energy supply association of australia

Energy Retailers Association of Australia

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Regulated Retail Electricity Prices 2013-14 – Interim Consultation Paper

The Energy Supply Association of Australia (esaa) and the Energy Retailers Association of Australia (ERAA) (the Associations) welcome the opportunity to make a joint submission to the Queensland Competition Authority's (the Authority) Regulated Retail Electricity Prices (2013-14) Interim Consultation Paper.

Australia's energy industry owns and operates some $120 billion in assets, employs more than 51,000 people and contributes $16.5 billion directly to the nation's Gross Domestic Product.

In accordance with a Ministerial Delegation received in September 2012, the Authority has been tasked with determining regulated electricity prices over a three year period from 1 July 2013 to 30 June 2016. Coupled with a suite of transitional measures, the Queensland Government envisages that the latest Delegation will assist consumers in managing short-term price shocks while also providing a degree of certainty to industry.

The Associations are firmly of the view that the most appropriate way to facilitate efficient pricing and provide certainty to industry where retail markets are contestable is to remove retail price regulation. Open, competitive energy markets free from distortions such as retail price regulation naturally encourage prices to be efficient through the development of market offers. Competition in retail electricity markets, as in other sectors of the Australian economy, incentivises businesses to improve service, develop products that meet consumer needs and find ways to lower their costs and to pass these savings onto consumers. This ensures that retail prices are set as low as is sustainably possible while businesses can still make an appropriate return.

However, should the Queensland Government choose to regulate retail prices in this environment, an overriding focus on ensuring cost-reflective tariffs and promoting competition is paramount. As highlighted in a 2008 report by Professor George Yarrow for the AEMC, the continuation of price regulation where there is healthy competition is likely to erode that competition over the medium term. The reason for this erosion is outlined below. We urge the government to set a pathway to more competition and less regulation.

To this end, the Associations are concerned that the Terms of Reference (ToR) governing the Authority's approach to determining regulated prices do not adequately reflect the importance of the key attributes of cost reflectivity and promoting competition.

In forming its determination, the ToR require the Authority to have regard to: the actual costs of making, producing or supplying the goods or services; and the effect of the price determination on competition in the Queensland retail electricity market. In addition, the Authority must also consider transitional arrangements for the standard residential tariff (Tariff 11), which is to be cost-reflective by 1 July 2015.

The Associations acknowledge the importance of transitioning Tariff 11 to cost-reflective levels and consider that a specific mandate to achieve this is useful. It is critical that Tariff 11 is transitioned to cost-reflective levels as soon as possible, preferably by 1 July 2013. While Tariff 11 is not cost-reflective, consumers will have no incentive to transition to a cost-reflective time-of-use tariff, which is a far more efficient tariff for shaping energy consumption patterns.

More broadly, the Associations also contend that simply having regard to underlying costs and the effect of the price determination on competition is insufficient. Rather, the Authority should specifically seek to ensure that *all* tariffs are cost-reflective with a view to promoting competition within the retail electricity market.

In particular, there is a need for the Authority to promote competition rather than simply have regard to it. In setting regulated prices for 2012/13 the Authority was similarly required to have regard to competition, but not to promote it. The net result has been that competition in Queensland has stalled. In mid-2011 retail churn rates in Queensland were around 18%, however they have since fallen significantly with the most recent month's data (September 2012) suggesting an annual rate of just 12%. This is in stark contrast to South Australia, Victoria and New South Wales, all of which have rates above 19%. Competition will drive more efficient outcomes than regulation; it is essential that regulation be structured to promote competition where possible.

The Associations have provided comment on three key issues that should be considered in the context of facilitating a competitive and market driven retail sector over the long-term, namely: the importance of cost-reflective pricing and a flexible approach to price setting; the difficulties associated with estimating wholesale energy costs; and the treatment of social policy objectives.

Cost-reflective retail tariffs – regulated prices should be cost-reflective and derived from a consistent and predictable price setting methodology

Cost-reflective retail tariffs allow businesses operating within the retail sector to recover the costs of electricity supply, as well as an appropriate return on investment. Accordingly, where cost-reflectivity is achieved, appropriate market conditions should evolve such that potential new market entrants may welcome an opportunity to enter the retail market. Conversely, regulated retail tariffs set below the cost of supply inhibit full cost recovery, potentially compromising the financial viability of businesses operating within the retail sector, and by extension, the electricity supply industry.

Importantly, cost-reflective pricing is also critical in the context of providing efficient and transparent price signals. Price signals are powerful tools to shape behaviour and are a fundamental aspect of resource allocation in almost all aspects of the Australian economy. Price signals have the potential to improve the efficiency of the energy system, including improving system utilisation by providing signals for time of use consumption, informing rational decisions on energy efficiency or responding to emissions reduction through carbon pricing. Notably, where energy prices are set below cost, those users cannot be expected to make rational energy efficiency decisions as the information they have is distorted. More specifically, below-cost prices will lead to the levels of energy efficiency being too low.

In this regard, the Associations view the implementation of a cost-reflective time-of-use tariff for domestic customers as a progressive move towards recognising that network charges have a role to play in signalling the price effects of customer behaviour. Restricting the full pass through of the costs associated with any network tariff structure does, however, limit the transference of price signals encouraging more efficient consumption patterns. As such, the Associations consider that network charges must not be constrained by regulation over and above that provided through the Australian Energy Regulator (AER).

Estimating wholesale energy costs – an LRMC price floor should be retained

The Associations acknowledge the inherent difficulties associated with trying to estimate the wholesale energy cost (WEC) component of regulated tariffs and note the Authority's preference for applying a hedging-based approach. However, the Associations continue to advocate for the derivation of the WEC component using an approach whereby the WEC should not be less than the long run marginal cost (LRMC) of electricity generation.

As discussed above, regulating prices in potentially competitive markets whereby regulated tariffs may be set below the cost of supply impedes the efficient operation of the market. It creates financial pressure for industry participants forced to absorb costs that cannot be passed on and removes incentives for energy companies to enter the market and compete for small-use customers. Conversely, in the event that prices are set above the cost of supply – including an appropriate retail margin – competition will erode margins back to efficient levels. The risks are thus asymmetric, with greater adverse consequences arising from setting the regulated price too low.

The LRMC approach, which is currently utilised by the Independent Pricing and Regulatory Tribunal (IPART) in New South Wales, appropriately reflects this asymmetry. It is consistent with setting a price cap at an efficient level and also ensures that the WEC is set at the level required to bring forward new investment in electricity generation capacity when needed.

Conversely, an approach based purely on prevailing market data will result in greater price volatility flowing from spot and contract markets into the retail price path and ultimately, non-cost-reflective prices. Retailers employ a variety of approaches to manage their wholesale energy costs including long-term power purchase agreements. As such, an assessment of market based costs alone may not necessarily be reflective of the actual costs faced by retail businesses. This could potentially expose retail businesses to costs that they cannot pass-on, while also diminishing the willingness of private capital to invest in new generation capacity in the state.

Critically, neither of these adverse outcomes is consistent with the Queensland Inter-Departmental Committee (IDC) on Electricity Sector Reform's key objective of ensuring that *"Queensland has a viable, sustainable and competitive electricity industry".* Further, such an approach is also at odds with the Minister's letter supporting the Delegation which indicates "*For consumers, the Government is committed to an approach that will assist in managing short-term price shocks, and for industry an approach that may assist in the longer term investment in the sector."*[1]

Social policy measures – social welfare outcomes should be decoupled from energy prices

Access to energy is an important social objective. In the past, governments have tried to achieve social objectives with respect to energy by limiting the price of energy. However, as has been clearly demonstrated with the Tariff 11 price freeze in Queensland and similar price freezes in Western Australia, this approach is self-defeating as costs must ultimately be recovered via taxation. Holding energy prices below cost is a blunt and very expensive measure that benefits all energy consumers receiving the discounted rate, even those that do not require assistance. Further, as discussed above, setting prices at artificially low levels prevents signals being used to create a more efficient energy system in general, creating a road block to any form of pricing reform.

The Associations consider that a superior approach is to decouple social welfare outcomes from energy prices. This approach has two general steps. Firstly, electricity prices should be transitioned to cost reflective levels. Secondly, to the extent that the efficient prices that emerge from the market are considered beyond the capacity of certain consumers to pay, such consumers should be supported by purposely designed, budget funded measures.

These measures need to be appropriately targeted. The State's electricity rebate in its current form fails to adequately protect vulnerable customers, instead smearing payments across a broader group of consumers regardless of the need for assistance.

In addition, consideration will also need to be given to the way in which budget funded measures such as Community Service Obligation (CSO) payments are actually applied. In the interest of facilitating competitive markets, the Associations consider that these payments should be applied in such a way that retail businesses are able to compete for grid-connected electricity market customers based on the competitiveness of their retail charges. Where this is not achieved, barriers to entry are created which ultimately stymie the evolution of competitive retail markets, as has been evidenced in the Ergon Energy distribution area.

The Associations support the development of a fully competitive and financially viable retail sector. Given the capacity of cost-reflective pricing and competition to deliver

[1] McArdle, M., *Minister's Covering Letter – Regulated Retail Electricity Price Delegation 1 July 2013 to 30 June 2016*, 4 September 2012.

these outcomes, the Associations consider that the Authority's 2013-16 determination has the potential to form the foundation of significant future reform.

Any questions about our submission should be addressed to either Kieran Donoghue, email kieran.donoghue@esaa.com.au telephone (03) 9205 3116 or David Lee, email dlee@eraa.com.au telephone (02) 8241 1835.

Yours sincerely

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