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Review of regulated retail tariffs and charges for electricity 2010-13
Independent Pricing and Regulatory Tribunal
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**Review of regulated retail tariffs and charges for electricity 2010-13 – Draft Methodology Paper**

Thank you for the opportunity to comment upon the Tribunal's *Review of regulated retail tariffs and charges for electricity 2010-13 – Draft Methodology Paper.*

*Re-opening provisions*

TRUenergy supports the Tribunal's view that the risk of changes in wholesale electricity costs should be addressed through a periodic review. However, consistent with the recommendations of the Australian Energy Market Commission, we also recommend that the review process include provision for the review to be retailer initiated.

At the recent public hearing, Tribunal members expressed concern as to how the retailer initiated process could work in practice. TRUenergy responded that the Victorian experience with price regulation under a propose-respond framework provides an appropriate model. In this respect we are concerned with the consultant's comments that:

> *"New South Wales does not have a proposed respond model. It is not the way that this framework is established. It is a very different framework. It is very consistent with what has happened for many years and that will not change between now and the end of the determination…. You might want a proposed respond model. That won't happen."*

Firstly, we would expect that the method of conducting the Determination, including periodic reviews, is a matter for the Tribunal and not consultants engaged by the Tribunal to review cost allowances.

Secondly, our comments were made specifically in the context of the periodic review and we note that, contrary to the claims of the consultant, the terms of reference do not preclude a propose-respond approach as the basis of the review.

The terms of reference state:

> *IPART should allow for a periodic review of the Energy Purchase Cost Allowance, including the costs of complying with greenhouse and energy efficiency schemes*

The review process requires an initial assessment of whether the variation in estimated costs has exceeded a specified threshold beyond the original estimate made in the determination. This assessment could be conducted by any party, including the relevant retailer. There is no reason to expect that a consultant would provide a more reliable assessment of how costs have changed over the intervening period than the retailer, particularly if the review relied on transparent market data. The Tribunal would then verify the extent of the variation, based on the evidence provided by the retailer (just as they would if the data was provided by a consultant), and determine an appropriate amendment to the price path. Whilst there may be concerns regarding the self-interest of retailers in estimating a cost component, discussion with the Victorian Government would provide an explanation as to how these concerns could be readily overcome.

Thirdly, the proposed-respond approach was demonstrated in Victoria as a workable framework within an overriding price-path framework, and was fundamental in establishing it as the most competitive retail energy market in the world. The only difference is that the New South Wales prices would still be determined by the Tribunal, in accordance with the terms of reference, whilst in Victorian prices were legally set by the retailers, but administratively approved by the State Government.

Fourthly, on the broader issue of the failure of retail price setting to achieve cost-reflective regulated tariffs over the past seven years, we note that whilst the current New South Wales determination may be *"consistent with what has happened over many years*", as expressed by the consultants, it has also been the least successful state in facilitating a competitive retail energy market. An acknowledgment of this failure would be the first step to a consideration of alternative approaches capable of delivering an outcome more consistent with the original policy rationale to establish a competitive retail energy market. Whilst we acknowledge this is a policy issue for the State Government, the Tribunal and its consultants should be pursuing every opportunity within the constraints of the terms of reference (although we would argue they are broader than is often suggested) to this end.

Finally, we note the comments of the consultants with regard to the scheduled 2011 competition review:

> *The government has made it really clear that it will be conducting a competition review in 2011 with a view to getting rid of that retail price regulation at the end of 2013.*

In response, we note that if the failure of the past seven years to achieve cost reflectivity is not rectified in the current determination, the removal of price regulation in 2013 will subject consumers to an otherwise unnecessary price shock, and undermine community support for the reform process. This would be in stark contrast to the smooth transitional process in Victoria, whereby price deregulation was successfully implemented with broad community and industry support.

*The failure of the previous Determination to encourage a competitive market*

At the public hearing, the consultants spoke to the objective of encouraging a competitive market:

> *That is not to suggest that the government has not been mindful of the need to encourage a competitive market. In fact the entire first page of the terms of reference talks about the context in which this review is to be done; that is, to encourage the operation of a competitive market.*

It is of concern to TRUenergy that the draft methodology paper does not consider why, on any objective basis, and particularly when compared to other Australian jurisdictions, the past seven years of price setting arrangements have failed to meet this objective.

TRUenergy has identified four specific factors in the previous determination which contributed to the failure to transition tariffs to cost-reflective levels, and thereby "*encourage the operation of the competitive market:*"

- Failure of the re-opening process to respond to increases in the actual wholesale costs incurred by retailers
- Non-escalation of retail operating costs over the determination period
- Setting the assumed customer transfer rates below efficient market levels
- Setting the retail margin at the mid-point of the acceptable range

These issues are discussed in the following sections.

*Actual wholesale costs*

The method of estimating wholesale costs for the 2007 and 2008 reviews was consistent with the method undertaken for the original 2007-10 determination. The Tribunal explained this approach on the grounds of "investor confidence" reflecting a need for regulatory consistency. However, investor confidence would have been best served by transitioning regulated tariffs to levels which facilitate a competitive retail market. In the case of both the 2007 and 2008 reviews this would have been through a greater use of market data.

The 2007 review found that wholesale prices had fallen since the original determination, whilst the "rolling hedge strategy based on market data" approach, adopted in some form in all other Australian jurisdictions, would have identified an increase in wholesale costs. Similarly, whilst the 2008 review found that costs had increased above the threshold amount, market data identified an even higher increase in costs. Adopting market data would have gone a long way to addressing the current shortfall in regulated tariffs, and is recommended by TRUenergy as the approach to be used in the periodic review process for the current determination. It is also compatible with the retailer-initiated approach discussed above.

*Escalation of retail costs*

New South Wales is the only Australian jurisdiction not to allow for an escalation of retail costs, and, given that it is the least successful state in facilitating a competitive market, this approach should be rectified in this Determination.

The decision not to escalate operating costs was based on three views, presented below with our views on each also provided:

- *Falling customer numbers should reduce call centre and IT system investment* - The financial impact of marginal customer losses upon employee numbers in a large retailer's call centre is negligible. Similarly, the view that IT system costs are divisible as customer numbers decline is illogical. In addition, IT investment for most large retailers has increased substantially in recent years, due to the replacement of legacy systems, competitive pressures in other jurisdictions, and the extension of interval metering to mass market customers.
- *Productivity improvements* - This claim ignores the ever increasing regulatory obligations, and increased jurisdictional inconsistency, to which national retailers have been exposed in recent years. This has included customer protection, renewable target, energy efficiency, and feed-in tariff regimes, which directly add to retail operating costs.
- *Standard retailers did not report increased operating costs over the 2002-06 period* - The wild variability in retail costs reported by the incumbent retailers from year-to-year casts serious doubt over their reliability as an accurate representation of future retail costs. It is unclear whether the reported variability is related to the stapled nature of the businesses, their ownership structure, or specific events. In any case, previous reporting of retail costs should not be taken as evidence that retail costs generally will not increase in the future, and indeed are irrelevant to any such consideration.

*Assumed customer transfer rates*

Transfer rates in customer acquisition calculations are self-reinforcing. The lower the rate set, the lower the allowance for retailers to launch acquisition campaigns. Given that New South Wales has consistently had the lowest customer transfer rates in Australia, the Tribunal should pursue all opportunities to adopt the highest assumed rate within the scope of the terms of reference.

Evidence from the Victorian and South Australian markets show that, with appropriate retail price settings in place, customer transfer rates will achieve an annual transfer rate of at least 25% on an ongoing basis. There are no underlying reasons, particularly given the same competing retailers, that New South Wales could not achieve a similar transfer rate, providing regulated tariffs are set at cost-reflective levels.

This view was dismissed in the previous Determination by the Tribunal:

> *The Tribunal remains of the view that increased competitive rivalry between firms may compel retailers to offer their existing customers discounts or innovative price/service packages to entice them to renew their supply arrangements, or agree to new terms, instead of simply leading to higher rates of customer switching. As such, a market may deliver competitive outcomes (in terms of market conduct and performance) but still have relatively low levels of customer churn.*

However, no explanation was provided as to why the New South Wales market should behave differently to other Australian jurisdictions if prices are set at cost-

reflective levels. Victorian and South Australian incumbents also have customer retention strategies available to them, and indeed they have been aggressively pursued. Nevertheless, the veracity of competition in those markets has led to an inevitable decline in their market share, and a customer transfer rate up to three times higher than in New South Wales.

Instead the Tribunal accepted the consultant's view of Europe as a more appropriate benchmark. Reviewing a European Union Study, it was concluded that "a well-functioning market would see residential customers remaining with a retailer for 10 years, and a business customers remaining with a retailer for about 6 years." We note that the VaasaETT world energy rankings identify only four European countries as active, two are slow, and the remainder are dormant. Overall, the European experience, particularly when compared to Victoria and South Australia, is not one of a successful transition to effective competition.

At the very least the onus should be to explain why European markets, with their wide ranging and unique regulatory and market structures, should be seen as a more appropriate benchmark than the Victorian and South Australian markets. In the absence of that case being made, customer acquisition costs should assume that customers transfer once every four years, consistent with observations of efficient Australian markets.

*Setting the retail margin at the mid-point of the acceptable range*

For the 2007-10 Determination the consultants recommended a retail margin of between 4 per cent and 6 per cent. The Tribunal provided no explanation for its decision to set the allowance at 5%, other than it was the mid-point of the consultant's range.

As argued previously;

- the risks of retail price setting are asymmetrical, whereby excess margins provided by cost overestimates will be eroded by competition, whilst cost underestimates will suppress competition and threaten energy security;
- there is overwhelming objective market evidence that regulated prices remain below cost-reflective levels, whereby the risk that a cost overestimate will lead to prices being set above market-based levels is negligible.

For these reasons the retail margin should be set within the acceptable range, whilst taking into account objective market evidence regarding the level of competition. Whilst competition remains well below levels that could be reasonably expected (based on jurisdictional comparisons), the retail margin should be set at the higher end of the acceptable range.

*Concluding comments*

The Tribunal and its consultants consistently speak of the restrictions within the terms of reference which have hampered the transition of regulated tariffs to cost reflective levels. However, on each of the issues identified above, it was within the Tribunal's scope to adopt a position which would have facilitated that process. In each case either the Tribunal failed to take into consideration the existing state of the market (and the heightened asymmetrical risks it creates) and adopted a

conservative position, or the burden of proof was unreasonably placed on retailers against the conjecture of the consultants.

The 2010-13 Determination will be the third conducted by the Tribunal. Despite commitments to the contrary, regulated tariffs have not transitioned to cost-reflective levels, and the level of competitive activity remains well below that of other Australian jurisdictions. TRUenergy recommends that the Tribunal pursue all opportunities, within the terms of reference, to adopt estimation methods and cost allowances which recognise and respond to the current state of the New South Wales. In doing so the burden of proof should be placed on the case against setting each cost allowance at the high-end of the reasonable or efficient range.

Please contact me on (03) 8628 1122 if you require additional information.

Yours sincerely,

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