Etrog Consulting

SUBMISSION

Prepared for submission to:

Australian Energy Market Commission (AEMC)

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Best Practice Retail Price Regulation Methodology – Issues Paper

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Date: 12 July 2013

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DISCLAIMER

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1. INTRODUCTION

This submission is a response from Etrog Consulting Pty Ltd (Etrog Consulting) to the AEMC's Issues Paper on *Best Practice Retail Price Methodology*, which was published for stakeholder comment on 14 June 2013 to assist the AEMC with the development of its advice on a best practice method for electricity retail price regulation. The AEMC has been requested to provide this advice by the Standing Council on Energy and Resources (SCER).

Most small electricity customers can choose to be supplied under a standard electricity contract or under a competitive market offer. In all states and territories, except for Victoria and South Australia, the price of standard electricity contracts is set by a jurisdictional regulator or government.

The approach taken to setting the regulated standard contract price for small customers currently differs from jurisdiction to jurisdiction. Decisions about the retention of retail price regulation and how prices are regulated are made by jurisdictional governments.

In providing its advice, the AEMC will develop a best practice method for setting regulated retail electricity prices for small customers. Jurisdictional governments may choose to adopt this method, where the regulation of retail prices remains.

The AEMC is particularly interested in seeking stakeholder comments in response to its Issues Paper on:

- the proposed objective for retail price regulation, and its supporting principles; and
- the appropriate method for setting the key cost components of the regulated retail price, which include: wholesale energy costs; retail margins; and environmental scheme costs.

The AEMC is required to provide its final advice to SCER, and to publish the final advice on its website by 30 September 2013.[1]

Etrog Consulting is a specialist consultancy in energy and utilities, focusing on regulatory policy and the interplay between regulation and competition in energy and water industries and markets. The director of Etrog Consulting, David Prins, who is the author of this submission, has 23 years consulting experience in this field. Much of David's recent work has focused on advice on electricity pricing.

1 Further details on this AEMC market review are available at www.aemc.gov.au/Market-reviews/Open/advice-on-best-practice-retail-price-regulation-methodology-.html.

Etrog Consulting is not currently engaged by any client on the subject of this submission. The views put forward in this submission are the views of Etrog Consulting and its author, and are not intended to represent the views of any client of Etrog Consulting.

Subject to any other client commitments or conflicts, we will be happy to discuss our views further with the AEMC or with any other stakeholders or interested parties that read this submission.

2. OUR PREVIOUS RELEVANT WORK AND PUBLICATIONS

The director of Etrog Consulting, David Prins, who is the author of this submission, was the lead advisor to the Victorian Government on retail electricity and gas pricing for residential and small business customers from 2002 to 2010. He was the instigator of landmark agreements between the incumbent retailers and the Victorian Government that set a four-year price path for electricity and gas prices in Victoria from 2004 to 2007. He then advised on price changes that were put in place for 2008, and on the transition to the removal of retail price regulation that was implemented in 2009.

David has advised on regulatory determinations of electricity prices and tariffs in every State in Australia.

Over the last few years, we have been advising Queensland Council of Social Service (QCOSS) on regulated retail electricity tariffs and prices in Queensland. We have written several reports which have been published as submissions from QCOSS to the Queensland Competition Authority (QCA). In these submissions, we have provided views on many of the issues on which the AEMC is particularly interested in seeking stakeholder comments in response to its Issues Paper, in regard to:

- the proposed objective for retail price regulation, and its supporting principles; and
- the appropriate method for setting the key cost components of the regulated retail price, which include: wholesale energy costs; retail margins; and environmental scheme costs.

Given that these submissions are in the public domain, we will be happy for the AEMC to review and quote from them and use information in them to assist in their final advice to SCER. Our reports which have been published as submissions from QCOSS to the QCA can be found at various websites:

- Some of the reports can be found among other reports on the QCOSS website;[2]
- All of the reports can be found among submissions from other stakeholders on the QCA website;[3]
- All of the reports can be found on a single page on our Etrog Consulting website.[4]

2 See www.qcoss.org.au/papers

3 On the QCA website there is a separate set of web pages for each year's setting of regulated retail prices, so our submissions are scattered across many pages. All can be accessed following links from www.qca.org.au/electricity-retail/NEP.

4 See www.etrogconsulting.com.au/pricing.html

Care will need to be taken when reviewing those previous submissions, to what extent the positions we have taken in those submissions are generic retail price regulation or are specific to Queensland and to the terms of reference and other conditions that applied when the submissions were written.

This submission does not consider further the appropriate method for setting the key cost components of the regulated retail price, which include: wholesale energy costs; retail margins; and environmental scheme costs. Rather we focus on the proposed objective for retail price regulation, and its supporting principles.

3. THE AEMC'S PROPOSED OBJECTIVE FOR RETAIL PRICE REGULATION

The Issues Paper states that the overarching objective guiding the AEMC's approach is the National Electricity Objective (the NEO). The NEO is set out in section 7 of the National Electricity Law (NEL), which states:

> "The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to -
>
> (a) price, quality, safety, reliability and security of supply of electricity; and
>
> (b) the reliability, safety and security of the national electricity system."

In developing its advice, the AEMC will consider how the best practice methodology will better allow for the NEO to be met.

We agree that the overarching objective guiding the AEMC's approach should be the NEO.

The AEMC's proposed objective for retail price regulation is as follows:

> Having regard to the long-term interests of customers, retail price regulation should determine electricity prices for small customers, which:
>
> - reflect the efficient costs of providing retail electricity services; and
> - facilitate the development of competition in retail electricity markets, where competition may be feasible.

Reflecting the efficient costs of providing retail services has long been the basis on which retail price regulation has operated, and is consistent with the AEMO.

We support the AEMC's view that consistent with the NEO, retail price regulation should have regard to the long term interests of customers.

We also agree that competition should result in:

- Prices which trend to efficient costs over time;
- A quality of service matching customer expectations; and
- A choice of products and services consistent with customer preferences.

Retail competition should not just facilitate competition for its own sake, but should facilitate competition that is sustainable in the long-term, and is actually in the long-term interests of consumers of electricity, through providing these and other long-term benefits to consumers. The AEMC should seek to encourage effective markets characterised by healthy and fair competitive forces that drive benefits for consumers through the entry of retailers offering greater efficiency or innovation.

These long-term benefits only accrue if competition is implemented in an effective manner, which includes consumer engagement, empowerment and participation.

We agree with the AEMC that regulation aims to act as a proxy for competitive outcomes.

However, we are concerned where attempts to facilitate or even encourage the development of competition through retail price regulation may distort the reflection of efficient costs, and than act as a proxy for competitive outcomes.

In most competitive markets, new entrants thrive through introducing new choices of products and services for consumers, and providing excellent customer service. Through efficient operations, and in many cases ongoing and continuous efficiency improvements, they also keep prices down so that customers are not dissuaded from purchasing from the active competitors due to price considerations. In many cases, new competitors thrive because of the excellent products and service that they offer, even if their prices are relatively high. In general competitive markets, new competitors do not depend on artificial raising of incumbents' prices so that they can enter the market.

Yet we see moves to do just that in electricity retail price regulation. It is not always easy to see how competitive entry in these circumstances does actual provide customer benefits. Our concerns include the fears that competition implemented in this fashion might result in:

- Prices that remain above efficient costs: since the competition was stimulated through allowing competitive entry at price and cost levels above efficient cost levels;
- A quality of service that does not match customer expectations: since competition was stimulated based on encouraging competitors to beat an artificially high regulated price rather than on the basis of improved customer service;
- No new choice of products and services: since competition is encouraged on the basis of providing the same products and services as the incumbent provides, but at a lower price than an artificially high regulated price;
- Lack of consumer engagement initiatives: since competition is encouraged simply through marketing of prices that are lower than artificially high regulated prices, rather than through the inclusion of consumer engagement, empowerment and participation in the market offers; and

- Competition that is not sustainable: since competition was stimulated based on encouraging market entry by inefficient retailers attracted by artificial margins that are not sustainable in the long-term.

We of course at the same time appreciate that electricity retailing has unique characteristics with which the AEMC must grapple when it considers how electricity price regulation should be structured in the long term interests of consumers of electricity through reflecting efficient costs and allowing customers to benefit from competition.

The AEMC states in its Issues Paper:

> The Commission notes that there may be a trade-off between facilitating long-term competitive outcomes, and short-term costs and lower prices. Competitive markets provide cost efficient outcomes over the long-term. However, unless carefully formulated, regulation may promote lower costs and prices in the short-term, which may discourage retailers from entering the market.

We would add that regulation that is carefully formulated may also provide competitive outcomes in the long-term interests of customers if it encourages retailers to improve efficiency (and hence lower costs and prices), as well as improving quality of service, and choice of products and services. We also note that significant price increases in the short-term can have an immediate and significant impact on cost of living. This can have flow-on impacts of undesirable social and economic outcomes, which are not in the best short-term or long-term interests of consumers.

Finally, we have two further observations in this section:

1. Electricity is an essential service, and there are reasons of geography and personal circumstances that mean that it is not appropriate at all times for end-use consumers to be asked to pay the full efficient costs of their electricity supply. There are various ways in which this can interact with retail price regulation. Currently those ways are set jurisdictionally, and include uniform tariff policies, and various concessions, subsidies and grants frameworks. There are ways in which those frameworks can interact with competitive outcomes. Regulating retail prices on purely economic grounds can only be implemented where there are also appropriate complementary frameworks in place. Best practice retail price methodology must include a place for these frameworks.

2. The second part of the AEMC's objective for retail price regulation is to facilitate the development of competition in retail electricity markets, ***where competition may be feasible***. The AEMC should recognise cases where, for various reasons, competition is not feasible, or is not being implemented, and the AEMC needs to take that into account in those cases.

4. THE AEMC'S PROPOSED PRINCIPLES FOR RETAIL PRICE REGULATION

The AEMC proposes the following principles that will be used to assess alternative methods for setting retail electricity prices and to guide the development of a best practice methodology. These are:

- Principle 1: Cost efficiency
- Principle 2: Cost reflectivity
- Principle 3: Transparency
- Principle 4: Open and consultative process
- Principle 5: Predictability and stability
- Principle 6: Minimising the administrative burden
- Principle 7: Appropriate allocation of risk

We support these principles. We can see how they easily complement that part of the AEMC's proposed objective for retail price regulation that states that retail price regulation should determine electricity prices for small customers which reflect the efficient costs of providing retail electricity services. We also urge the AEMC not to deflect from those principles when it considers how facilitating the development of competition might be reflected in best practice retail price regulation. We have in mind here the first three principles in particular.

In regard to Principle 3: Transparency, we note that transparency should extend not just to the methodology, but also to data and information which should be made publicly available. This also supports principle 4 in regard to open and consultative process.

In regard to Principle 7: Appropriate allocation of risk, we note that consumers are not homogenous, and some consumers will have ability to manage risk that others will not. The level of risk will vary across the consumer base.

We wonder also whether acting in the long-term interests of consumers also needs to be stated as a principle.