# INDEPENDENT PRICING AND REGULATORY TRIBUNAL

# REVIEW OF EARLY TERMINATION FEES FOR ELECTRICITY CONTRACTS

## PUBLIC HEARING

**Tribunal Members**

**Dr Peter Boxall, Chairman**
**Mr Simon Draper, Member**
**Dr Paul Paterson, Member**

**Members of the Secretariat**

**Mr John Smith and Ms Anna Brakey**

**At**

**IPART Offices, Level 8, 1 Market Street, Sydney**

**On Monday, 4 November 2013, at 10.00am**

OPENING REMARKS

THE CHAIRMAN: Good morning, and welcome. Thank you very much for coming. My name is Peter Boxall and I am the Chairman of IPART. I am accompanied by my two fellow tribunal members, Simon Draper, on my left, and Paul Paterson, on my right.

Welcome to our public hearing on early termination fees. Last month we issued our draft decision on the maximum amounts for early termination fees to commence on 1 March 2014. This will limit the fees that retailers can charge customers for breaking their electricity supply contract early. Today's hearing provides an opportunity for us to hear your views and for you to ask questions and comment on our draft decision.

The draft decision would apply to small customers in New South Wales under market contracts for electricity or the electricity component of dual fuel contracts. These are market contracts where both the retailers and the customers are acting within the contract. Issues concerning prices being charged outside the contract should be addressed under consumer law. In any case, in such instances, early termination fees would generally not apply.

We have set these early termination fees aiming at a level where retailers can recover any legitimate costs so they do not need to recover these costs by charging higher electricity prices to all customers.

I also note that under the regulations, these caps cannot be applied to customers on hardship programs or customers receiving other payment assistance. I note also that we are recommending the setting of the maximum fee only. Many retailers charge much lower fees, including zero fees, and customers can and should shop around for the offer that provides them with the best deal for their individual circumstances.

Today, we will have a presentation by the secretariat which summarises our draft decision and stakeholders will then have the opportunity to provide comment.

A transcriber is present to record the proceedings and the transcript will be publicly available within the week.



So that we can have a complete record, please introduce yourself when you start to speak and please also speak clearly.

With that, I invite John Smith, from the secretariat, to provide an overview of our draft decision.

OVERVIEW OF THE DRAFT DECISION

MR SMITH: Thank you, Peter. I will start with a bit of background on early termination fees and what the current arrangements are and what IPART has been asked to do.

The retailers incur a range of costs when they establish contracts with customers. Generally they will try to recover those costs over the term of the contract. However, there is a risk that the customer may leave before the term of the contract and the retailer is unable to recover its costs. Early termination fees are a way to manage this risk.

Currently the level of early termination fees is unregulated in New South Wales. Retailers can decide whether or not to impose early termination fees and, if so, how much. However the New South Wales government has recently decided to impose requirements.

Under the new arrangements that will come into place on 1 March 2014 early termination fees cannot exceed the sum of the caps determined by IPART and the pro rata amount of any up-front inducements provided to the customer. We were asked to set the cap for one component of the early termination fees. We call this amount the base early termination fee or the base ETF cap.

Under our draft decision the maximum fee that retailers can charge electricity customers who terminate their market contract early will be $130 within the first 12 months of the date of first supply and $45 thereafter until the end of the contract. Retailers can also add to this the pro rata amount of any up-front inducement.

This decision will apply to small customers under market contracts for electricity or the electricity component of dual fuel contracts. The caps that IPART determines cannot be applied to customers on hardship programs, customers receiving the low income household rebate or the medical energy rebate or customers who have paid any part of their last bill using an EAPA voucher.

Before I get into the details of how we made our draft decision, there are a few important components of the terms of reference that I need to outline. The terms of reference require that the amounts to be determined must reflect the reasonable costs of giving effect to early termination. It must exclude up-front inducements and the costs based on lost supply or lost profit, and in making our decision, we needed to consider the impacts on consumer prices and on competition.

Our approach involved four key steps. The first step was to consider the types of costs that retailers are currently recovering through their unregulated ETFs; secondly, which costs should be included in the base ETF cap that IPART is determining, given the requirements in our terms of reference; thirdly, consider the level and range of these costs; and, finally, set the base ETF caps having regard to the level and range of these costs and also the requirements in our terms of reference.

We found that currently retailers consider a broad range of costs in setting their early termination fees. This also give rise to quite a broad range of ETFs in current offers. We found that these range from zero up to around $270 in the first year but these amounts would include up-front inducements.

One of the reasons why there is such a broad range of ETFs is that retailers make a trade-off between recovering their costs and the risks of setting an ETF that is too high and then cannot attract customers.

In our issues paper we proposed a couple of approaches for considering what are the relevant costs of early termination. Under our draft decision, we have included the costs that a retailer would avoid if the customer had not signed a contract. This gives rise to costs including customer acquisition costs, administrative costs including the costs of bad debt, investments made on behalf of the customer; and energy purchase adjustment costs.

In our view, these are operational costs and they are not costs based on lost supply or lost profit. We took this approach because we consider that this would allow



retailers to recover legitimate costs that they face in relation to early termination and it would mean that electricity prices would not need to rise for all market customers.

To determine the level and range of these costs, we invited retailers to submit data to us. Three retailers provided this data. We went through a process to ensure that this data was for relevant costs under our framework and that the level of the costs was reasonable.

The two most significant costs provided were customer acquisition costs and this includes the direct costs of enticing a customer onto a market offer. For example, that could be commissions paid to brokers, fees for comparison sites and also online channels. So there is a mix of costs and we took an average of those costs.

The second significant cost was the cost of bad debt. This is the incremental bad debt associated with the final bill.

We also needed to take account of the fact that retailers will start to recover their costs before a customer terminates their contract early. To do this we developed a model. In the model there are two important assumptions: the first is the length of the contract. This affects how fast retailers recover their costs. The second important assumption is the length of the period before the early termination. Obviously the longer the relationship with the customer before the early termination, the more costs that can be recovered and therefore the lower the ETF.

The table in this slide shows the variability of the base ETF when we change those assumptions. For the purposes of our draft decision, we assumed a two-year contract. This is the most common contract that we found in the market at the moment. We also assumed that the customer would stay for either six months or 18 months. This gives rise to ETFs of $130 and $45 thereafter. We opted for simplicity in just setting two base ETF caps, but this is an area where we would like submissions to focus on and give us feedback on.

Finally, to summarise the considerations we have taken to reach our draft decision, we set the caps so that retailers can recover legitimate costs that they face in relation to early termination. We undertook a process to make sure that only reasonable costs were included. If we were to set the base caps lower or zero, it would mean that retailers would need to recover their costs through higher electricity prices for all market customers. This would mean customers who terminate their contracts early would impose costs on other customers.

Under our draft decision the customers who terminate their contract early will face the costs that they impose on the retailer. Because retailers continue to offer products with no ETFs or lower ETFs than our caps, as they do at present, our draft decision should have minimal impact on product diversity and competition.

GENERAL Q&A SESSION

THE CHAIRMAN: Thank you very much, John. I will now invite comments initially from people up at the table and then from anybody else in the audience. Please limit your remarks to five minutes per intervention. Just to remind you again, for the benefit of the transcript please let us know who you are and where you are from before make your comment. Thank you.

Who would like to go first? Carolyn?

MS C HODGE: I am Carolyn Hodge and I am the senior policy officer with the Energy + Water Consumers Advocacy Program at the Public Interest Advocacy Centre.

I would really like to focus a little bit on the framework that you used to develop these cost models. Just looking at the terms of reference, it says:

> The amount or amounts must reflect a retailer's reasonable costs of giving effect to the early termination of a market retail contract or fixed benefit period under a market retail contract ...

IPART has decided between two choices, being the costs the retailer would avoid if the customer had not signed; or the costs if the customer did not complete the contract.

We think the second point more accurately reflects



what the terms of reference were seeking to do because it gives effect to the costs of early termination rather than an event that did not happen.

If you were to follow this model, you would not include customer acquisition costs that are lifting our fees way beyond what are charged in Victoria. Victoria has a $20 early termination fee. The regulator made a decision with regard to acquisition costs and included items such as sales commission, which are mentioned in the report and I take as being included in what you consider legitimate fees. The Essential Services Commission has spoken about commissions as being a cost of doing business.

I guess what we are trying to get to is that we think the government did absolutely the right thing in setting a cap on these fees. We do not want them to be uncapped, but setting these fees at such a high rate means that all of the risks retailers face from being in a market are compensated for and passed on to consumers.

Do you have any comments about why you took this approach and why you think acquisition fees in New South Wales are not a cost of doing business but they are in Victoria?

MR SMITH: We did look at those two approaches, as you pointed out, but we found customer acquisition costs were relevant costs that a retailer needs to recover. If we had taken the other approach as you mentioned, that would not include those costs. The focus of our decision is on allowing retailers to recover reasonable costs of early termination and to allow retailers to recover those costs so that electricity the prices do not need to rise for all other customers.

THE CHAIRMAN: Do you wish to make any further comment, Carolyn?

MS HODGE: I am kind of interested in that because in your model, the model that you decided to go ahead with, you talked about the costs of closing the account and bad debt. To me that assumes that you are saying that all customers who terminate early have bad debt and so all customers who terminate early should pay a fee that reflects that.

On one hand, you are saying that we should have a fee that prevents the costs of early termination going to all customers and therefore lifting price; but on the other hand, you are saying that we need to include the costs of some people leaving bad debt behind them in this early termination fee which is really lifting it beyond what we think is acceptable. How can you keep those two thoughts concurrently? That is something that is really challenging for us.

MR SMITH: With respect to bad debt, what we captured was an average bad debt for a customer. It is not saying that every customer will have a bad debt but a retailer can expect, on average, a certain level of bad debt. What we did was not just capture the total bad debt but we captured an incremental bad debt. There is a level of bad debt associated with any bill that goes out to a customer but the level of bad debt is much higher when it is a final bill, so we caught the incremental cost on average.

MS HODGE: I just think we are kind of moving between two parameters or two paradigms. You want to encourage competition. We are looking at a jurisdiction in Victoria that is often cited as being the most competitive energy market in the developed world and which has a $20 early termination fee.

We are also looking at developing a consumer engagement blueprint to encourage consumers and tell them how they can get benefits from a market and possibly a market that does not have the protection of a regulated price; then at the same time we are saying that we should include all of these costs so that when they do enter the market - and a point that I want to return to - where the retailer puts the price up after people have signed, they need to then also bank on paying a fee up to $130.

It seems to me that really we are limiting the advantage of consumers being in the market and we are giving the industry so much cover for the risks, and that is how they make their money. I don't want to put them at any risk, but I can see that they are not at risk in Victoria so I don't understand why we need this fee.

THE CHAIRMAN: On that point, Carolyn, as we mentioned, it is the maximum fee that can be applied, so there is scope for retailers to charge less and indeed at the moment many do charge less.



In terms of protecting the consumer, the government, by putting a maximum fee, is preventing higher fees being is applied to the consumer. In a sense the government capping the amount of fee that can be paid to the consumer. If anything, it actually would tend to encourage people to take contracts because they would know that the maximum, under this draft decision, is $130 or $45 as opposed to something that could be much higher.

MS HODGE: I think that they would be more encouraged to enter the market if that fee were capped at $20, though. I don't think there is any debate on that.

THE CHAIRMAN: On that point, because I know you have made that point, and in the interests of having a constructive dialogue, if you were to set the fee at zero or close to zero, what you would do then is increase the price that would have to be charged to all customers on the market. Hence that would tend to discourage customers from going into the market.

There is a trade-off here because if you were to set the early termination fee close to zero or zero, then the electricity retailers would have less incentive to offer market contracts than they otherwise would and when they were to offer market contracts, they would tend to be a higher price than would otherwise be the case, so there is an important trade-off here.

MS HODGE: I understand that, but what research has IPART done to check that trade-off and what the effects on prices have been in Victoria?

My second point is that what we don't want to see - in New South Wales, you have this very generic set of energy prices - retailers starting to compete on fees. One retailer will say, "I will only charge you a $30 ETF" and, another will say, "I'll charge a zero dollar ETF", but they have the exact same energy price and that will not benefit the consumers who are doing the right thing because that will never affect them anyway.

THE CHAIRMAN: Again in the interests of dialogue, what would tend to happen is that if you have some scope to have a fee higher than zero, rather than having generic, you will actually have more variety because you can have a combination of somebody setting a fee at the maximum of $130 and charging a slightly lower price compared with somebody setting a fee which is very low - let's say zero - and charging a slightly higher price, and that might well suit particular consumers and particular retailers.

If anything, setting the maximum fee, as is proposed in our draft decision, will preserve the variety of the electricity market contracts that we have in New South Wales as opposed to constricting them. If you set the maximum fee close to zero you will tend to then push everybody, all retailers and all customers, onto one particular type of contract which has a higher ongoing price than otherwise would be the case and you would limit the choice of both retailers and customers

MS A BRAKEY: Mr Chairman, I might add to that. In response to part of your question about our observations of the Victorian market, what we did observe there with the $20 cap is that retailers do not tend to offer diversity around that. I don't know but presumably it is not worth competing on that particular element. So we see that the existence of a cap at a low rate has led to a more uniform product offering around early termination fees.

MS HODGE: But what about the product offerings more broadly? We are talking about energy prices. Are you saying that in Victoria there is not a competitive market in regard to energy prices or it is less competitive because of this fee?

THE CHAIRMAN: No, Carolyn, we are not saying that at all. What Victoria has done is, as you mentioned, deregulated its energy market to a greater extent than a number of other jurisdictions. However, it has set an early termination fee of $20.

What we are saying is that if New South Wales were to set an early termination fee close to zero, you would restrict the competition in New South Wales to less than it otherwise would be. Now, that is not an analysis of what goes on in Victoria because there might be other aspects of the electricity market in Victoria which are less regulated than New South Wales. What we are saying in New South Wales is: if you set a fee close to zero, you will restrict competition because you will limit the choice that both retailers and customers would have if the fee was set



higher.

MR R SOUSSOU: Ramy Soussou from the Energy Retailers Association. First of all, I am not going to comment on the cost assumptions here in the first year and the drop in the second year. All I can say is that in regards to the Victorian situation that you are talking about, the $20, IPART has actually confirmed it correctly. If there are no early termination fees, all customers will pay a premium on their pricing because you have to factor in that risk in all your pricing. It becomes a premium on top of your pricing, so all consumers would be disadvantaged.

In regards to acquisition costs and early termination fees, to enter into a competitive market there are certain fees you have to pay up-front - commissions and all that stuff. Those you have to recover somehow. You can either recover from those customers you have entered into contracts with or you can basically recover those costs from all the customers you deal with. The early termination fees play a bit of an important role in market contracts because you will not disadvantage all consumers.

In regards to applying a cap of $130, this morning before I came here I looked at the Energy Made Easy website. I typed in my postcode to see how many market offers out there would charge me an early termination fee of $130. There were not that many. Most were actually below that figure. There were a couple of retailers way above that. Now what that cap really introduces is more protection for consumers, so, in essence, you are protecting consumers here.

THE CHAIRMAN: Thank you, Ramy. Who would like to go next?

MS M GREEN: Melinda Green from EnergyAustralia. We do not agree with some of the comments made by Carolyn. We provided a lot of our costs - they were very detailed - to IPART in making this determination. I think the review IPART has done is actually much more comprehensive than Victoria ever did. I have done some investigations on what we provided to Victoria when it made its determination of the $20 cap. I also talked to someone who was at the Essential Services Commission at the time and I really don't think they had the level of detailed information that we have here.

Although the market is competitive in Victoria, obviously even if we are setting up our exit fees at that cap level it is much, much lower than the costs actually are.

You talked about all risks being compensated for us in having a cap set at the level that IPART has proposed in the draft decision, but I would say that the costs we provided to IPART were essentially higher than the cap that it has set.

We also have to waive that early termination fee for customers who are vulnerable. We often waive that for other customers as well depending on their circumstances. It is a discretion we have, and also we do not have certainty that we will be able to recover that. We do have a high level of bad debts especially for customers who terminate early and there is no guarantee that we will be able to recoup those amounts. We are not compensated for those risks in any way - sorry, we are partially compensated for those risks but not fully.

The fact is that early termination fees are common in many markets. Customers are used to the idea for many types of products and services. They can enter into an engagement and they can get a better deal if they have the flexibility to enter into contracts which have termination fees. We are transparent about that. The National Energy Customer Framework also supports that. Customers are notified about that when they sign up. There is a cooling-off period if they do not wish to do that. Also when they call us to leave, they are notified of that early termination fee that is required and there can be a discussion around whether it is waived or not.

I think we are being quite up-front in the way that we are behaving on this. I support the comment IPART has made about the diversity of offers. We believe that in a market like Victoria where you have quite a low cap - $20 - it drives retailers to focus more on the acquisition of customers and not retention, because we can recoup the costs of our acquisition through the up-front inducement costs but we cannot recoup the costs of retention. So we are not likely, in those sorts of conditions, to offer any loyalty schemes because we cannot recoup those costs.



Under the situation we have in, say, Queensland, South Australia and New South Wales at the moment, we can focus on those retention activities more because we have more flexibility. In terms of competition I believe that if you focus on customer retention activities that is better for customer outcomes in the long term. It goes more to customer satisfaction rather than that up-front sale process.

Overall, I think IPART has the position right in that it is saying that having too low a cap will alter retailers' behaviour. We will not offer the level of diversity of product structures that we now offer. It may lower the barriers to customers to shop around, but then it will alter retailers behaviour, which is the other aspect of competition that you are not focusing on.

This is all about a market where buyers and sellers come together to find something of mutual benefit. Customers may want that but if retailers are not participating, you will get situations where they are putting other prices up or they are withdrawing and making things less accessible to customers.

On the flip-side you could have a situation where retailers are offering something at quite a high price and customers baulk at that and they don't want to participate. I think it is about finding the right balance. IPART, in setting a cap that is above where a lot of the early termination fees are at the moment, allows that diversity to occur and allows that balance to be found in the best way with the best outcomes for competition.

MR SOUSSOU: Just to clarify on this point, whilst IPART has set termination fees of $130 in the first year and $45 in the second, it is actually way below the market at present. It is not as if termination fees have been set very high. Most retailers charge termination fees that are just year one, year two. It is very rare to see a step-down in termination fees, although Victoria does have a step-down in termination fees.

THE CHAIRMAN: Thank you very much, Melinda and Ramy, Oliver?

MR O DERUM: Thank you. Oliver Derum, policy officer in the Energy + Water Consumers Advocacy Program of the Public

Interest Advocacy Centre.

I want to ask Melinda a little bit about what she was saying. Melinda, both you and IPART have talked about how the level of the fee constrains diversity. PIAC has said we agree with the fee, but following that logic why not set the fee at $5,000 so you can have a contract that is just an early termination fee?

THE CHAIRMAN: Because if you set if at $5,000 that is way above market and it would be non-binding, and that is why. You try and set something and it is a question of judgment. You try and pitch something which is not too constraining on the market. Otherwise you don't want a situation where if you set it to zero and you basically force everybody into the same regime - that's both the customer and the retailers. So you have a limit which provides some sort of protection.

If you were to set the early termination fee at $5,000, that would offer nobody any protection because that is so far away above market, so that's why. It is a non-trivial issue and I am taking your comment seriously.

MR DERUM: I appreciate that, thank you, but fees are set out in contracts as well when you sign on.

The second issue is you are making it sound like in Victoria the low fee handicaps retailers or constrains them from offering diversity in that area, but we see in Victoria the highest levels of product diversity in Australia. I think wherever you constrain retailers, they will diversify in other areas.

MS GREEN: In response to that, there are differences in the Victorian and New South Wales markets that are pertinent to this. The Victorian market has price deregulation. It also has a large number of smart meters so you are seeing some diversity being facilitated by those things. This does constrain the range of types of offers we might make and you may find fewer loyalty-type schemes than up-front inducements, so it is just different.

THE CHAIRMAN: Melinda has given a practical answer to that. The economic answer to that is that, all other things being equal, if you set the early termination fee closer to zero, you will restrict the competition. In



order to make a comparison between Victoria and New South Wales, you have to take account of all the other differences in the market, which is what Melinda just said.

We need to sort of analyse this with an "all other things being equal" or by taking the situation as it is in New South Wales at the moment and asking ourselves: "If we set the fee close to zero or if we set it somewhere at $130, which one will give the best market outcome for both customers and retailers?"

MS HODGE: I agree with you there. I think all things being equal is a good way. We always encourage comparing apples with apples rather than apples with oranges. But we also know, and the reason why we are so intent on seeing this fee come down, that the AEMC has recently released its report saying that New South Wales energy markets are competitive and that is usually a precursor to removing price regulation.

We do not know what the government will say yet, but we are very concerned that we would have a similar time frame, if the New South Wales government does announce that it will remove price regulation, with these fees coming into existence at $130. We just believe that we will not be comparing apples with apples any more.

THE CHAIRMAN: That is a good point, Carolyn, and neither you nor I know whether the New South Wales government will deregulate. However, at the moment prices are regulated in New South Wales and we are saying that if you if you set the early termination fee close to zero, it will restrict competition more than if you set it at $130 and $45.

In the event, and it is in the event, that the New South Wales market is deregulated, the same argument would hold. If the New South Wales market is deregulated and you have a cap on termination fees which is close to zero, you will restrict competition compared with a situation where you have a cap on fees of $130 and $45. That is what I mean by saying all other things being equal, so, in a sense, this decision will apply in the market which is now regulated and it will apply in any future markets in New South Wales unless the government asks us to review it.

MR SOUSSOU: May I say that I support your comments there, Mr Chairman. It is also not setting a termination fee of

$130; it is setting a cap of $130. At present, there are retailers out there in the market who are offering zero termination fees. Some retailers are offering above $130. This actually adds to consumer protection and, at the same time supports competition, which is what I think we are all striving for.

THE CHAIRMAN: Thank you, Ramy. Oliver, did you want to say anything else?

MR DERUM: There are a couple of other points that I wanted to return to from earlier, but maybe Keith would like to say something about this.

MR K ROBERTSON: Keith Robertson from Origin Energy. I think Ramy has actually covered all my points. I would like to point out that in the market at the moment there are a lot of offers and retailers are offering zero termination fees. The customer has a choice and can weigh up the larger benefit usually associated with this and the higher termination fee. Origin's fee, by way of example, is $70 for a residential customer at the moment but it also has on offer zero termination fees.

To Peter's earlier point, if there was a cap on the early termination fee that was at a very nominal, negligible amount there would be little incentive for a retailer to pitch a zero termination fee product.

THE CHAIRMAN: Thanks, Keith. Oliver, I would like to give some other people a chance and then I will invite you to continue.

MR GOH: Thank you, Peter. Meng Goh from AGL Energy Limited. I would like to say that the early termination fee, in a sense, is optional. If you fulfil the terms of the contract, you will not incur that fee. I think we need to keep that in mind. Alternatively, with customers who have just entered into a non-fixed term contract, in which case the benefits or the discounts would reflect that flexibility. I think we should keep in mind that that fee is optional.

We support IPART's approach in that the fee is cost reflective. So customers who incur, I guess, that cost or rather give rise to the cost to retailers would, in a way, pay for that cost.



What I would like say about Victoria is that we should keep in mind again that the $20 is the base fee and there are inducement costs as well. AGL, for example, charges the same fee in Victoria as it currently charges in New South Wales. I guess it comes to that broader point about this being a price cap and retailers are very conscious of the fact that this early termination fee is not something that is positive from a marketing point of view, so we do try to keep that down if we can.

THE CHAIRMAN: Thank you, Meng. Carolyn?

MS HODGE: I would like to say that, from a consumer perspective, I agree that it is optional. There is no argument there and that if you do the right thing, you will not incur the fee - I agree again.

Generally, consumers do not have an expectation of signing a contract for a particular term and having that price change over that term. That is what can happen in energy contracts. When we are talking about whether people are used to early termination fees, in a more general sense, I think that is right, yes, they are, but I think they are more used to it where they sign on to something at a fixed price and a fixed term and if they want to get out of it, then they are happy to pay.

What we hear very often is that people spend a lot of time - there is literature on this - looking for the best deal. It is a complex market. They invest their time. They sign a contract and, within a short space of time, they get a letter saying, "Your charges have now increased by 10 per cent."

That is where consumers really get very frustrated about investing their time in the market and facing charges that are higher than they signed up for. I know that is covered in terms of the contract, but unless you are very au fait with energy contracts, you will not think to ask that question.

THE CHAIRMAN: Thank you, Carolyn. We will hear from Meng. Then I will ask Jesse and Annette and we will go from there.

MR GOH: When customers sign a fixed term contract, it is the term that is fixed and not the price. We do have costs, as we are well aware, with network charges and so forth which are beyond our control and which are passed on. Even with a non-fixed contract, prices do go up in any case. I cannot speak on behalf of other retailers but AGL's contracts have a fair pricing policy where if you don't like the price increase you can change; you can exit your contract without any early termination fee being payable.

MS J FORAN: I am Jesse Foran from Minister Hartcher's office. I will give a bit of background on the policy intent of this, because that is where we are coming from in handing over to the Independent Pricing and Regulatory Tribunal to set the price for the policy.

The idea of this policy in the first place was to provide certainty for customers in the market. There is also a strong portion in there about protecting those most vulnerable, which is why there is the waiver for people on hardship and receiving rebates from EAPA.

In terms of setting a cap we are, in New South Wales, obviously different from Victoria in that we are not in a deregulated market yet and still have strong incentive to encourage competition, so the idea of having a cap was to provide room for the costs to be truly covered. As you have heard from a couple of retailers, those costs are not covered by the $130 or the $45. That is not the entire risk they are taking with the customer.

It is interesting to hear the debate today to see whether the balance is right there, but from a government perspective, the certainty for customers was what was the main intent.

I do take your point, Carolyn, that it is an issue that customers are not as up to speed on what they are signing up to if the price is going to change. That is something that, obviously, needs to be worked on along with the general topic of energy literacy for customers across the board. I think that is something that will be worked on regardless of an exit fee policy, but that idea of saying, "This is the most a retailer can charge you if you were to exit a contract early" is what we were trying to provide with this policy. So that gives a bit of a background to it.



THE CHAIRMAN: Thank you, very much, Jesse. Annette?

MS A SHEPHERDSON: Annette Shepherdson, Energy and Water Ombudsman, New South Wales. Thank you for the opportunity to comment on the maximum cap. Our concern is that if it is set too high, it will be a barrier to customers exercising their choice to switch.

Another concern is we do get a lot of customers contacting us concerned about the application fee of the early termination fee. They either forget that there is an early termination fee or they are simply unaware at the time of contracting.

I acknowledge your comments, Melinda, that you do advise customers at the point of contracting with EnergyAustralia that there are these early termination fees, and that you do advise them when they are closing the account as well, but there is this period in between in which they can forget that early termination fees apply. We feel there needs to be customer engagement on this issue.

I acknowledge the comment in the draft report that the energy price facts sheet must include information about early termination fees. Again I don't think that addresses the issue that customers do forget that these are applicable.

Customers also come to us concerned that they have been charged an early termination fee when they have moved properties. They don't understand that, necessarily, the energy contract follows the site; it does not follow the person. I understand that some retailers do have policies where, if the customer does open another account with them in other property, they will waive an early termination fee but that is not mandated. Thank you.

THE CHAIRMAN: Thank you very much, Annette. Yes, Oliver?

MR DERUM: Thank you, Mr Chairman. I have three questions for IPART. Perhaps I can give them to you all at once.

Firstly, going right back to the start, we talked about bad debt and that, yes, of course, bad debt is higher with the last bill, but is not that just a cost associated with any contract termination rather than early termination specifically and therefore retailers have no choice but to recover those costs across everyone because they don't know when it is going to end?

Secondly --

THE CHAIRMAN: Sorry, Oliver, if it is okay with you, can we take them one at a time?

MR DERUM: Sure, absolutely.

THE CHAIRMAN: All right, bad debt. Who wants to go --

MR SMITH: Yes, I'll talk about that. As we mentioned earlier what we estimated was an additional cost of bad debt. So, yes, we are saying that there is a general cost of bad debt that retailers will face, and that is kind of perhaps a very low proportion of outstanding amounts on any bill. But when you switch to a final account, that proportion or the percentage that you end up writing off is much higher, so what we have estimated is the additional amount that will relate to early termination.

THE CHAIRMAN: I think the questions are going to be to IPART first and then we can pick up the conversation.

Oliver, does that answer your question?

MR DERUM: Just to be clear, do you think there are additional bad debt costs of early termination? Presumably you can assume that at some point every contract will end and a small percentage of those contracts will have bad debt associated with them. I am not understanding why there are specific bad debt costs associated with early termination as opposed to any other termination.

MR SMITH: It was difficult to determine the proportion of bad debt for just early terminating contracts. One would expect perhaps that if you could just isolate early terminating customers, it might actually be higher than the amount that we have estimated. We have estimated it based on the proportion of final accounts that, in a sense, would get written off in addition to an average amount of write-off on any typical bill.

THE CHAIRMAN: So you are seeking to distinguish between



bad debt which is due to customers who terminate early and bad debt which is due to customers who just terminate at the end of the contract?

MR DERUM: Yes. PIAC would argue that that is a cost of any contract, not a cost of early termination.

THE CHAIRMAN: But in the event that the incidence of bad debt for customers that terminate early is greater than the incidence of bad debt from customers who just terminate at the end of their contract, that would be an additional cost of early termination.

MR DERUM: It certainly would be if that was the case, but if you terminate early, to my mind you would have had less time to accumulate your debt and therefore it should be lower. I don't know what evidence IPART has as to the costs being higher.

MR SMITH: It is based on the information that the retailers provided to us. Perhaps they might be able to provide more detail after this, but what we saw from them was additional costs of bad debt associated with early termination.

It is sometimes hard to disentangle early termination from just any final account, but if you think about early termination where there is an early termination fee applied, in all likelihood what we have estimated is probably reasonably low because the fee itself may be a reason why there is a higher proportion of write-offs for early terminating accounts.

THE CHAIRMAN: The next question, Oliver?

MR DERUM: Yes, thank you for that. You said earlier, John, that the three retailers provided information on their costs to you and you averaged those. Did I get that right?

MR SMITH: That's right, in most accounts we averaged the amounts. We also undertook a benchmarking exercise. For example, when we looked at bad debt, the figures that we got from bad debt we actually thought were a little high compared with what we found in our electricity determination where we got similar information when we did that. So we actually benchmarked those costs and that brought them down a little bit from just the data that we were provided from the retailers. It was more than simple averaging; it was a benchmarking as well to make sure that we were happy with the amounts that they gave us and that they were reasonable.

MR DERUM: Good, I am glad you used the word "benchmarking" because that gets thrown around a lot particularly in the AER when they are looking at network price determinations. To my mind, if you have three examples of what something costs, if you are looking for efficiency, you go to the lowest cost and say, "Okay, that's what this can be done for, therefore that's what we include in this regulated fee."

MR SMITH: I suppose that is an option but we bore in mind that we were setting a cap. We averaged costs, so we are not setting it based on the highest cost retailer; we are setting it on an average. Because it is a cap, we think setting an average is a reasonable thing to do because there is some room to move underneath and we are not setting it at the highest possible level either.

THE CHAIRMAN: Just to clarify, when we calculated the average, there were cases where we left outliers out

MS BRAKEY: Yes.

MR SMITH: That's right.

THE CHAIRMAN: So we did exercise some judgment. If we had three figures for a particular cost and one was very, very high and the other two were within a ballpark, then we took the average of the two. But in general, as John said, we went with the average rather than the lowest cost.

MR DERUM: Again, thank you. Finally, this is perhaps a slightly new point, but part of the cost is related to hedging and adjusting the portfolio. In that, it seems that you were careful to compensate retailers for all the risks that they face from the early termination. But retailers have sophisticated trading operations and in any trading operation you retain a bit of risk to price for profit. I am wondering if IPART has taken any account of that.

MR SMITH: There are different ways of thinking about that



energy purchase adjustment cost. One way would be to look at what a retailer would do at the time that a customer terminates early and then decide whether they are going to sell down the contract and whether there is a gain or loss on that.

The approach that we took was slightly different. What we assumed was that a retailer knows there is a risk of losing customers early before the term of their contract and they will seek to manage that risk using options, so what we worked out was the per customer cost of doing that.

Basically we are saying that retailers would look to minimise their risks. I think there are some similarities in that assumption with what we do in an electricity pricing determination. When we work out energy purchase adjustment costs, we also assume that a retailer would seek to minimise its risks, so I think we have been consistent with that.

MR DERUM: I am just not sure that that is the correct assumption because if the retailers are minimising risk, they are also minimising their scope to profit in that area.

THE CHAIRMAN: Simon will make a comment.

MR DRAPER: I was going to say that there is a difference between what we regard as systematic risk in the market, where people earn their right to earn margin because they face market risk - that is broad market risk and not whole electricity market risk. Most retailers would actually try to minimise the wholesale market exposure that they have when entering into a contract with a retailer, and that is a different type of risk.

You are right in one respect. You get a return on risk, and that is a generally accepted proposition, and I think we would accept that, but we do not base returns to retailers on them exposing themselves to unmanageable wholesale market risks in the electricity market. That is not the idea.

MR DERUM: I am not talking about unmanageable. I think that big retailers have sophisticated operations doing this sort of thing and the fee compensates retailers for the risk but there is no quid pro quo.

THE CHAIRMAN: Talking at a general level, if a retailer has a lot of people on two-year contracts, and after nine months they all walk, the retailer will have purchased electricity forward in anticipation of supplying those people for two years and it is then left, in a sense, holding the electricity because everybody walked.

One reason that you have an early termination fee, apart from the other things, is to provide in part - sorry, part of the early termination fee would go towards compensating the retailer for the fact that everybody walked and that retailer is left holding the electricity. Is that --

MR DERUM: Yes, I do understand that and to reiterate a point that we made in our submission, if the price has gone up and they can get new customers in, then those contracts are in the money.

MR DRAPER: John can respond to that, but I think it is more likely that there is a systematic bias towards customers switching more when prices are falling, because that is when one these guys at the table can go to another retailer's customers and offer them a better deal and induce them to switch. So there is a sort of a bias towards people switching as wholesale markets are falling and that has tended to be supported by what you can observe in the market.

MR DERUM: Except that in recent times prices have only been going up and we are still seeing increasing amounts of switching.

MR DRAPER: Actually prices have been going down quite substantially.

MR DERUM: Retail prices?

MR DRAPER: No, wholesale prices.

MR DERUM: The customer only knows retail prices. That is what customers see and that is what they are interested in and that is what will make them switch.

MR DRAPER: It is the relative price between what one



retailer can offer. Facing the same costs, it is the relative price that one retailer can offer versus another. If you sign a customer today, if AGL signs up a retail customer today, and the wholesale price falls in six months, EnergyAustralia can then go to that same customer facing all the other costs, albeit the retail prices may have gone up, and offer a better price then AGL would have offered.

THE CHAIRMAN: John, do you want to add anything?

MR SMITH: I guess just to reiterate, the approach we took was not to work out whether they would make gains or losses on contracts. It was a cost based on managing that risk up-front on a per customer basis.

THE CHAIRMAN: I will ask Andrew to speak next, then go to the floor and then we can have time for more comment.

MR A HARPHAM: Andrew Harpham from Frontier Economics. I would add that, yes, there are risks associated with being a retailer, quite substantial risks. Retailers have very sophisticated ways of managing those risks, but they don't make the risks go away. There are costs of managing those risks that the retailers face.

We did some work benchmarking the estimates that the retailers came up with on the cost of managing those risks. The approach we took was basically to think about there are good ways of managing the risks and there are bad ways of managing the risk that will have different costs, but if we assume that the retailers are as efficient as possible, so they seek to manage those risks in the lowest cost way possible, what will it cost them to do that? If we don't give them that money, then effectively they are not compensated for taking those risks and managing those risks on the customers' behalf.

THE CHAIRMAN: Thanks very much, Andrew. We can come back to those at the table, but does anybody from the floor wish to say anything? Are any questions or comments from the audience? Would you come up to the microphone and please tell us your name and which organisation you are affiliated with.

MS SHAGOFTA ALI: My name is Shagofta and I am from the New South Wales Department of Trade and Investment.

I wanted to ask about the same fee being set for electricity contracts and the electricity component of the dual fuel contracts. Is there any variability between the two different contracts and having a fee for one component of the dual fuel contract?

MR SMITH: I am not sure I understand your question exactly. Are you saying did we consider whether there was any sort of cost savings by having a dual fuel contract?

MS SHAGOFTA ALI: Yes, particularly for, for example, the administration costs of closing an account for a dual fuel contract, because the early termination fee set by IPART would only --

MR SMITH: Yes, that's right. We found that the costs we set would be incremental to any costs associated with gas. So does that answer your question?

THE CHAIRMAN: Does your question go to: are the costs of somebody terminating when they are in a dual fuel contract different from the costs of terminating in an electricity contract and so therefore we should recommend different early termination fees? Is that where your question is going?

MS SHAGOFTA ALI: Yes, I would have assumed the costs of terminating a dual fuel contract would be similar to the costs of terminating an electricity contract, but these early termination fees only apply to the electricity component of a dual fuel contract. So would the early termination fee associated with the electricity component of a dual fuel contract be lower possibly than the fee of terminating an electricity contract?

MR SMITH: We looked at the costs for just electricity and what we are saying is that there are other costs associated with gas. We didn't look at those costs and I could not say whether it would be more or less than the electricity ones, but they would be in addition to the costs we worked out for electricity.

THE CHAIRMAN: Does that answer your question?

MS SHAGOFTA ALI: Yes.

THE CHAIRMAN: Thank you. Is there anybody else from the



floor who would like to ask a question or make a comment? No? Okay.

Does anybody else around the table have further comments or discussion? Are there other points that you would like to raise? Carolyn?

MS HODGE: Yes, I was just wondering about - the draft report has not discussed, or if it has, I have missed it - the money that the retailer can make while they retain the customer. We are talking about costs in isolation. We are not at the same time - I understand that there is a cost in having an early termination but if that person stays, say, for 360 days of that one year, the retailer has really recouped quite a considerable number.

I know you put up that sliding scale in your presentation, John, and that was included in the report, but I was thinking that perhaps the retailers also have a responsibility to offer prices that are attractive in a competitive market so that people don't want to switch away from them. How did you consider the revenue gained from the customer who might switch early to influence how you would set the fee?

MS BRAKEY: What we actually did was capture the costs. So if a customer did not terminate early, those costs would be recovered over the life of the contract. We did look at those costs and say, "If it was terminated early, these would be otherwise be in the price and we so will allow the retailers to recover those from the early termination fee."

With respect to the timing, we looked at a two-year contract - that is something we were open to discussion about - and for the first year, we assumed that the customer terminated halfway through that first year.

We could make some other assumption about that and obviously there is a relationship between when the customer terminates and what the termination fee should be, but for simplicity, we decided to have a first-year fee and a thereafter fee. The early termination fee costs represent the costs that we think would be recovered over the remainder of the contract for those legitimate costs faced by the retailer.

MS HODGE: It just seems to me by doing that, what we are saying is that the consumer bears all the risk of being in the market and operating their right to terminate early; but the retailer can walk away with not only the fee but any profit they have generated while that consumer has stayed with that business.

I am just interested in teasing that out because I think PIAC supports a really equitable sharing of risk and reward. We do not want to see retailers go out of business because that will cause untold misery for consumers and retailers of last resort are expensive exercises, but I am not seeing a balance here between those risks and rewards.

THE CHAIRMAN: Thanks, Carolyn. That is what it is about; it is about a judgment. It is a judgment about what is a reasonable cap on the management of the risks. As we have mentioned, many retailers will have an early termination fee which is less than the cap, so that is obviously open to the market. What is essentially ruled out here is the capacity for retailers and customers to negotiate something above the cap.

In balancing the risks by setting a cap - as Jesse outlined, what the government wanted to do was to set a cap - you have actually taken out of the equation any higher early termination fee which would be an example where the retailer bears more of the risk. Therefore, if anything, you are skewing it towards a situation where the retailers - sorry, by setting a cap, anything higher than a cap means that the customer bears a lot of the risk relative to the retailer. That has now been taken out and so anything below the cap, the retailer will bear a bit more of the risk and the customer a bit less.

In a sense, if I know what your equity position is, if your equity position is that retailers should bear some of the risk and customers should bear some of the risk, this actually limits the amount of risk that the customer would bear.

MS HODGE: We will have to agree to disagree on that, because I think that while the customer pays a fee of $130 and if that reflects pretty much - and that is maybe arguable on the other side - the costs of that early termination, the retailer has generated some profit while that customer has stayed in that contract. The retailer is



still retaining that profit and I don't see that being shared. However, I am happy to move on to a new point.

THE CHAIRMAN: Does anyone want to address this particular point? First Ramy and then Simon.

MR SOUSSOU: We have to take the concept that early termination fees have been in the market for quite a while, so this is actually just introducing a cap on what we can charge as early termination fees. It is not something new. Especially for tier 2 retailers, it supports them entering the market when they have some sort of protection there.

As I globally said before, if you look at the Energy Made Easy website right now, in my particular situation of all the 43 offers available to me only two were above the $130 under the termination fees. A lot of retailers have eroded that away. It is part of the value of a proposition available to your customers. I think what we are doing is just introducing a cap here. We are not trying to say whether termination fees are bad or good in the market.

MR DRAPER: I have more a question of clarification. I understood from your example that what you are concerned about is that someone may get quite a long way, say through the first year, and then a certain amount of those costs would have been recovered through the contract and then they face the termination fee. That goes to the point that John made earlier that we picked a six-month cost and 18-month cost. Is your preference the idea that we will break that down and make it some sort of monthly or quarterly breakdown of costs rather than an average for the first year and an average for the second year? Is that what you are getting at?

MS HODGE: I think that is pretty complicated. I guess what I would prefer is a bit more analysis in the report of what the retailers would gain from retaining that customer and whether that gain could be used to reduce the fee in the first year.

I just think that we are talking about all of the costs and none of the money coming in to the retailers because customers have gone to them and also have stayed with them for any period of time. When the retailers are working out their costings, they obviously don't do that on a profitless system. I mean there is profit. I think if a customer walks away, the retailer retains the fee, which represents the cost, and retains the profit. I just do not see that as being a good outcome for a competitive market, not for both participants. I think it is a good outcome for some.

THE CHAIRMAN: Just on that, we will take this point on board, but as I think about it on the run if somebody walks out of their contract in less than a year, say at the eleventh month or the ninth month, what I think you are saying is, "Well, the retailer actually made some profit out of that customer for the first nine months and shouldn't that be taken into account?" Yes, they make profit when they supply anybody for nine months or anybody on an ongoing basis, in a sense. In a sense, they would make some profit out of the nine months.

We specifically cannot take into account loss of profit for the remainder of the contract. That is in the terms of reference. We cannot take that into account. I cannot quite see the argument why the profit that they made on a particular contract for the first nine months should be offset against the costs. That would mean then that they made nothing out of the whole thing.

MS HODGE: I don't think I am saying the total amount. What I am saying is that in the analysis - I agree the terms of reference talk about not accounting for profit, but I read that to be that the retailer could not say, "We would have made this much profit out of this customer if they had stayed", and you can't compensate them for the profit that they have not made. That is how I interpret the terms of reference.

There are costs to the retailer for the early termination, but we are not in agreement with what those costs should be. I also think there are benefits to gain in this customer, and I think somewhere in the middle of that, we have to take both into consideration when setting the cap

MS BRAKEY: Because we have assumed six months for the first year, in effect, there is six months worth of recovery of those costs that are deducted off the total costs of early termination in that first year. If the customer were to terminate before the six months, then the $130 would be too little, but if the customer were to



terminate in the second half of the year of that first year, then the $130 would be too high; but on average, of that first year we have taken it at six months.

The chairman: Thank you, Anna. Oliver?

MR DERUM: This is just a comment. I think Carolyn's point is particularly pertinent because IPART has taken the approach of saying, "How do the retailers have to be compensated to return to a position where it is as if the customer never signed up in the first place?" If you are going back to the start, we say you have to take into account the money that the retailer made in that period as well as the costs that were incurred, noting that we would rather IPART go the other way and take the other set of costs.

THE CHAIRMAN: Thanks, Oliver. As I have said earlier, we will take this on board. We need to understand exactly what your point is and I think we do understand that now, thank you.

Are there any other questions or comments? Melinda?

MS GREEN: I think there are some assumptions being made by PIAC that the fee will be $130, but it won't be. I mean it is not $130 at the moment. We are competing below that. Our costs are significantly higher, so that $130 does not allow us to recoup those costs.

Also in terms of any profits that we make, we are operating in a price regulated market at the moment and IPART makes a separate determination around what margins are appropriate there. On our contracts that offer an early termination fee, they are market offers and the price for those is invariably below what the regulated price is.

To say that we should share some of that - any revenues we make or any profit we make in terms of balancing out this early termination fee - would clearly have effects on the market and competition. If you say that we should accept less revenue and profit with customers who terminate early, that will clearly change how we operate and how the competition balance is found. So I do not accept that that is an appropriate suggestion.

THE CHAIRMAN: Thanks, Melinda. Meng?

MR GOH: I have a few points that I wish to make. Let me first put my point of view on the profits. With the profit argument, I guess, profit is a reflection of your return on risk to some extent. For us to have formed that risk over that time period and then to give it back, as you have suggested, is not appropriate from our point of view, so I will just leave it at that.

There are three points I would like to make about IPART's decision from a broader point of view. Firstly, you talked about the benchmark costs. Given that this is a regulated cap, I guess there is an argument that perhaps instead of looking at average cost, you might want to look at the other end of the range of costs. That is one point I would like to put forward.

Another point is we have talked about this fee being applied to small customers. I would like to ask if IPART has considered making the distinction between residential and small business customers because there are some costs that are quite different between residential and small business.

My third point is that with the early termination fee,after the first year being set at $45, it just looks like a very large drop from $130. I was wondering if it would be more appropriate not to have such a large difference.

THE CHAIRMAN: Thank you, Meng. John, do you want to make any comment on that?

MR SMITH: I will take your comments on board. I am happy to receive information on differences between small business and residential customers. Obviously given the nature of the calculations, to work out the early termination fees in our financial model the longer a customer stays the more costs recovered. So you are talking about $45 is based on 18 months of a two-year contract. It is just a function of the bulk of the costs being recovered.

THE CHAIRMAN: Thanks, John. Yes, Oliver?

MR DERUM: I am just asking for clarification from Meng. Did you say if you were going to benchmark, it should be at



the upper range of the costs? I don't follow why you would do that.

MR GOH: I guess obviously from a policy point of view it has been regulated. It is a cap; it is not setting the efficient level of cap. You want to set the maximum possible cost.

THE CHAIRMAN: Anybody else? Are there any other comments? Carolyn?

MS HODGE: I have a completely new question with regard to GST on the cap. We have heard that, in Victoria, some retailers have been charging GST on top of the fee, the early termination fee. Can we have some clarification around that?

MS BRAKEY: We recommend GST-exclusive prices and the application of the GST or any other tax is up to the retailers, with their compliance with the Taxation Office.

MS HODGE: So the consumer would likely pay $143 for an early termination?

MS BRAKEY: In some cases with respect to late payment fees, the GST is applied and in other cases it is not applied. It is not within our jurisdiction to say whether it should be applied or not.

MR SOUSSOU: Can I go a few back? This is just a cap, so early termination fees in the market will not hold to the $143. We see that right now where there is no regulation in early termination fees or a cap and the variety of termination fees is quite enormous. I just do not want to keep saying that retailers will be charging $143 because that is not what the current market shows at all in New South Wales.

THE CHAIRMAN: Thank you, Ramy.

Are there other questions or comments around the table or from the audience? Would anybody like a final comment. No?

CONCLUDING REMARKS

THE CHAIRMAN: Thank you all very much. That was really interesting and we had some good discussion. Thanks very much for your time.

The transcript of the hearing should be available on our website in a few days time, certainly by the end of the week.

Also just a reminder that submissions are due in by 18 November. The timeline is tight and we will not be able to accept late submissions. We would ask you to just keep that in mind.

Is there anything else? No?

Thank you all very much. Have a nice afternoon.

AT 11.20AM, THE TRIBUNAL WAS ADJOURNED ACCORDINGLY