Submission
2011-2014 Electricity Standing Contract Price Determination

(October 2012)

"Adopting a short run approach to regulating retail prices doesn't lower prices, even in the short-term. Such approaches may even increase prices in the long term."

"Short run regulatory approaches make the market more confusing, and limit consumers' ability to reduce their electricity bills."

"Short run regulatory approaches amplify the peak demand problem."

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Introduction

Meridian Energy Australia (**Meridian**), along with its retail business Powershop Australia (**Powershop**), has built a significant position in the Australian energy market, with a focus on efficient and sustainable energy supply for consumers. On this basis, Meridian welcomes the opportunity to provide a submission in relation to the Essential Services Commission of South Australia (**ESCOSA**) Draft Determination on 2011-2014 Electricity Standing Contract Prices (the **Draft Determination**).

In the past five years, Meridian has – on the basis of an efficient National Electricity Market (**NEM**), a stable Renewable Energy Target, and a competitive and deregulated retail electricity market – made a number of significant investments in Australia, including:

- The $200 million Mt Millar wind farm in South Australia, acquired with an off-take agreement that will expire this year;
- A 50% interest (in joint venture with AGL Energy) in the $1 billion Macarthur wind farm in Western Victoria, which will be completed in early 2013;
- The establishment of wholesale market trading capability supported by a BBB+ credit rating in Australia;
- The $260 million Mt Mercer wind farm, which will be constructed in 2012-2014 and which is not the subject of a long-term off-take agreement; and
- The launch of Powershop – a retailing business focused on delivering savings to Australian households by providing them with more choice in the way that they measure, use and pay for electricity.

All of these investments have been made on the basis of the stability of the NEM and the Renewable Energy Target (**RET**), and the existence of a competitive & deregulated retail market in Australia.

Meridian's investment in Powershop is aimed at giving Australian householders and businesses:

- Clear, simple information and tools (including via their smartphones) with which to manage their electricity consumption; and
- genuine choices (via an online "shop" that offers a range of retail electricity packages) about how they purchase and consume electricity.

The combination of clear insights and genuine choice has enabled thousands of New Zealand customers to achieve significant reductions in their energy bills. Powershop hopes to have the opportunity to achieve the same for Australian customers.

Long Run Marginal Cost as a basis for regulating prices produces better outcomes for consumers

Meridian considers that price monitoring is all that is required in South Australia, given the existence of effective competition in that market.

However, if price regulation is to be retained, then it must be based on long run marginal cost (**LRMC**) estimates and not short term wholesale energy costs. Any regime based on short run regulatory approaches:

- is unlikely to achieve any consumer benefit, even in the short term;
- will increase consumer prices in the long term;
- may lead to increased customer confusion;
- limits customers' ability to reduce bills; and
- amplifies the peak demand problem.

Short run regulatory approaches don't lower prices, even in the short-term

In a competitive market, as primarily exists in South Australia, the key driver of retail prices is the level of retail competition and its impacts, and not the "fall-back" tariff guaranteed to consumers through retail regulation.

This was confirmed by the Australian Energy Market Commission (**AEMC**) in its Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia:

> *"In light of its finding that competition is effective … retail price regulation should not be continued in South Australia. In its place, … retail prices [should] be set by the competitive market, accompanied by a comprehensive price monitoring and reporting regime and a*

statutory reserve power to re-introduce retail price regulation ..."[1]

Consumers have access to competitive prices that are below the fall-back tariff, and most consumers are in fact receiving the benefits of such competitive prices.

A reduction in the fall-back tariff will have no impact on competitive prices, unless it is such a drastic reduction that it is below the true cost of providing a retail service to customers. Adopting a short run approach to regulating retail prices – for example by attempting to pass through current short-term reductions in wholesale prices without considering long run marginal cost – is unlikely to provide any customer benefits.

"Regulation emphasising short run wholesale market conditions is likely to lead to higher prices for consumers in the long-term without any compensating short-term benefits."

Indeed, as set out below, such regulation is likely to lead to higher prices for consumers in the long-term without any compensating short-term benefits.

Short run regulatory approaches increase prices in the long term

New entrants in electricity retailing are required to make long-term investments in order to enable a sufficient critical mass of customers to be acquired over time, with a fair return unlikely to be available until the back end of the investment horizon.

Sustainable retail competition requires a degree of vertical integration, as a means of managing (and reducing the cost of) exposure to volatile wholesale prices. Generation investments in turn have an even longer investment horizon.

Critical to the encouragement of new entrant retail investment is the removal of unnecessary uncertainty impacting the ability to achieve a fair rate of return.

It is an axiom of financial investment that increased uncertainty results in either (i) increased prices; or (ii) withdrawal of investment (especially if prices are limited).

It is universally accepted that short-term movements in wholesale energy prices – even when smoothed by hedging[2] – are far more volatile than the medium to long-term movements in the long run marginal cost (**LRMC**) of new entrant generation (which reflects the expected long term movement in wholesale prices).

"When customers are given clear information and effective choices, they can and do manage their electricity arrangements and save more money."

Using a method of retail price regulation emphasising short run wholesale energy prices will increase the uncertainty associated with the new entrant retail investment decision, without actually leading to lower (regulated or competitive) prices over the medium to long-term.

This too was confirmed by the AEMC:

> *"retaining direct price regulation in a rapidly changing and uncertain future regulatory environment is likely to harm the viability of existing retailers, discourage entry into the market by new retailers and impede the effectiveness of energy retail competition."*[3]

This impact is further accentuated by the risk that regulators may fail to pass through the higher costs where short-term wholesale energy prices rise above the LRMC, in which

[1] Australian Energy Markets Commission, "Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia" Second Final Report, 18 December 2008.

[2] During times of peak demand, wholesale electricity prices can be above forty times the retail price, and this risk needs to be managed (at significant cost) by retailers.

[3] Ibid, note 1.

case retailers fail to achieve a fair rate of return across the investment horizon.[4]

This was confirmed by the AEMC to have already occurred in South Australia:

> *"… the regulated standing contract price had become a constraint on the ability of market prices to respond to cost increases."*[5]

"The absence of economic incentive for retailers to promote the benefits of the competitive market as against the (regulated) fall-back tariff may lead to periods where consumers incorrectly assume that the fall-back tariff remains their best option, even in periods in which this is no longer the case."

Short run regulatory approaches make the market more confusing

Regulated fall-back tariffs may have an important role to play in ensuring that consumers who are unable to engage in the competitive market are not unreasonably disadvantaged. However, setting such tariffs on a short run regulatory approach may lead to consumers being further confused because – in some periods – their best outcome is achieved by accessing the competitive market, while in other periods their best outcome does not require any engagement with the competitive market.

Moreover, the absence of an economic incentive for retailers to promote the benefits of the competitive market as against the fall-back tariff may lead to periods where consumers incorrectly assume that the fall-back tariff remains their best option, even in periods in which this is no longer the case.

Healthy levels of competition among retailers (and associated downward pressure on prices) over a sustained period achieves a far more educated consumer base and lower prices over the longer term.

Meridian's experience – where its new entrant retail business Powershop is the fastest growing business in New Zealand and the highest ranked retailer for customer satisfaction[6] – is that when customers are given clear information and effective choices, they can and do manage their electricity arrangements and save more money.

Short run regulatory approaches limit the ability to reduce bills

Much of the recent debate about increasing household electricity bills has focused on the rate (price per unit of consumption) at which electricity is purchased. However, it should be emphasised that consumers can have the capacity – if they are provided with clear information and practical tools – to significantly reduce their consumption and thus the size of their electricity bill.

The provision of such clear information and practical tools requires an innovative approach to the retail electricity relationship.

Innovation in turn is best driven by the introduction of new entrant participants who have a commercial imperative to offer customers new approaches to electricity management.

By way of example, Powershop – a new entrant in Australian electricity retailing – offers customers an unrivalled ability to understand and react to their electricity usage.

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[4] ACIL Tasman (July 2012 report to ESCOSA) notes that in a regulatory scheme focused on short-term market conditions, wholesale energy costs rise as supply tightens, and fall as supply is injected. Investment in generation which relies purely on wholesale market receipts only occurs once long-term wholesale energy prices are sufficiently certain. Given that wholesale energy prices often drop below LRMC, and if generators cannot enter into long-term contracts at prices exceeding wholesale energy prices, they will not invest in generation until there is a shortage exists and a threat to the security of supply.

[5] Ibid, note 1.

[6] Powershop's awards in New Zealand include: Consumer Magazine customer satisfaction survey – #1 four years in a row with unprecedented satisfaction (2009-2012); Deloitte Fast 50 – New Zealand's fastest growing company.

Short run regulatory approaches amplify peak demand issues

It is now well known that a key driver of higher electricity prices for consumers is the requirement for network investment to cover peak demand conditions, notwithstanding that these conditions exist for only a small fraction of time each year (if at all).

Addressing this peak demand challenge will require consumers to be actively engaged in understanding and adjusting the impact of their consumption. Australia's current market structure severely limits the ability of networks to play a role in this, because their price signals are intermediated (and often smeared) by retailers.

Innovation in retail electricity offers will be critical to changing this situation. Experience throughout the world has demonstrated that such innovation is rarely offered by incumbent retailers, especially in regulated retail markets. It requires new entrant participants who have a commercial imperative to develop new ways to attract customers by delivering value.

"Powershop offers Australian householders and businesses an unrivalled ability to understand their electricity usage, and a genuine choice to purchase products which are tailored to achieve customer savings and network / market benefits."

As part of its customer-oriented approach, Powershop offers Australian householders and businesses the ability – among other things – to purchase products which are tailored to achieve customer savings and network / market benefits.

Powershop's ability to sustain this innovative business model (and therefore its willingness to invest) in the South Australian market will be negatively impacted by any initiatives to regulate retail prices on the basis of short run market conditions.