2 AUGUST 2004

Energy Retailers Association of Australia Incorporated

Enquiry into Electricity Price Path
Essential Services Commission of South Australia
GPO Box 2605
Adelaide
South Australia

escosa@escosa.sa.gov.au

Inquiry into Retail Electricity Price Path
Issues Paper

Energy Retailers Association of Australia (ERAA) welcomes the opportunity to comment on the Essential Services Commission of South Australia (the Commission's) Issues Paper on the Inquiry into Retail Electricity Price Path. The ERAA represents the core of Australia's energy retail organisations and is the peak body representing energy retailers in Australia.

The ERAA believes that the Commission, in order to deliver on its primary objective under section 6(1) of the ESC Act of protecting the long-term interests of South Australian (SA) consumers with respect to the price, quality and reliability of essential services, must meet the following key objectives:

- Promote competition in the energy market to ensure efficiency in the supply of energy;
- Achieve an environment that encourages long-term investment in intermediate and peaking plant (or transmission augmentation) to meet the growing energy demand in SA and to encourage retailer participation in retail supply; and
- Provide the long-term certainty necessary with respect to the treatment of the state's (and national) environmental objectives to support such investment.

Against this background, the ERAA is firmly of the view that standing contract prices should continue to be viewed as the "fail-safe" supply arrangement rather than a "standard" supply arrangement. We would argue that the "fail-safe" approach is the approach that is consistent with meeting the objectives of encouraging the competitive market and appropriate protection of consumers. In general, the evidence to date is that the "fail-safe" approach better supports the development and consumer acceptance of a variety of market offers and of a vigorous market place.

The decision of governments in the mid 1990s to introduce competition reforms into retail energy markets was based on, in our view, the correct presumption that competition provides the most effective form of customer protection available. This presumption is consistent with economic theory and a wealth of experience of the success of competitive markets in effectively and efficiently delivering most of the goods and services customers want. Based on this premise, the United Kingdom regulator, Ofgem removed price controls in the energy market from April 2002.

The ERAA is aware of the significant public debate on the level of electricity prices to residential and small business customers in SA. We are concerned that uninformed debate and potential[1] for a disproportionate emphasis on short-term price reductions may impact on the investment climate and as a consequence on the quality and reliability of electricity supply in SA. There is also a risk that pursuit of short-term retail price outcomes could precipitate a cost-price squeeze that will impede the development of a competitive market and affect the viability of retail businesses.

The supply/demand balance has reached a level where SA no longer has enough supply to maintain the industry-accepted reserve, or safety margin for the coming summer of 2004/05[2]. Whilst the Basslink Interconnector from Tasmania will relieve this somewhat in the following summer, the state will again fall below accepted safety margin by 2006/07. Despite the forecasts showing demand will exceed supply by 2007/08 there are currently no new scheduled power station projects for the future. It is critical that the Commission provides the incentives for long-term investment if its primary legislative objective of ensuring quality and reliability of supply is to be met.

A 2001 paper[3] on the analysis of the California energy crisis noted that a financial crisis caused by extremely high wholesale prices, compounded by concerns about retailers' ability to pay, exacerbated the already tight supplies and led inevitably to rolling blackouts. Rolling blackouts impose tremendous social and economic costs on a society and threaten to wreck its economy.

Whilst references to the California crisis may appear alarmist in the context of SA, it must be noted that demand will outstrip supply in 4 years time (the potential term of the retail price path).

It is therefore critical that the Commission achieve a retail price path that reflects the costs and risks of supply and provides regulatory certainty with respect to prices beyond this period to ensure investment in generation/transmission assets that have lives in excess of 30 years. Further, whilst we note that it is not the Commission's role to determine the environmental response that may be required to address the greenhouse challenges, the Commission must provide transparency and certainty in the price path with respect to pricing signals to customers and the industry's ability to recover the cost of such response.

It is our view that the long-term interests of SA consumers with respect to the price, quality, and reliability of electricity supply can be best served by allowing competitive markets to work. We believe that the focus of the inquiry should be on increasing competition in the energy market to deliver benefits that are sustainable in the long-term. Where there is a conflict between the objectives of economic efficiency and social equity, it is important that these are identified and addressed in an efficient and transparent manner to avoid distorting the operation of the competitive market.

Our detailed comments on matters identified in the Issues Paper and other relevant matters are provided in the attachment.

---

[1] For example the terms of reference for the SA Select Committee on the Electricity Industry in SA is with a view to reducing the price of electricity to residential and small business customers.
[2] South Australian Annual Planning Report, the Electricity Supply Industry Planning Council, June 2004
[3] Manifesto on the California Electricity Crisis, Institute of Management, Innovation and Organisation, University of California, Berkeley, January 2001

If you have any queries on the content of this submission, please contact me or Nicole Stillman at the ERAA Secretariat on 0417 101 452.

Yours sincerely,

Deane Russell
Executive Director
Energy Retailers Association of Australia Inc.
0419 444 112

Attachment 1
Inquiry into Retail Electricity Price Path - Detailed comments

Price regulation in competitive markets

The ERAA notes that the SA Minister for Energy has directed the Commission to investigate a price path from 1 July 2005 for a period of no less than 3 years. We welcome the move to provide price stability over the medium term which is consistent with the approaches in the other jurisdictions.

However, with regard to facilitating consumer protection, the decision of governments in the mid 1990s to introduce competition into retail energy markets was based on, in our view, the correct presumption that competition provides the most effective form of customer protection available. This presumption is consistent with economic theory and a wealth of experience of the success of competitive markets in effectively and efficiently delivering most of the goods and services customers want.

The sooner market competition sets customer prices - and not a regulator - the sooner more efficient outcomes will be realised.

Therefore, in principle we do not support the underlying premise, that in the transition to effective competition, price regulation remains a legitimate and ongoing role for governments to facilitate consumer protection goals. Based on the accepted premise that effective competition is the ultimate goal, it is the ERAA's view that the causative link is the exact opposite – that price regulation is a key impediment to effective competition. For a market to be effectively competitive, market forces must determine prices.

Whilst retail price controls remain, efficient market outcomes will be distorted and effective competition inhibited. For example, demand side responses require flexible and innovative pricing structures to be effective. Price controls prevent these innovations from developing, and thus frustrate the very objectives that governments are seeking from demand side response.

The ERAA recognises that governments may wish to pursue social equity and/or affordability issues. To the extent that governments identify these issues, they should be addressed not through price controls which inhibit competition, but through direct and transparent government payments.

While artificially low regulated tariffs remain attractive alternatives to market contracts, competition from retailers will continue to be stifled. The ERAA would promote that regulated tariffs should transition to cost-reflective levels quickly and then, ultimately be removed. Governments may continue to monitor retail prices and take action under competition law, if required.

The difficulty with regulating prices in competitive markets is articulated by the United Kingdom (UK) regulator Ofgem following its review of gas and electricity competition and supply price regulation[4]. On the option of continued price caps for suppliers Ofgem commented that:

[4] Review of domestic gas and electricity competition and supply price regulation, Conclusions and final proposals, February 2002.

"Ofgem considers that this option has a number of identified regulatory risks that could unjustifiably prevent or distort competition to the detriment of customers' interests. "

In a 2003 press release[5] Ofgem's Chief Executive Callum McCarthy stated that:

"… All the evidence suggests price competition is a key driver of consumer choice. To artificially set one price for all customers would kill competition, as well as stopping those who shop around from getting better deals. It would also remove the competitive pressure on prices for those customers who remain with their traditional supplier."

Ofgem concluded that price controls would do more harm than good in a competitive market and as a result took the decision to remove price controls from April 2002.

Implementation of competition reforms in the electricity market has benefited SA electricity consumers overall. However, the benefits in terms of electricity prices have been shared differently amongst the consumer classes. Business consumers have seen real price reductions whereas residential customers have seen price increases as part of the readjustment to cost reflective prices.

A November 2003 report[6] by the Commission notes that the broad trend of total customer real average electricity prices shows a decline of 7% over the period 1989/90 to 2002/03. This includes the effect of GST in 2000. In the Report, the Chairman of the Commission notes that:

"Liberalisation of the electricity market has seen significant price reductions for large business, a period of price stability for smaller consumers, and finally an increase in charges as true wholesale market prices commenced. That is the outcome of "user pays" and was one of the un-written implications of reform policies initiated in the early 1990s. Business is now far more internationally competitive, because its electricity prices have fallen in real terms over that period."

The ERAA accepts that the unwinding of cross subsidies has resulted in price increases for residential customers and small business customers. However, this result was expected as cross subsidies were unwound. The significant adjustment in prices to small retail customers in 2003 is attributable to the "artificially low tariffs" that were supported by vesting contracts under the Electricity Pricing Order that preceded the introduction of full retail contestability. The key to managing the transition (unwinding of cross subsidies) is to implement initiatives to ensure customers are not exposed to unacceptable price increases and that the operation of a competitive market is not distorted in the process. The Network Tariff Rebate in Victoria is an example of a transparent subsidy that avoids unacceptable price movements without producing a distortion in the energy market.

It is essential that the price path that is to be established does not impact on the operation of a competitive market or lead to the need for a significant price adjustment in future.

---

[5] Ofgem Press Release "Vigorous Competition for domestic customers, but Ofgem remains vigilant" – 16 June 2003

[6] 4th Annual Performance Report, Performance of Regulated Electricity Businesses in South Australia 2002 – 2003, Essential Services Commission of South Australia (ESCOSA), November 2003 (p.34).

Objectives of Price Review

The Commission seeks views from stakeholders on the objectives it has stated for establishing a retail price path. Based on relevant legislation, are there other factors to which it should have regard?

The Commission's questions appear to be based on the Independent Pricing and Regulatory Tribunal's (the Tribunal's) suggestion that the objective of protecting the long-term interests of consumers should be balanced against other objectives. There appears to be a suggestion that there is a "trade-off" between the primary objective of protecting the long-term interests of consumers and subsidiary objectives of promoting competition, providing incentives for long-term investment and ensuring the financial viability of regulated industries etc. The Tribunal suggests that consideration be given to strike the right balance between the primary and subsidiary objectives.

The ERAA believes that the primary and subsidiary objectives outlined in the ESC Act are not a matter of trade-offs but rather a means to deliver on the primary objective. In other words the Commission must achieve the subsidiary objectives in order to achieve its primary objective.

Our view is reinforced by the view taken by the UK regulator Ofgem[7]:

"Protecting Customers

Everything Ofgem does is designed to protect and advance the interests of consumers present and future.

Ofgem does this by:

- *Promoting effective competition, wherever appropriate;*
- *Regulating only where necessary; and*
- *Ensuring that special help is targeted to vulnerable customers."*

Taking into account the accepted premise that regulators are not able to set efficient retail prices but that the market is, then it follows that the emphasis in the objectives (consistent with the ESC Act) should be on:

- Promoting competition through a light-handed approach to the price path that allows prices to settle to market-based rates;
- Providing incentives and regulatory certainty for investment in new generation/transmission capacity given the impending shortfall in supply from 2007/08; and
- Providing regulatory certainty with respect to the State and Federal government's response to the greenhouse challenge.

The other objectives mentioned by the Commission of establishing the lowest possible price path, cost recovery and an appropriate return for an efficient retailer will follow if the above objectives are realised.

---

[7] Protecting Customers 11/12/2002, Ofgem main page www.ofgem.gov.uk

The ERAA believes that effective competition and new investment will ensure that the objective of protecting the long-term interests of SA electricity customers with respect to prices, quality and reliability of supply is met.

Form of regulation in a competitive electricity market

The Commission seeks views on the form of regulation/price path formula and correction factors and balancing parameters, if required.

There is consistent evidence in South Australia that interstate retailers are seeking to identify opportunities in the market and to increase their market share. In addition, there are competitive outcomes of customer churn now, with no evidence of a retail market failure. The extent to which the most attractive customers are identified and 'switch' will be the most obvious form of immediate competition with retailers seeking to win these customers by offering lower prices.

According to a Commission Report[8] there are eleven licensed electricity retailers competing for customers in SA. At least five retailers (AGL, Origin Energy, TXU, PowerDirect and EnergyAustralia) are targeting small retail customers.

After a slow start during the first few months of full retail contestability in SA, 38,000 small electricity customers (5.2%) had transferred to market contracts over a 12-month period to December March 2004. A further 20,000 (2.7%) transfers were in progress, bringing to the cumulative total close to 8%. Monthly switching rates have also increased from 5,000 (0.7%) in January 2004 to 11,000 (1.5%) in March 2004. This shows that competition is robust and increasing.

A survey by the Commission[9] found that awareness of ability to change retailers amongst the SA small customers is high with about two thirds indicating that they are aware that they can change retailers. Around a quarter of the customers surveyed indicated that they are quite likely to take out a new contract within the next 12 months.

The scope of competitive outcomes posed by entry or the threat of entry by interstate retailers also includes non-price-based differentiation. In the medium term further entry by interstate retailers in the balance of a less price-differentiated market is more likely to be characterised by positive loyalty. Competent rivals will quickly and easily match any achievable discounts whereas advertising battles, on the other hand, may well expand demand and enhance the level of product differentiation in the industry to the benefit of all.

The ERAA believes that the competitive market is already delivering benefits to small customers, which is only likely to increase with the gas market being opened for competition. In this context, a strong regulatory intervention in the market is not necessary as in our view it will only contribute to distorting the operation of a competitive market.

[8] Monitoring the Development of Electricity Retail Competition in South Australia, Statistical Report, The Essential Services Commission of South Australia (the Commission), May 2004.
[9] Monitoring the Development of Electricity Retail Competition in South Australia, Statistical Report, The Essential Services Commission of South Australia (the Commission), The Essential Services Commission of South Australia (ESCOSA), November 2003.

Based on the evidence above, the ERAA believes that competition in SA has reached a level of maturity where a light-handed approach is more appropriate for the minimum 3-year price path.

There are a number of options for how such an approach could be implemented and a range of design issues that need to be taken into account. For example, the option selected should:

- account for the key aspects of the SA electricity environment, such as the peaky and volatile nature of demand (which feeds through into volatile spot and contract electricity prices) and the absence of a Government risk management scheme (such as NSW's ETEF) – this makes accurate forecasting of energy costs for the purposes of a medium term price path a fairly imprecise exercise;
- recognise, more generally, the impact of a range of uncontrollable factors on the standing contract retailer's costs (such as network tariff pass throughs, tax changes etc);
- serve to provide a transparent and predictable fail-safe benchmark against which consumers can evaluate market offers; and
- minimise the regulatory burden associated with determining standing contract prices and, by suitable design, limit the need for full or partial re-opening of the price path before its conclusion, to only exceptional circumstances.

Moving forward, we believe that the Commission should carefully evaluate the existing Victorian and NSW approaches for electricity and gas. In the interests of minimising unnecessary differences in regulation, it would be desirable if a pre-existing approach could be adapted to the SA electricity context by addressing the factors listed above.

The ERAA notes that the terms of reference require the Commission to assess any cross subsides between customer classes and whether these cross subsidies are justified to prevent a disproportionate price impact on any small customer group.

Maintaining cross subsidies in a competitive market is not sustainable. To ensure individual tariffs transition to cost reflective levels, the Commission should consider tariff constraints in excess of the average price threshold whilst ensuring that customers are not subject to unacceptable price shocks. Should the Commission or the government see a need to subsidise a certain class of customers these should be through transparent arrangements that do not distort the operation of a competitive market.

The ERAA urges the Commission to adopt a light-handed approach in SA to provide the maximum capacity for the market forces to come into effect.

Considerations on estimates for wholesale electricity costs in SA

The cost of electricity in South Australia has historically been higher than the costs in Victoria, New South Wales and Queensland. This is due to:

- Higher fuel costs. Leigh Creek lignite is of poor quality and located remotely from power stations. Gas for powering South Australian base load power stations is more expensive than fuels used in generation in other states;
- Peakier load. The extreme variation in demand due to temperature in SA means that a large proportion of the available generation is idle for most of the time.

South Australia has a small number of times a year when the demand for energy approaches the capacity of its (generation and distribution) supply system; and

- Poor network load factor. The transmission and distribution networks in SA are very long for the population served, and are also under utilised due to the peakier load effect noted above.

The introduction and operation of the NEM has:

- made the higher costs more obvious because the published pool price can be viewed directly; and
- increased the cost of energy imported through Victoria since the Interconnector Operating Agreement (IOA) and capacity contracts between ETSA and the SECV had to be replaced with commercial, non subsidised arrangements[10].

At the time the market commenced, SA required additional capacity to meet its energy needs. It had been importing a large proportion of its power from Victoria and had routinely reached the limit of the interconnector forcing high priced local plant to be dispatched.

The construction of Pelican Point Power Station and the completion of the Murraylink interconnector have both contributed to resolving capacity concerns for SA for the immediate future. SA is still a net importer of energy, and therefore has wholesale electricity prices above those in the eastern states[11].

Reliance on imported energy to a significant degree has caused SA to suffer more volatile energy prices than NSW or Victoria. This is due to network constraints and outages that can cause prices to rise suddenly in SA.

Further, SA does not have in place risk management arrangements such as, the Electricity Tariff Equalisation Fund (ETEF) in NSW, where generators and retailers are government owned. The retailers in SA thus carry a higher risk.

The ETEF in NSW is a mechanism for managing the price risk of wholesale electricity for NSW retailers through a fund established by the NSW government that covers their load for small customers on regulated rates. Incumbent retailers are given an effective fixed wholesale price for the majority of those customers. This approach is only possible where both the generators and the retailers are government owned since the fund has to be topped up by generators if there is a shortfall.

The supply/demand balance in SA has reached a level where SA no longer has enough supply to maintain the industry-accepted reserve, or safety margin for the coming summer of 2004/05[12]. Whilst the Basslink Interconnector from Tasmania will relieve this somewhat in the following summer, the state will again fall below accepted safety margin by 2006/07. Despite the forecasts showing demand will exceed supply by 2007/08 there are currently no new scheduled power station projects for the future. It is critical that the Commission provides the incentives for long-term investment if its primary legislative objective of ensuring quality and reliability of supply is to be met.

[10] SA was compensated, by around $80 million, for the balance of the benefits of the IOA.
[11] An importing region's price is normally always above the exporting regions price due to losses on the interconnectors
[12] South Australian Annual Planning Report, the Electricity Supply Industry Planning Council, June 2004

The uncertainty with respect to the long-term response to greenhouse and other environmental objectives has an impact on the type and timing of new investment resulting on further pressures on the wholesale supply market.

Despite these pressures, interstate benchmarking by the Commission[13] shows that the non-distribution component of the South Australian electricity prices is broadly consistent with those in Victoria. This assessment is against a background where South Australian energy prices would generally be expected to be higher than in Victoria, given the higher reliance on the more expensive gas and coal fuel sources.

In summary, SA has a more volatile wholesale electricity price than other regions which is due to its peakier and more volatile load, industry cost characteristics, and reliance on imports. In addition the anticipated shortfall in supply capacity and uncertainty with environmental response that impacts on investment means that there will be considerable pressures on the costs of wholesale electricity in the near future – in terms of future contract and pool prices. These need to be factored in the assessment of wholesale electricity costs for the price path to:

- provide the incentives for new investment in generation/transmission; and
- ensure retail businesses remain viable in the short to medium term.

- The California Electricity Crisis and Learnings for South Australia

The ERAA does not believe that SA is on the verge of an electricity crisis. However, if the issue of the shortfall of supply is not addressed as a matter of priority there is a risk the retail businesses will struggle to be viable in SA due to the increasing wholesale electricity prices (contract and pool) as supply shortfall emerges and the regulated prices restrict their ability to pass through costs. These were the two key factors that contributed to the California electricity crisis.

The Institute of Management, Innovation, and Organisation (IMIO - an ad hoc group of concerned professors, former public officials and consultants) at the University of California[14] have been blunt in their assessment of the California crisis:

In summary the IMIO states that:

"California has a crisis which has been deepened by inaction, and by political trade-offs trumping good public policy analysis. Time is running out. Electricity should not be a political commodity. The laws of supply and demand cannot be ignored except at a great peril."

The IMIO assessment states that "the initial causes of the high wholesale electricity prices reflect a complex mixture of a faulty restructuring plan, faulty regulation, environmental regulations, and unanticipated reductions in supply and increases in the demand for electricity… Two of many shortcomings stand out at the present time. First, utilities were encouraged to divest a substantial portion of their generation, while being blocked by CPUC regulations from entering into stable long-term contracts. Put differently the utilities were forced to procure their unmet needs on the

---

[13] 4th Annual Performance Report, Performance of Regulated Electricity Businesses in South Australia 2002 – 2003, Essential Services Commission of South Australia (ESCOSA), November 2003 (p.36).

[14] Manifesto on the California Electricity Crisis, Institute of Management, Innovation and Organisation, University of California, Berkeley, January 2001

spot market where price volatility has been realised, especially in the past year. Second, California froze the retail rates at low levels and banked on low wholesale prices to support a profit margin high enough to pay off historical uneconomic investments. “

The subsequent increases in demand, increasing generation costs and lower interstate imports pushed up wholesale market prices threatening the viability of retail businesses. The inability of retailers to pass through wholesale electricity costs brought retailers to the brink of bankruptcy with the perceived risk of non-payment making generators reluctant suppliers even at the dramatically elevated prices leading to rolling blackouts.

- **Learnings for South Australia**

Whilst the conditions in SA are not identical to California there are some important lessons from the California experience.

Whilst retailers in the National Electricity Market (NEM) are not prohibited from taking out stable long-term contracts, they remain exposed to high wholesale electricity costs in the event of supply constraints.

As noted earlier, demand in SA will outstrip supply from 2007/08. Hence forward hedge contracts entered into for wholesale supply leading up to and beyond 2007/08 is expected to include a wholesale price premium.

If retailers are subject to retail price caps that do not reflect the true cost of wholesale electricity, then they will not have the confidence to enter into long-term contractual arrangements with generators. The impact of this lack of contract cover will mean that more energy will be traded on the spot market, and due to impending supply shortages increase the price volatility and risk in the wholesale market driving the prices up further. The risk is a Californian style cost/price squeeze could emerge, impacting on the viability of retail businesses.

In addition, the reluctance of retailers to enter into back-to-back long-term supply contracts with generators will act as a disincentive for generators to invest in new peaking and intermediate plant compounding the problem of the supply shortfall.

The challenge for the Commission in setting the price path is, in addition to accommodating the unique characteristics of electricity demand in SA, to ensure that the wholesale electricity costs of:

- Prudently hedged declared retailers is fully recoverable ; and
- The level at which the wholesale electricity prices are set encourage new investment.

Actual historical costs can only be used as a guide to future wholesale electricity costs.

Fail safe or normal prices – allowance for headroom?

The ERAA is firmly of the view that standing contract prices should be viewed as the “fail-safe” supply arrangement, and indeed that this view is broadly consistent with the approaches adopted in both Victoria and previously by the Commission in South Australia. The evidence to date supports the view that these are the states with the highest inter-retailer churn rate and most active participation of non-incumbent retailers in the market with a broader range of competitive product offerings. In parallel, customers in these regimes have been encouraged to seek out market contracts.

Given the benefits of the “fail-safe” interpretation of standard contracts in terms of the vigorous development of the competitive market place, we are particularly concerned that the proposed implementation of a price path regime with no pre-specified expiry date, together with the requirement for no specific allowance for headroom (in the Terms of Reference), may be seen as an indication that the resulting standing contract prices will be the standard form of electricity supply to small customers in the long-term.

Indeed, it is the ERAA’s view that the recent agreement between incumbent retailers and the Victorian Government on the 4-year Victorian retail electricity price path was consistent with the “fail-safe” interpretation as the overarching philosophy. For instance, the Victorian Government’s fact sheet states that, “The changes apply to the 2004 standard prices of electricity and gas retailers for consumers who decide not to take advantage of market offers made by electricity and gas retailers under full retail competition.” [15] The clear implication from this is that the Victorian Government anticipates that consumers in general will have access to market offers that are superior to standing contract prices.

Against this background, the ERAA is firmly of the view that standing contract prices should continue to be viewed as the “fail-safe” supply arrangement rather than “standard” supply arrangement. We would argue that the “fail-safe” approach is the approach that is consistent with meeting the objectives of encouraging the competitive market and appropriate protection of consumers. In general, the evidence to date is that the “fail-safe” approach better supports the development and consumer acceptance of a variety of market offers and of a vigorous market place.

We note that headroom is not defined in the terms of reference. However, given that this issue has been raised by the Independent Pricing and Regulatory Tribunal based on criticisms by consumer groups in NSW, we interpret the context of headroom to relate to “inflating prices” to allow competition to occur.

The ERAA believes that the concept of headroom when referred to in this context is inaccurate and misunderstood.

The UK regulator, Ofgem made reference to headroom in its review of gas and electricity competition and supply price regulation[16]. Ofgem compared the differential between the regulated prices and market offers at the time it deregulated domestic gas and electricity retail prices in the UK. It assessed this differential to be on average 8% for electricity.

[15] Victorian Government Fact Sheet – Key elements of the 2004 energy pricing decision, www.doi.vic.gov.au
[16] Review of domestic gas and electricity competition and supply price regulation, Conclusions and final proposals, February 2002.

The ERAA believes (supported by a KPMG discussion paper prepared for the ERAA[17]) that the Ofgem assessment indicates that the standing offer price on average is valued 8% more than market offers in the UK.

This difference in the valuation of standing offer and market offer prices reflects the difference between the services provided under the two options. Some of the differences may include a fixed term, restricted payment option such as direct debit and shorter collection period as a result, low risk of default, reduced need to issue reminder notices, and termination fees under market contracts. Standing offer contracts on the other hand do not provide for these options.

Another example of the different valuation of the different pricing options is in the telecommunications industry. Telstra for example offers a range of home telephone services including the Homeline Plus, Homeline Complete and the Homeline Budget that comprise different pricing plans and levels of service.

In the retail energy industry the minimum service standards and prices are set at a level that impedes product differentiation, due in our view, to lack of the proper valuation of the default option.

The Commission needs to ensure that the standing offer prices reflect an appropriate valuation to differentiate it from the potential market offer prices in order to encourage innovation in products in the electricity market. Based on the UK evidence this difference would be of the order of 8% on average.

[17] The Effectiveness of Competition and Retail Energy Price Regulation, A Discussion Paper prepared by KPMG for Energy Retailers Association of Australia, December 2003.