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Mr Lew Owens
Chairperson
ESCOSA
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Dear Mr Owens

**Inquiry into Electricity Price Path – Issues Paper**

NRG Flinders offers the following comments on the issues on which ESCOSA has sought input at this stage for its inquiry into the electricity retail price path.

*Objectives for Retail Electricity Price Path*

NRG Flinders believes that prime emphasis should continue to be placed on the establishment of effective competition as the long-term solution for the retail market, and that this should form the overriding objective in establishing an appropriate price path.

The key challenge in regulating prices in a contestable market segment such as retail is therefore to provide an effective transition path to a competitive market environment, which forms the key mechanism for delivering efficient price outcomes for customers over time. This builds on the approach adopted by ESCOSA to date.

In contrast, a short-term focus on pricing restraint would risk entrenching cost-based price regulation more suited to monopoly industry segments, thereby undermining the further development of competition and providing a suboptimal outcome for customers.

The ideal outcome would be for the regulated price path to become effectively redundant by the end of the regulatory period, with prices set by market forces below this level. Competitive forces would then effectively remove the need for continued price regulation as the emphasis shifts from regulated pricing controls, to the ability of customers to change supplier as the primary means of price restraint.

*Form of Regulation*

Guided by the overall aim of providing an effective transition path to competition, the form of tariff path should ideally be as straightforward and simple to interpret, apply and administer as possible.

In this context, a price path in the form of a CPI-X formula based on average unit prices might offer the simplest price setting approach. This method would avoid the complexity of individual tariff regulation, is relatively easy to administer and monitor, and simplifies annual price adjustment during the regulatory term.

Under an average unit price approach, individual tariff movements could be capped if desired, while allowing some scope for tariff rebalancing. An annual adjustment could also be applied to correct for any over or under recovery in the previous year if desired, but is probably not necessary.

In contrast, the regulation of maximum revenue may pose difficulties, being heavily dependent on variables such as consumption levels and patterns, and churn rates.

Similarly, setting an actual price path or starting point for each customer category could be highly prescriptive and may prevent any tariff rebalancing necessary to adapt to market pricing levels.

Under the approach adopted, it would also be desirable to allow for the pass through of regulated network costs. Appropriate and prudent cost assumptions across other areas should avoid the need for pass through of other cost changes or impacts, in the interests of simplicity, and consistency with the fundamental objective of providing a glide path to competition.

As the main aim is to provide a transition to market pricing in a competitive industry segment, the encouragement of efficiencies is not of primary relevance. Consequently, the risk of over-regulation and suppression of prices poses the greater threat of stifling retail competition and market entry, compared with the risk of over-estimating prices, which merely acts to encourage more rapid development of the competitive market.

*Overall Approach*

ESCOSA has established a robust methodology for approximating the costs of a prudent retailer, which could be applied to the task of determining a forward three-year price path.

Adapting this methodology to suit such a longer-term outlook might require assumptions to be made over future wholesale price trends over the period, rather than a pure reliance on present forward contract values, recognising that the forward contract market is very illiquid in SA beyond 1-2 years.

A longer retail price path is more conducive to longer-term contracting at the wholesale level, and greater allowance for long-term contracting should be made. Longer-term contracting contributes to market stability and is more conducive to investment in generation.

However, any use of actual contract cost data in wholesale cost estimation should be limited to aggregate data used to provide a comparator or rough guide only, to avoid the risks of cost-based pricing regulation.

*Actual Versus Prudent Costs*

The use of prudent retailer costs is consistent with the aim of providing a transition path to open market competition. Conservative and realistic cost estimates provide scope for more innovative and efficient retailers to enter the market and compete.

However, a focus on actual costs departs from this goal, and denies the competitive pressures exerted by competitors in the market. Arguably, competition should provide the prime restraint on retail prices, rather than regulatory pricing solutions. Short-term cost based pricing would only act to stifle competition, and perpetuate the need for on-going regulated price control.

For these reasons, actual cost data should be used loosely as an indicator only, to ensure deemed prudent costs are realistic. Since the retail market is not a monopoly, all effort should be made to avoid entrenching cost-based pricing regulation. The actual cost structure of the franchise retailer is not of primary importance when seen against the backdrop of providing a glide path to competition.

*Re-opening of Price Path*

The established price path should be open to review in limited and defined circumstances. This recognises the inherent risk in applying price caps at the retail level, whilst wholesale supply is sourced in a deregulated market.

Under a price-capping regime, exposure to unforseen market events can create major financial losses or gains for host retailers, not necessarily limited to events occurring within the region. These may include major generator failures, major transmission failures, step changes to rates and taxes, regulatory disruption events, natural disasters, introduction of greenhouse measures, and a range of other force majeure events. In this light, it would seem highly desirable to provide an 'off ramp' or adjustment mechanism for such events.

In general, the pass through of regulated network charges and prudent cost allowances for all other cost elements should avoid the need for any re-opening of the tariff path in all but the most severe circumstances. However, the tighter the price cap, the more likely that the price path will need re-opening.

*"Fail-safe" or "Normal" Prices*

As outlined above, the treatment of regulated prices as the norm in a competitive market segment such as retail denies the existence of competition, risks entrenching cost-based pricing regulation more suited to markets with monopoly characteristics, and ultimately defeats the goal of providing a suitable transition to a competitive retail market.

For these reasons, regulated retail prices should only be seen as providing a safety net as full competition becomes established, to avoid pre-empting market outcomes. The continued risks of retail price capping should also be recognised.

The level of customer transfer suggests that competition is steadily evolving, and an entrenched regulatory pricing approach that loses sight of the ultimate goal of effective competition would only serve to undermine the progress achieved to date.

In this context, the extension of the standing contract pricing sunset date under legislation provides a potentially longer transitional pathway to competition. However, any assumption that price regulation is to be perpetual threatens the development of the retail market, and risks disadvantaging customers that have already elected to lock in to market contracts in response to pricing signals.

*Demand Assumptions*

In the absence of a mandated meter rollout, the shape of the average (residual) system demand profile would be a key demand consideration from the perspective of the host retailer.

The use of measures such as a representative sample of interval meters might potentially provide a useful cross check on the accuracy of load shape estimates, but would be useful primarily from a historical perspective.

Ultimately, sufficient conservatism in estimating the regulated price path should avoid any unintended adverse consequences for the host retailer. Conversely, any windfall gain would be rapidly competed away by new entrants.

*Information from AGL*

In addition to the data sought to date, ESCOSA may wish to consider obtaining information on estimated customer churn rates, and any available load profile data and projections.

However, NRG Flinders considers that only aggregate wholesale contract cost data should be sought, in order to avoid creating unnecessary regulatory risk, and violating the confidentiality of contracts entered into between private sector participants in the market.

*Alternative Approaches*

ESCOSA's established building block approach, based on estimation of prudent retailer costs, continues to provide an acceptable cost approximation method in the circumstances, particularly if combined with analysis of actual aggregate cost data, albeit purely as a 'sanity' check.

*Other Issues*

In recognising retail pricing control as a temporary pathway to competition, ESCOSA may wish to consider defining the criteria by which it would judge retail market development to have reached a sufficient stage so as to enable regulatory price controls to be relaxed or removed, perhaps in favour of lighter-handed regulatory approaches (eg price monitoring).

This would provide valuable regulatory transparency and clarity to the market, and increase certainty for participants.

NRG Flinders would be pleased to discuss the issues raised in this submission with ESCOSA or its consultants, or to provide any additional clarification or information required. I can be contacted on (08) 8372 8726.

Yours Sincerely

Reza Evans
Manager
Regulation and Market Development