

14 May 2004



NSW Electricity Retail Pricing 2004/05 to 2006/07  
Independent Pricing and Regulatory Tribunal  
P O Box Q290  
QVB Post Office, NSW 1230

Dear Sir/Madam

### **Review of regulated retail price for electricity to 2007 Draft Report and Draft Determination**

The Energy Retailers Association of Australia (ERAA) welcomes the opportunity to comment on the Independent Pricing and Regulatory Tribunal's (the Tribunal) draft report and draft determination on review of regulated electricity prices in NSW.

The ERAA represents the core of Australia's energy retail organisations and is the peak body representing energy retailers in Australia.

We note the Tribunal's finding<sup>1</sup> that existing electricity prices for small retail customers are much lower than the cost of supply. The ERAA is disappointed that after a decade of competition policy reforms when the issue of cross subsidies first became evident and after 2 ½ years of full retail contestability, the small customer market still requires further significant price adjustment.

The ERAA has serious concerns with the pace of retail price reforms and is of the view that the approach to retail price regulation adopted by the Tribunal:

- has impeded the achievement of cost reflective tariffs for small customers;
- has missed opportunities to address cross subsidies in the small customer market in an effective manner;
- has failed to deliver on the objective of promoting competition in accordance with the Minister's terms of reference in 1999, 2000, 2002 and 2004;
- has not met one of the main objectives of the fully competitive national market to ensure no discriminatory legislative or regulatory barriers to entry for new participants in generation or retail supply; and
- will impact on investment in generation and retail supply in the NSW market.

The Tribunal further notes that based on its cost benchmarks (which are significantly lower than other jurisdictions), NSW retailers<sup>2</sup> will not achieve fully cost reflective tariffs by 2007. The ERAA believes that the lower benchmarks adopted by the Tribunal will leave the regulated retail electricity prices well below levels that are sustainable or commercially acceptable in a competitive market at the end of the next regulatory period.

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<sup>1</sup> IPART News Release, IPART Releases Draft Determination on Electricity Prices, 30 April 2004.

<sup>2</sup> Table 5.2, p.20, Draft Report and Draft Determination, Review of Regulated Retail prices for electricity to 2007, Independent Pricing and Regulatory Tribunal, April 2004

## 1. Impeded the achievement of cost reflective tariffs for small customers

As part of its decision on regulated retail prices in December 2000<sup>3</sup>, the Tribunal concluded that “the regulated retail tariffs for many small retail customers will reach the relevant target level (its definition of cost reflective) at the first price change while others may only reach the relevant target levels after several years (which could be beyond 2004).” At the time the Tribunal noted<sup>4</sup> that cross subsidies with reference to the target tariffs would be reduced to \$25.4M by 2004. The Tribunal later revised this shortfall to \$24.4M as part of its mid term review of electricity prices.

We note with concern that the under recovery for 2003/04 has now been revised to \$83.8M in the Tribunal’s report<sup>5</sup> on the current price review. Furthermore, the Tribunal estimates the under recovery over the next regulatory period to be \$152.5M. A residual under recovery of \$39.5M is likely to remain at the end of the next regulatory period in 2007. These under recoveries will continue to be funded by NSW taxpayers.

This outcome demonstrates deficiencies in the Tribunal’s analysis when assessing the extent of under recovery and the failure of its regulatory approach. The regulatory approach comprised of multiple constraints on retail prices that have impeded the achievement of cost reflective prices expected by the Tribunal.

Despite its failure in dealing with the cross subsidies, the Tribunal proposes to substantially maintain its historical approach to price regulation. The Tribunal has again proposed multiple constraints that comprise:

- no increases to tariffs that are above target levels;
- limit on overall bill changes; and
- limit on increases to the retail component.

In addition, the Tribunal has placed a limit on the variation of the fixed component. This approach is not consistent with light-handed regulation.

We are concerned that these limits will unreasonably constrain the transition to cost reflective retail prices, below that anticipated by the Tribunal, and urge the Tribunal to reconsider the number of constraints proposed.

Further, the report does not provide any evidence as to whether the proposed constraints on retail prices will enable retailers to accommodate distributor tariff reforms targeted to providing price signals to customers. If not, then the distributors’ objectives of tariff reforms for demand management will not be achieved but will place additional pressure in achieving cost reflective retail prices.

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<sup>3</sup> Regulated Retail Prices for Electricity to December 2004, Independent Pricing and Regulatory Tribunal, December 2000, (p.12)

<sup>4</sup> Mid Term Review of Regulated Retail Electricity Prices for Electricity to 2004, Report and Determination to the Minister for Energy, IPART, June 2002 (Table 4.1, p.14)

<sup>5</sup> Review of Regulated Retail Prices for Electricity to 2007, Draft Report and Draft Determination, IPART, April 2004 (Table 5.2, p.20)

## 2. Missed opportunities to address cross subsidies in the small electricity customer market in an effective manner

As a result of the regulatory approaches adopted and a preoccupation with ensuring average prices for small customers do not increase in real terms, the Tribunal has missed opportunities to unwind cross subsidies in a manner that would have ensured a “smooth” transition to cost reflective prices.

The Tribunal notes that average electricity prices for small retail customers are among the lowest in Australia – only the ACT has lower prices. Since 1992/93, average prices for residential customers have decreased in real terms by 15 percent (if the impact of GST is excluded from analysis), and in the recent years average retail prices have been nearly constant in real terms.

Pegging price increases to CPI increases from the time that the competition reforms commenced or at a reasonable level in the more recent years would have delivered cost reflectivity. Further, the Tribunal’s determination to replicate competitive market outcomes (and keep regulated tariffs “neutral” with respect to competition) and its conservatism with respect to costs and margin benchmarks has left it with little scope to accommodate market risks such as the proposed significant distribution price increases. In order to mitigate price impacts on customers arising from such risks, the Tribunal has chosen to delay the achievement of cost reflective retail prices resulting in less than commercial returns to retailers and delaying effective competition for parts of the market.

The ERAA urges the Tribunal to review its position on keeping tariffs neutral and build in a risk premium in prices to accommodate market risks and the risks associated with its decisions on benchmarks.

We are of the view that the Tribunal also needs to review and increase the constraints (in future years to CPI+3% on the retail component as proposed for Country Energy) for variation of the retail prices to ensure that the industry does not find itself in the current situation at the end of the next regulatory period. A CPI constraint on over recovering retail tariffs will not be unreasonable as it would also allow the Tribunal to test its own decisions on margins.

## 3. Delivery on the objective of promoting competition

The Minister’s terms of reference for price reviews in 1999, 2000, 2002 and 2004 required the Tribunal to implement the objectives on competition reforms and to promote competition in the small customer market. More specifically, the Minister’s terms of reference for the current review noted that the difference between regulated tariffs and market based prices is the key determinant of how many eligible customers remain on regulated tariffs. The terms of reference further note that the Government’s policy aim is to reduce customers’ reliance on regulated prices.

This requirement clearly places the role of regulated prices into context, which is of providing a safety net for customers who choose not to participate in the market. The market-based prices referred to in the terms of reference would be the economically efficient (or “neutral”) prices to ensure that competition can occur. In this context we are surprised at the Tribunal’s attempt to replicate competitive market outcomes with its regulated prices. If this were possible it would eliminate the need for competition.

Given the opportunities for transition to cost reflective prices (discussed under item 2 above), we can only conclude that the Tribunal has placed a disproportionate emphasis on maintaining prices in real terms at the expense of promoting competition required under the Ministerial directions and for competition reforms.

The ERAA urges the Tribunal to demonstrate a commitment to promoting competition by setting out a reasonable timetable for achieving cost reflective prices. Given the extent of under recovery, an innovative approach, significantly different to the Tribunal's existing approach, will be required (refer item 7). Many other jurisdictions, in Australia and overseas, have dealt with this problem. Universally it is resolved by allowing greater than CPI price adjustments across a period of years across classes of customers. Innovation may deliver the critical result, but tried and true methods currently not being adopted by the Tribunal cannot be ignored indefinitely.

#### 4. No discriminatory legislative or regulatory barriers to entry for new participants in generation or retail supply<sup>6</sup>

One of the main objectives of the fully competitive national market is to ensure that there are no discriminatory legislative or regulatory barriers to entry for new participants in generation or retail supply.

The Tribunal's analysis and outcomes focused entirely on the cost structure of incumbent businesses who have the advantage of arrangements such as the ETEF. This has resulted in the market risks of second tier retailers and recovery of their customer acquisition costs being ignored in the Tribunal's decision. The Tribunal has not reflected risks associated with wholesale electricity purchases in its allowances for energy costs or in the net margins.

If the Tribunal feels that it is constrained from giving consideration to costs of second tier retailers, such as by the terms of reference (we do not believe this to be the case), then there are serious issues of competitive neutrality in the NSW market which need to be addressed.

#### 5. Impact on investment in generation and retail supply in the NSW market.

Entry by new retailers to the NSW small customer market and their contribution to increasing competition in the market is dependent on prices being cost reflective (including commercially acceptable returns). Participation in the market will be constrained whilst regulated prices remain below cost reflective levels.

Furthermore, investment in new generation capacity in the market is dependent on long term back-to-back contracts with retailers. If prices are not cost reflective, or if there is lack of regulatory certainty on when this may be achieved or on the level of prices, then retailers are not likely to enter into long term arrangements. Lack of investment in peaking and intermediate generation capacity could impact on security and reliability of supply in the NSW market.

As has been seen in other aspects of the wholesale market a lack of supply in one part of Australia has significant impact on prices in other regions, in both the pool and

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<sup>6</sup> COAG Communique 19 August 1994, Attachment A – Report on Electricity Reform, (Section 2)

the contract markets. It would be unfortunate if a lack of adherence to principles of competitive neutrality were to impact on the national market through the looming potential for shortages in NSW being priced into other region's medium term contracts.

It is important that the market has confidence in regulatory outcomes.

#### 6. Effectiveness of competition

The Tribunal's view at this stage is that while retail competition is developing, it is not yet effective. This is based on a report to the Tribunal by PWC. This would be hardly surprising given the Tribunal's finding that existing prices are much lower than the cost of supply.

The Tribunal also cites evidence from the United Kingdom (UK) where the UK regulator withdrew from regulation of retail prices when 40% of the market had changed their supplier. The Tribunal fails to acknowledge that this level of customer switching was achieved because falling wholesale electricity costs<sup>7</sup> resulted in a significant increase in retail margins from the 1.5% initially established by the regulator. The Tribunal has proposed a net margin of 2% that is not likely to support the level of customer switching evidenced in the UK.

The ERAA believes that the work carried out by the Tribunal is not conclusive and that further analysis of the market is required to establish the effectiveness of competition. Such a review will enable the Tribunal to take a lighter handed approach to price regulation for segments of the market where competition is effective, such as establishing CPI constraint on tariffs that the Tribunal considers are over recovering.

#### 7. Innovative approach required for expeditious achievement of cost reflectivity

The ERAA has concluded that there is a risk that a continuation of the current approaches to price regulation will not deliver cost reflective prices. An alternative option for the Tribunal may be to move retail prices to cost reflective levels immediately, supported by government policy on rebates to customers most affected by price increases such as through the "Winter Power Bonus" and the "Network Tariff Rebate Scheme" used in Victoria to address similar issues.

If you have any queries on the content of this submission, please contact me or Nicole Stillman at the ERAA Secretariat on 0417 101 452.

Yours sincerely,

*transmission by e-mail*

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<sup>7</sup> Section 3.2, Electricity Supply Competition, An Ofgem Occasional Paper (18/02), 16 December 2002