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Australian Energy Market Commission
PO Box A2449
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[by email]

26 August 2011

Dear Commissioners

POWER OF CHOICE (EPR 0022)

Thank you for the opportunity to comment on the AEMC's Issues Paper Power of Choice. My comments centre on the economic framework that the AEMC has set out in this paper and, based on this economic framework, the assessment process the AEMC intends to use. As the AEMC is aware, establishing a robust economic framework up front is central to ensuring that customers are the primary beneficiaries of proposed regulatory changes.

AEMC's proposed economic framework overly supply-side orientated

The AEMC's economic framework (section 3.2) appears overly supply-side orientated in that it focuses primarily on the opportunity cost of the capital invested in the industry (particularly networks) rather than considering the relative costs and benefits to the customer of demand side participation.

There are fundamental problems with adopting a supply-side focused economic framework. First, it ignores the value that consumers derive from energy use of a given quantity at a point in time. Second, it risks overlooking the costs consumers can incur in accessing DSP services (eg solar panels). Third, it implies that if the capital invested in networks were reduced, that society as a whole would be better off whereas the value that customers place on consuming energy at any point in time might suggest otherwise.

The economic framework should focus on the consumer

The economic framework should focus on the consumer and seek to make consumer sovereignty the central tenant of the AEMC's assessment. To this end, the framework should seek to assess the status quo for customers (ie no change in energy usage) against the value to customers of changing their energy use. In effect:

> "… promoting the use of DSP up to the point at which the value of reducing demand by an extra kWh is equal to the cost of supplying an extra kWh of electricity"[1]

should be replaced by:

> The value to consumers of changing their energy use must exceed (or at least equal) the value the consumer derives from not changing their use.

For example, society as a whole will be better off if the benefit a consumer receives from peak shifting exceeds the benefit of not peak shifting. However, it also works in reverse so that society will also be better off if the benefits a consumer receives from *not* peak shifting exceed the benefits of peak shifting.

[1] AEMC 2011 Power of Choice, p. 15

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Allowing the customer to choose the outcome they want at any point in time will ensure that there is an efficient allocation of resources.

The AEMC's supply-side economic framework runs the risk of pre-determining the customer's choice. For example, peak shifting will always be the preferred outcome (regardless of what the customer actually wants) because it can reduce the cost of supply. However, consumers may be prepared to pay this cost if the value that they receive from additional network services exceeds that cost.

The AEMC's framework seems to assume that lower cost equals an efficient allocation of resources. However, this is not always the case as an efficient allocation of resources actually means that sufficient resources are allocated to meeting customer demand. This could mean that more resources need to be allocated to an industry (ie costs should rise) if that is what customers demand.

Measuring value

Having established the right framework, the question then becomes one of how value is measured.

Measuring the value to consumers of changing how they use energy is fairly straight forward as it can be measured as the change in the value of energy services used (ie, c/kWh)

Measuring the value to consumers of *not* changing their energy use is more difficult and needs to consider the following:

- The value derived from energy use. Ideally this would be measured using a contingent valuation methodology (eg, a survey of customer value). However, in the absence of this type of valuation methodology, a shadow price could be derived using the total cost to the consumer of the appliance plus the cost of using them (ie cost of the energy and connection over the life of the appliance). However, this needs to recognise that the shadow price may under-estimate the true value of use for consumers because their willingness to pay may exceed the dollar price that they pay.

- To the value of the derived demand must be added the avoided cost of not participating in DSP (eg the cost of solar panels), the information and time cost to consumers of evaluating their tariff structure to understand and make decisions about when and how they use energy, cost of switching fuels etc.

AEMC's assessment process

The result of the economic framework that the AEMC has used is that the AEMC's assessment process (section 3.4) starts from a position that the customer places a net positive valuation on DSP (ie that the benefits of DSP exceeds the value lost from changing usage behaviour).

The AEMC has not undertaken this assessment nor has it demonstrated that this is the case.

Conclusion

The AEMC should not feel compelled to generate an outcome for the MCE because of the wording used in a Terms of Reference. I would recommend that the AEMC look toward the Productivity Commission for guidance on how to use first principles to develop recommendations of benefit to the customer, even if it is not what the MCE want to hear.

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I have set out short responses to some of the questions raised in the paper in the attachment. If you would like to discuss this submission further, please contact me on (03) 8807 1132.

Yours sincerely

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Senior Regulatory Manager

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Attachment: Response to questions raised in the Issues Paper

Chapter 3: Methodology and assessment	
1. Do you agree with our approach?	See commentary in main letter
2. How should benefits be measured?	See commentary in main letter
3. What are appropriate discount rates?	No comment
4. Are there other issues we should consider	See commentary in main letter
Chapter 4: Consumer participation and DSP opportunities	
5. What are the drivers for consumers changing their electricity consumption patterns?	• The value that consumers receive from changing their behaviour relative to the value they derive from not changing their behaviour • The paper also needs to recognise that customers are often constrained in their energy consumption decisions. When and how they consume energy can be dictated by geographical location, income, life circumstances (eg children, unemployed)
6. Are there other plausible DSP options?	• No comment
7. Are there DSP options not commonly used?	• No comment
8. Are there DSP options that could be available if the appropriate technology were available?	• No comment
Chapter 5: Market conditions	
9. What are considered the relevant market conditions to promote the take up of DSP?	• This question is an example of why the AEMC's economic framework may lead to the wrong outcome. "Promoting DSP" should not be the AEMC's starting position. Rather the AEMC should focus on whether there are market failures that prevent customers from maximising their welfare.
10. Are there specific market conditions which may need to be in place to enable third parties to facilitate consumer decision making?	• No comment
11. What market conditions are needed to make other DSP options available to consumers?	• No comment
12. Do you consider retail tariffs currently reflect the costs to a retailer of supplying consumers with electricity?	• Assuming that the AEMC is referring to the structure of retail tariffs and not the level. • As is common in a lot of retail markets, pricing structures are a form of product differentiator between retailers. Mobile phone charging is a classic example of where retailers will offer different pricing structures to ensure their mobile phone services are appealing to a wide variety of customers. Some customers will want to buy their mobile out right and only pay for usage on an ongoing basis. Others may find it more convenient to bundle the price of their handset into their monthly bill. Hamburger outlets offer similar pricing structures with the availability of 'meal deals' for one fixed price. • Energy retailing is no different. Retailers already have

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	time-of-use tariffs available to customers but take up is limited because customers have traditionally wanted their retailer to manage the price risk for them and take up a flat rate tariff. Customers are not only buying energy from their retailer but they are also buying a risk management service so the customer can spend their time doing other things. • What the customer wants will depend upon the customer. Some customers may want TOU pricing and so manage their own usage in accordance with that pricing structure. Others will find it more convenient to pay one flat rate charge to avoid the cost of managing their usage. • It would need to be demonstrated that there was a market failure in the types of tariffs that customers have available to them before any regulated structures were forced upon customers.
13. Are changes needed to retail price regulation to facilitate DSP?	• No comment
14. Do the charges to retailers for use of the transmission network reflect the value of that use?	• No comment
15. Do the charges to retailers for use of distribution networks reflect the value of that use?	• No comment
16. Do all consumer groups benefits from having cost reflective prices in place?	• No comment
17. Do customers understand how they can reduce their electricity bill?	• This question is an example of why the AEMC's economic framework may lead to the wrong outcome. This question assumes that customers are seeking to (and thus place a net positive value on) reducing their electricity bill. Each consumer will make their own electricity consumption choice based on the price, their income and the value they place on using energy at a point in time. It is possible that some consumers don't want to understand how they can reduce their bill.
18. What issues are associated with provision of existing information in the market?	• The primary issue with providing information to consumers about their energy use is their apathy about the topic. It would need to be demonstrated that customers demand different or more information for which they will have to pay and that the competitive market would not be able to provide this information.
19. Could better information be provided to consumers on the actual consumption of individual appliances and pieces of equipment?	• Most appliances have information on the power that it will consume. However, often consumers will place a much higher value on the output of the appliance than the cost associated with using it (big screen TVs are a classic example). • It needs to be demonstrated that there is a market failure in the provision of this information where

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	customers demand it. • The competitive market will provide this information where customers demand it as a supplier/retailer can use it as a product differentiator from their competitors. For example, a/cs are typically sold with information on the energy efficiency characteristics of the unit. This may influence the choice of unit but it is the value of staying cool in summer that will influence whether a customer buys an a/c or not.
20. Are retailers' business models supportive of DSP?	• Retailers' business models are supportive of providing the customer what he/she wants. If customers want DSP services, then the competitive retail market will evolve and provide this service to those customers who want it. Customers will seek out the services that they want and the retailers that can provide those services to them. If there is value in DSP to the customer, then a demand will be created and retailers will find value in supplying this service to customers. • If retailers' business models have not been supportive of DSP in the past, this is probably due to the fact that customers have not demanded these types of services until recently. Retailers' business models have changed and will continue to change to support DSP if this is what customers are demanding.
21. What incentives are likely to encourage R&D?	• No comment
22. Are there any barriers that affect the take up of DSP opportunities?	• No comment
23. What contracts/clauses are required?	• No comment
24. Are there specific issues associated with investment in infrastructure?	• No comment
25. Are there split or misaligned incentives?	• No comment
26. What are measures for addressing misaligned incentives?	• No comment
27. What are the specific issues concerning access to capital?	• No comment
28. What are the significant energy market challenges?	• No comment
29. Do current technology, metering and control devices support DSP?	• No comment
30. How can issues relating to weak and/or split incentives be addressed to ensure that the benefits of smart grid technologies are aligned?	• No comment
31. How can pricing signals/tariff arrangements be made complementary?	• No comment
32. What are the issues with consumer protection and privacy?	• No comment

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Chapter 6: Market and regulatory arrangements	
33. To what extent do parties have appropriate incentives?	• No comment
34. Are there aspects of the NEL or Rules which prevent parties taking actions that would otherwise allow for more efficient levels of DSP?	• No comment
35. Are there market failures?	• Forms of market failure include public good characteristics, either positive or negative externalities, information asymmetry, and imperfect competition or market power. • Not aware of any studies that have identified that these market failures exist in regard to the take-up of DSP by consumers.
Chapter 7: Energy efficiency	
36. What energy efficiency policies and schemes should be considered?	• All energy efficiency schemes at the Commonwealth and State level require consideration. All white certificate schemes and feed-in tariff schemes require urgent review as they are poorly designed and are increasing energy prices for all customers for the benefit of the few.
37. To what extent can energy efficiency schemes be adopted as options for DSP?	• Increasing energy efficiency is a form of demand side response so energy efficiency schemes can be adopted as options for DSP. • However, the current schemes (eg REES, VEET) are supply driven and very costly for consumers. They are schemes that have been forced upon retailers' customers by government whereas, as far as I'm aware, there has been no assessment of the value that customers place on achieving these energy efficiencies and whether the cost is worth it. Again, if customers valued these types of services, then there would be no need for a regulated scheme so it suggests that customers place very little value on the energy efficiency that these schemes achieve. • The design of existing schemes is poor and it is likely that the cost of delivering a unit of energy efficiency to a householder under these schemes exceeds the value of that unit to the householder.
38. To what extent do existing retailer obligations facilitate efficient choices by consumers?	• It is not clear that they do as the true cost of delivering the energy efficiency activities to the householder concerned is hidden in energy prices. As a result, the householder does not 'see' the real price they are paying. • In its Review of Energy Efficiency Policy Options for the Residential and Commercial Building Sectors, PricewaterhouseCoopers noted that: While international experience … is fairly limited

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	to date, early indications are that mandatory energy efficiency targets (ie white certificate schemes) can be effective in delivering energy efficiency improvements. However, the schemes are complex to design and do not come without their own challenges. A key concern with white certificate schemes is their level of cost-effectiveness. If mandatory targets are not easily met by liable parties, consumers could be forced to pay for uneconomic forms of abatement. [2] • PricewaterhouseCoopers also noted that a key risk with these schemes was that retailers incur costs in 'seeking out' and implementing energy efficiency gains that may happen anyway due to increases in energy prices.[3]

[2] PricewaterhouseCoopers 2008 Review of Energy Efficiency Policy Options for the Residential and Commercial Building Sectors, Report prepared for the Energy Retailers Association of Australia, p. 4.
[3] Ibid, p. 5