.

The point is that prices will be rising under the next determination and for some customers perhaps rising by a considerable amount. We do not think there can be benefit for consumers in this environment to have more complex tariffs or more confusing choices around the supply of an essential service.

As noted above, PIAC does not support the introduction of a weighted average price cap (WAPC) approach to designing standard tariffs. The basis of the WAPC approach is the use of cost allocation models that rely on arbitrary decisions about the sharing of costs between customer classes. The critical aspect of this model is the 'subsidy free zone' defined by the bounds of marginal and stand-alone costs. Our view is that this 'zone' is so wide as to render meaningless the notion that a customer can determine whether their prices reflect the actual costs involved in their use of the distribution network

In this sense, then, introducing a WAPC approach to the standard tariff would be intended to provide a proxy for the pricing decisions of retailers in a market with more dynamic competition. As we have argued above, however, this is not a reasonable approach given the higher prices it is likely residential customers will see during the next regulatory period.

Our response to the proposal for a 'targeted average price cap' is based on these same considerations. We are concerned that the impact on customers will largely be the same whether target tariffs are determined by a WAPC approach or a targeted average price cap. EnergyAustralia has made a number of strong points in support of its proposal for this new approach. However, the position of PIAC is that the essential characteristics of the standard tariff should be preserved for the next regulatory period or until such time as the NSW Government formally abolishes price protection.

The proposal from Country Energy for a target based on revenue rather than individual tariffs has considerable merit. This is especially the case for Country Energy. As we understand the proposal it could provide a fairly simple solution to the ongoing problem of some tariffs being set at levels that

are significantly below cost recovery. Yet, we question whether in practice there is little to set this model apart from a WAPC approach.

PIAC does not support the relaxation of side constraints as part of the introduction of a target revenue approach. We do not see how consumers will benefit by standard tariffs being weakened by making them more closely resemble tariffs in a competitive market. The point of providing consumers with the choice of standard tariffs is that these tariffs exist alongside the offers made in the competitive market. The NSW Government intends to remove this choice after the next regulatory period, supposedly because at that time the competitive market will be so developed as to offer adequate protection from price exploitation. Since it is clear this condition does not yet exist there can be no compelling case to undermine standard tariffs by dramatically weakening side constraints.

PIAC does consider it may be appropriate to alter the N + R approach by permitting a full pass through of changes to distribution charges. Further comment on this option is provided below.

6. Opt-in standard tariffs not acceptable

PIAC does not support the proposal requiring existing standard retail customers to ‘opt-in’ to regulated tariffs. Given that the vast bulk of NSW households currently receive electricity supply via regulated standard tariffs the introduction of such a requirement would require considerable effort and resources, particularly in establishing a mechanism whereby the choice to opt-in could be exercised.

In effect, this proposal is aimed introducing a mild price shock to encourage consumers to consider a wider range of retail energy products and retailers. We view it as a thinly disguised attempt to manipulate churn rates.

Under this approach incumbent retailers would have clear incentives to have as few customers as possible return to a regulated standard tariff. We do not have confidence that the current marketing strategies of energy retailers are adequate to meet the needs of the majority of customers.

It is claimed by many that in the long run effective competition will restrain the retailers from acting in ways which are economically or socially unacceptable – ie. by taking advantage of consumers. We do not think that this case is made out as well as some would claim. For example, research in the United Kingdom (cited above) suggests that a considerable proportion of customers will remain vulnerable in respect of essential services even in markets where competition is adjudged to be effective. Proponents of the view that competition will constrain retailer behaviour also tend to ignore the evidence of price shadowing by competitors in some markets.

The critical point, however, is that competition is not so well developed in the NSW retail energy market that it can function to protect the majority of consumers. Instead we are forced to rely on a *Marketing Code of Practice* that is not easily enforceable and is characterised by a significant level of breaches by retailers.

In these circumstances requiring customers to opt-in to a standard tariff would amount to a very sizeable disbenefit.

7. Price constraints

PIAC continues to give strong support to the retention of side constraints in regulated tariffs as well as in the network tariffs dealt with by other determinations of the Tribunal. We endorse the point made by the Tribunal that the aim of these constraints on price rises is to protect consumers from rapid increases in the price of essential services such as electricity. Furthermore, we note the benefit to households of side constraints where these act as a limit on the difficulties faced by some households in managing often concurrent rises in prices for energy, water and other goods and services.

In the case of regulated retail tariffs we recognise that side constraints have made it difficult for the standard retailers to raise their revenue to the target level identified by the Tribunal. On the other hand, it seems that the retailers are earning revenue that is only slightly under the level of full cost recovery. Indeed, publicly reported data indicates that the incumbent electricity businesses, 'stapled' retail and distribution providers, overall are earning reasonable rates of return and paying healthy dividends to their shareholder – the NSW Government.

The issue, then, is one of the form or impact of any such limits in a market with weaker price regulation and where the policy intent is to rely on competition between supply businesses to restrain price rises. As we have noted elsewhere in this submission, such a less regulated and (it is presumed) more competitive market will not be forced onto NSW consumers until at least after mid-2010. That being the case we do not see any justification for removing or significantly weakening side constraints for this determination. This is particularly the case since, as we have argued above, the cumulative effect of increases in retail costs, in distribution charges, in wholesale energy prices and higher costs arising from environmental measures will result in NSW households paying higher prices for electricity in any event.

PIAC does not have a firm view as to whether side constraints ought to be applied to individual tariffs or to customer bills. Our initial preference would be for the constraints to apply to customer bills since this would mean that all residential users are treated the same irrespective of historical choices, household size or total demand.

However, we believe there may be a case for some customers to see a price rise higher than the average. The aim would be to address those tariffs where customers are paying prices that are under-recovering by a significant margin and perhaps have been for a considerable period of time. This could take the form of an adjustment applied on a one-off basis to at least reduce the level of under-recovery. An approach such as this would be more consistent with side constraints being applied to individual tariffs.

PIAC supports one further change to the application of side constraints. That is to exclude changes in distribution prices from the side constraints established for the final N+R tariffs. In other words, movements in distribution prices should not be allowed to eat into the side constraint for the total price. The current approach of including movements in network prices under the total bill side constraint clearly restricts the capacity of retailers to lift under-recovering tariffs towards the target level. PIAC remains concerned about the impact on customers of increases in network charges. We believe, however, that the appropriate place for these impacts to be considered is when distribution revenue caps are being determined by the Tribunal (or the Australian Energy Regulator in future) or when the outcomes of a WAPC approach are being reviewed

We do not support proposals to design side constraints so as to permit retailers arbitrarily to move standard customers onto ToU tariffs.

8. Assessing the options

PIAC maintains its support for the N+R form of regulation as the approach to standard tariffs which best balances customer impacts and the need for appropriate returns to retailers and other businesses in the energy supply chain. This is most particularly because N+R allows for prices to be set in a way, which approximates closely the actual costs for each of generation, transmission, distribution and retail activities. By contrast, it may be observed that tariffs set under weaker regulation do not necessarily provide such clear information about the costs incurred on behalf of each end-user.

We recognise that not all of the incumbent retailers have tariffs that are fully cost recovering in all cases. However, it needs to be recognised that not all the retailers are under-recovering. This being the case, we think the Tribunal (and the NSW Government) ought to consider means of addressing these problems other than attempting to resort to proxies for competition.

That Country Energy, the incumbent with the most difficult position with respect to cost recovery, is reporting retail revenues 3% below the level of cost-recovery suggests a small increase in customer prices, not inconsistent with side constraints imposed by previous determinations, deserves consideration by consumers and the Tribunal.

It is difficult for PIAC to provide detailed comment on the exact details of the price increases that may be warranted. This is because we lack information about whether the reported under-recovery has arisen primarily from residential tariffs or those applied to commercial customers. We believe it is likely that a large proportion of this under-recovery is the result of a small number of customers on tariffs that individually are well below the level of cost-recovery. If this is the case it may be reasonable for these customers to face a price rise which is greater than that applied to residential users generally. That is, in some cases it may be appropriate for the Tribunal to set a side constraint for customers on certain tariffs that allow for a greater level of price increase than for customers generally.

It is important to point out that both small overall price rises and targeted adjustments to tariffs comprise a form of detailed management of the pricing decisions of the energy supply businesses. As a result these options conflict with the overall policy orientation preferred by the NSW Government, the retail energy industry and the Tribunal by giving a role to regulatory intervention over and above that of 'market forces' or the operation of competitive markets.

We do note, however, the irony of the NSW Government supporting regulatory interventions where it believes these are needed to support the growth of a competitive market despite their being contrary to the apparent desires of most consumers – that is, introducing retail price headroom in order to stimulate customer switching and the appearance of a more dynamic retail market.

9. LRMC and hedge costs

PIAC considers that the next retail tariff determination will impose a significant increase in costs on consumers for the supply of electricity. This is the result of the terms of reference given to the Tribunal and policy of the NSW Government. Further, there will be very few benefits available to consumers from increased competition during the next regulatory period that will offset those higher costs.

As a result, it will be important that the Tribunal attempt to identify the lower end of a range of estimates for the costs to the incumbent retailers of increased costs for hedging and the long run marginal cost (LRMC) of generation. We believe focussing on the lower end of costs, particularly for energy hedging contracts, is appropriate since this would reflect the behaviour of energy market participants and the increased use of strategies such as joint ownership structures for generation and retail businesses.

In the absence of consultants' advice to the Tribunal it is difficult for PIAC (and perhaps any other stakeholder) to offer more detailed comments. The question of the level of allowance for LRMC captures some of the central elements of the debate about the future of the Australian energy market. On the one hand we are concerned that allowances of LRMC are serving to drive up end-user prices for what is an essential service. On the other hand we recognise that, given current government policy across the NEM, there is a significant public interest in ensuring there is continued private investment in new generation capacity.

PIAC identifies the challenge for regulators and governments as finding the appropriate balance between affordability and reliability.

However, it is important that the Tribunal distinguish clearly between the costs associated with hedging and those derived from estimates of LRMC. A simplistic view might be that LRMC and hedging costs both provide signals for investment in generation. The difference is the timeframe over which the signal might be said to be operating. It is important that the Tribunal avoid 'double counting' of these signals – in effect, compounding the signal and the costs to end-users by including it in both hedge costs and LRMC.

EnergyAustralia has argued that the costs of hedging and risk management by retailers are the more important factor for the Tribunal to take into account. Certainly PIAC agrees there is merit in the point that hedging costs are easier to observe directly and perhaps easier to estimate in the shorter term.

Given the argument put by EnergyAustralia it may be that the Tribunal ought to decide to include in its determination an allowance for only one of these costs.

10. New entrant costs

PIAC and its community stakeholders see this element of the terms of reference wholly as intended to introduce headroom to standard retail prices. That is, the aim is not so much to compensate retailers for appropriate, efficient costs but to stimulate more dynamic competition in the NSW retail energy market. The Government believes it is enough to entice new entrants to the NSW retail energy market by the crude measure of lifting prices for all small end-users. This is irrespective of the likely extent of competition for the majority of NSW residential consumers or whether the end result is a windfall to the incumbent retailers.

There is a case to be made, in the public interest, that regulated prices need to be raised to match higher costs of wholesale energy and to address the under-recovery of retail costs on average. Regulation is used in markets such as for the supply of essential services to ensure that prices remain close to the level of efficient costs. In other markets it is competition that supposedly operates to constrain costs. What is being offered to NSW households now is the prospect of prices being lifted above efficient levels in order to perhaps create the dynamic competition that may eventually reduce prices to their efficient level.

The obvious difficulty is that, having moved away from efficient costs as the gatekeeper for likely new entrants neither the Government or the Tribunal can be sure how much allowance should be made. For example, we would assume the lowest cost retailers would be those businesses that are integrated with a generator. In the case of retailers without such a 'natural hedge' the question is whether the regulatory arrangements should compensate those businesses for the relative weakness of their business strategy.

The broader problem with this aim of stimulating more dynamic competition is that it is unlikely the community will accept that they can benefit from competition in the supply of essential services where this relies on higher prices. It should be noted once more that the introduction of retail price headroom is to occur before any credible assessment is undertaken of the effectiveness of competition in the NSW retail energy market and the extent to which it will prevent further, unreasonable price rises.

PIAC understand that the NSW Government believes that more intense retail competition can address wider market issues such as future investment in baseload generation. Our view is that centrality of this belief in energy market policy reflects the conviction of this Government, and those in other jurisdictions, about what Ronald Reagan referred to as 'the magic of markets'. Retail competition is a very imprecise instrument for attracting new investment in the generation sector, particularly in a market where to date both retailers and consumers have shown a degree of reluctance to engage in the competitive space.

Decisions about investment in generation are for the longer term, certainly beyond the term of the next determination. Any retail price headroom, on the other hand, will impact in the short term. Since standard tariffs will rise from July 2007 the inclusion of higher retail costs on the basis of what might be incurred by a new entrant represents a windfall to the incumbent businesses as well as underwriting higher profitability for second tier retailers. The introduction of retail price headroom will involve consumers in subsidising the creation of a more dynamic market. It will create a wealth transfer from consumers to energy retail businesses

The extent of this transfer will be greater where the Tribunal determines to set the price headroom on the basis of the highest cost new entrant, for example a retailer without an existing customer base in another jurisdiction and without the protection of an internal hedge through being jointly owned with a generation business.

We urge the Tribunal to take a very cautious approach in considering whether to include an allowance for new entrant costs in the standard tariffs.

11. Retail margins

PIAC is not surprised that the incumbent retailers have highlighted examples of higher levels of recovery of retail costs in other jurisdictions. What PIAC and its community stakeholders see in these examples is that jurisdictions with higher levels of competition and customer switching would seem to have higher costs and higher prices. Again, we are left to ponder how consumers can be said to benefit from more dynamic competition where it seems this can be achieved only through the imposition of higher prices.

That the level of cost recovery may be higher in other jurisdictions does not lead to the conclusion that prices must be too low in NSW. As the Tribunal itself is aware, there is strong evidence that in some cases regulators in other jurisdictions have made inappropriate decisions about the types and level of costs which ought to be recovered through regulated or capped prices.

PIAC does not support the retail margin being calculated so as to ‘compensate’ the incumbent businesses for asymmetric risks such as the failure of a retailer’s billing system. It simply is unreasonable for retailers, whether incumbents or new entrants, to expect a free ride such that they can pass on any and all costs and risks to their customers. We are bemused to see energy retail businesses on the one hand eager to expose consumers to the risks of competitive markets but, on the other hand, unwilling to shoulder the consequences of their own planning and management decisions.

Similarly, we question the extent to which the incumbents should be ‘compensated’ for the risk inherent in customers being lost to other retailers when they exercise choice and switch between suppliers. Retailers should not be protected from the consequences of competition, especially not at the expense of consumers. If churn rates do rise as promised then presumably the individual retailers will increase the rate at which they secure new customers from their competitors.

EnergyAustralia have proposed a further ‘compensation’ by way of a mark-up in retail margins to account for the ‘risk’ that market customers of the incumbent retailers may opt to transfer back to a standard tariff. PIAC do not support this option. In our view it is a weak attempt to justify a further increase in retail margins. EnergyAustralia have not provided any evidence to support this proposal other than the implied argument that it is too easy for customers to revert to standard tariffs. In essence, this comes down to an argument that in many cases market contract offers are not sufficiently attractive to consumers to be able to compete with the standard tariffs. This is an argument not about costs but about the level of retail headroom to be set in the next determination – an issue we have addressed above.

12. 10% Green Power

PIAC is interested in the price implications of the NSW Government's new policy that each 'new' customer (whether moving house or changing retailer) be offered a Green Power component of a minimum 10% of their total consumption. We support this policy. In our view it would not be appropriate to attempt to address concerns about price impacts through standard tariffs.

The requirement is for retailers to provide the option of the 10% Green Power component. This will apply to both standard customers and market contract customers. Clearly it will be difficult for the Tribunal to attempt to regulate the price of this component for one group of customers and not for another.

For standard customers the 10% offer effectively will be made in addition to the regulated standard price. We believe this will be consistent with the proper role of standard tariffs in providing a simpler, flatter tariff. Accordingly, we would argue against the inclusion in standard tariffs of an allowance for the 10% Green Power option.

PIAC notes the concerns of the Energy and Water Ombudsman (EWON) about the potential for confusion on the part of standard customers. To paraphrase, we see this as an argument for price regulation to protect standard customers, particularly those who may be described as vulnerable, in cases where it may not be made clear whether the 10% Green Power component is offered along with an offer of a standard contract or the offer of a competitive contract.

We share the concern about the potential for confusion arising from the wording of the legislation and the observed behaviour of energy retailers in marketing 'green' energy products. PIAC has made representations to the Government seeking improvements in the legislation that will implement this new policy. Should such amendments not be made we may elect to make a further representation to the Tribunal on the question of the pricing of the 10% Green Power component.

13. Miscellaneous charges

PIAC welcomes the arguments submitted to the Tribunal by EWON and the NSW Council of Social Service (NCOSS) in relation to miscellaneous charges. We endorse their view that increases in the level of these charges should be approved by the Tribunal only on the basis of firm evidence being supplied by the retailers concerning the costs they incur in relation to these matters. Information on the level of comparable charges in other jurisdictions or industries is not sufficient for this purpose.

As the Tribunal will be aware, PIAC has consistently expressed its concern with these charges and their impact on consumers, especially those on low-incomes or who are tenants. We tend to the view that miscellaneous charges cover costs or activities performed by the retailers which reasonably could be seen as merely the costs of doing business as an energy retailer.

We also note that the retailers each adopt their own practice about when they levy these charges onto their customers. This suggests to us that the claim that these charges are important to the financial integrity of the retailer cost to serve model are weak at best. Indeed, in some cases we are aware that retailers do not levy these charges in deference to the objections of their customers. That

being the case we continue to wonder whether miscellaneous charges are the best way for the retailers to recover the costs they supposedly are designed to address.

Furthermore, while miscellaneous charges can be applied to all 'small' retail customers, we are aware that in some instances the retailers might wish to have recourse to these charges only in respect of some customers. For example, security deposits may be appropriate for small business customers rather than for households.

Our view, then, is that it would be appropriate for the Tribunal to consider whether there is a need to continue with the approach of relying on miscellaneous charges to recover the costs associated with specific customer service activities by the retailers.