



Energy Retailers Association  
of Australia Incorporated

---

15 October 2004

Inquiry into Electricity Price Path: Discussion Paper  
Essential Services Commission of South Australia  
GPO Box 2605  
Adelaide  
South Australia

[escosa@escosa.sa.gov.au](mailto:escosa@escosa.sa.gov.au)

### **Inquiry into Retail Electricity Price Path Discussion Paper**

Energy Retailers Association of Australia (ERAA) welcomes the opportunity to comment on the Essential Services Commission of South Australia (the Commission's) Discussion 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 refers the Commission to our submission to the Issues Paper on this inquiry and reaffirms the views expressed in that submission.

We believe that the Commission, in order to deliver on its primary objective 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.

The ERAA is pleased with the balanced analysis of issues and options in the Commission's Discussion Paper. However, we are concerned that the emphasis of the analysis is entirely from the perspective of the Commission attempting to establish an efficient retail price (market-based price), without sufficient recognition that the electricity market is open to competition or evidence of a market failure. We believe that competition for small electricity customers in SA is now established and conducive to a market-based discipline to retail price setting without the need for regulatory intervention.

We note that the Commission has been directed by the Minister to establish default prices for the medium term. We urge the Commission to take the matters outlined below into account when setting the retail price path.

- The Commission's analysis in the Discussion Paper shows that current electricity prices are not extracting monopoly profits in particular relative to benchmarks used in other jurisdictions (Victoria);
- The level of competition and customer awareness amongst the SA electricity customers is high and increasing. This level of competition allows the Commission to adopt a light-handed approach to price regulation. The focus should be on identifying and assisting customers with insufficient income as a shared responsibility between the industry, government/relief agencies and customers;
- The approach to retail pricing should be consistent with that adopted in the past and with those in other Australian jurisdictions to ensure that there is regulatory certainty. In this respect the Commission should continue with a "cost plus margin on sales" approach rather than the return on investment option. Further, the Commission must ensure that it does not adopt a "lowest common denominator" approach to setting benchmarks. The benchmarks that the Commission adopts should reflect as near as possible the actual costs in retailing energy. To do otherwise will have a significant adverse impact upon competition in SA.

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.

If you have any queries on the content of this submission, please contact me or Diane Campbell at the ERAA Secretariat on (02) 9369 4296.

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

#### Competition for SA electricity customers allow the Commission to take a light-handed approach to price regulation

Competition for customers and awareness amongst SA electricity customers is high and provides the Commission with the ability to adopt a light-handed approach to retail pricing. A light-handed approach will enable the default prices to settle at levels that would be considered efficient in a competitive market whilst preventing unacceptable price increases to customers. Further, such an approach will ensure that development of competition is not impeded through regulatory intervention.

A September report<sup>1</sup> on competition in SA shows that competition is robust and increasing for electricity customers. The following table summarises the key features in relation to small (domestic) electricity customers.

Feature	Performance
Number of retailers	5
Customers accepting market offers	Customer survey shows 28% of customers have accepted market offers. More low-income customers (37%) and pensioner concession customers (44%) have accepted market contracts. ESCOSA's data shows 18% accepted market offers with 3% in progress - a total of 21%.
Offers	44% of survey respondents received market offers. 50% of low-income customers and 55% of pensioner concession customers received offers.
Customer awareness	79% of customers said that they were aware that they can choose a retailer.
Transfer process	85% of those taking a market contract said the transfer process was easy or very easy.
Customer Information	76% of those who sought information said information was easy to obtain.
Misleading conduct	Overwhelming majority, 87% indicated that they had not experienced misleading behaviour, including pressure selling.
Innovation	High level of agreement that there was greater variety of offers.

The above summary shows that customer awareness is high, customers are receiving market offers, can easily change retailers and there is no discrimination between customer classes when market offers are made.

<sup>1</sup> Monitoring the development of energy retail competition in South Australia, The Essential Service Commission of South Australia, September 2004.

Under these circumstances, a light-handed approach is more suitable as it would encourage competition whilst providing a safety net for customers.

To address the concerns raised by the Conservation Council of Australia (CCSA) with respect to the protection of customers in financial hardship we recommend that consideration be given to targeted and transparent customer protection programs for these customers, as opposed to market wide solutions.

The current Energy Code provisions require retailers to assist customers by:

- ensuring they receive adequate notifications with respect to intention to disconnect (bill, reminder notice, disconnection notice, and disconnection warning over a minimum period of some six weeks after a bill becomes due);
- offers of assistance to customers through payment plans, taking into account customers' capacity to pay;
- referrals to financial counsellors and relief agencies; and
- energy efficiency advice.

In addition retailers offer voluntary hardship programs on a case-by-case basis to assist customers out of debt.

We also note that the SA Government has increased the annual electricity pensioner energy concession from \$50 to \$120 in November 2003. In addition, the Federal Government recently announced a Utility allowance for self funded retirees to help them pay their telephone, power and water bills:

- Supplement to older Australians of Age Pension age receiving income support - \$100 pa for singles and \$50 for each member of a couple, paid twice a year commencing March 2005; and
- Payment of \$200 per year to self-funded retirees, paid twice a year commencing December 2004.

The ERAA supports the initiatives by the SA and Commonwealth governments.

The ERAA believes that targeted programs based on a shared responsibility between the industry (energy accessibility), government and relief agencies (affordability) and customers (seek out and participate in industry schemes) will be more efficient in protecting customers in hardship compared to broadly based price caps that have the potential to adversely impact on a competitive market.

### **Form of regulation in a competitive electricity market**

The ERAA believes 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.

The sections below provide comments on specific issues raised by the Commission.

- **Instrument of control**

The ERAA believes that the retail price path should operate at a high level, such as an average price per MWh, consistent with the approaches in the past and those adopted in other jurisdictions.

Maintaining cross subsidies in a competitive market is not sustainable. To ensure individual tariffs transition to cost reflective levels, the Commission should consider an approach consistent with the approaches adopted in other jurisdictions.

The ERAA does not support limits on the variation to supply charges or energy charges. In a competitive market, tariffs need to be cost reflective. Arbitrary constraints that determine the tariff structure will inhibit the achievement of cost reflective tariffs.

Should the Commission or the government see a need to subsidise a certain class of customers then this should be through transparent arrangements that do not distort the operation of a competitive market.

- **The conditions for reopening**

In order to achieve price certainty over the regulatory period, the ERAA believes that the price path should only be reopened under special circumstances. Such circumstances may include but not be limited to events such as a generator failure/breakdown that materially impacts on wholesale energy costs.

The price path should include a risk premium to allow for minor deviations in the costs of supply as a trade-off to achieve price certainty. It is not reasonable that the retailers carry the risk of significant and unanticipated increases in costs.

Special circumstances provision should only be used in the event of significant and exceptional events, at the request of the retailer and be subject to review by the Commission at the time of the event. The ERAA believes that such a review should be limited to examining the direct consequences of the reopening event on the cost of supply. It should not be a full review of matters unrelated to that event given the significant time and costs involved in a full review.

- **Pass through items**

The ERAA believes that costs that are currently not quantifiable but are possible in future should be treated as pass through items. These costs may include:

- Network charges (including transmission charges),
- Changes in taxes, industry levies, participant fees, and market related charges, or
- Any new charges to the industry that are currently not applicable.

Pass through items should be fully accommodated at the time of annual price variations. It is not reasonable for retailers to bear risks for any costs that are beyond their control.

- **Flexibility for rebalancing**

Refer to the section on “instrument for control” on our view on this matter.

The ERAA supports that objective of the Conservation Council of South Australia to address energy affordability and accessibility issues. As indicated above, we believe that this issue is more appropriately addressed through targeted customer assistance programs (offered by retailers), government/relief agency support in terms of social welfare payments, and customers' willingness to seek out and participate in such programs.

- **Wholesale electricity costs**

We not able to comment on the specific issues raised by the Commission. However, we refer the Commission to our submission on the Issues Paper with respect to the matters that should be considered.

We note that despite the peakier load profile of the SA small customers, the current retail component which is largely made up of the wholesale electricity costs, is in line with that allowed in Victoria.

- **Retail operating costs**

The ERAA believes that standalone retailers will incur higher operating costs than retailers that share the fixed costs with their stapled distribution businesses. The method used for the allocation of costs between the retail and distribution businesses where they are stapled will also impact on the retail operating costs.

We believe that operating cost benchmarks should take into account the actual costs of the regulated retailer and be tested against benchmarks used in other jurisdictions. The Victorian operating cost benchmarks given the lower level of stapled arrangements and similar ownership structure will provide a better guide to retail operating costs.

Adjustments to future operating costs should take into account the drivers to increases in operating costs and the scope for efficiency improvements.

- **Retail margins**

The ERAA strongly believes that the Commission should adopt a retail margin benchmark as a percentage of sales revenue because:

- This is consistent with the Commission's approach in the past and the approaches in other jurisdictions and ensures regulatory consistency and certainty for retail businesses; and
- It is a better reflection of retailer risk, given that majority of the revenue is related to the recovery of costs external to retail businesses.

As indicated in our submission to the Issues Paper we believe that a regulated safety net price that is available to all customers without the need to enter into a contract should reflect this value. Evidence from the United Kingdom (UK) at the time that the retail price control was removed for electricity customers indicates that the differential between the regulated price and market offers was on average 8%. Assuming that the Commission's costs benchmarks are efficient, margins would need to be in excess of 8% to support competition.

The Commission notes that a report by Charles River Associates identified margins of 7% to 9% implicit in the retail prices agreed for 2004 for small customers in Victoria. This allowance is consistent with the evidence from the UK.

The ERAA notes the Commission's analysis of margins based on return on investment. The analysis clearly demonstrates serious weaknesses and risks from adopting such an approach.

The Commission's analysis raises a number of questions in applying a return on investment approach. For example:

- What is an objective basis for the valuation of a retail business - should it be based on the price paid by AGLSA, a current market valuation of the business (today's sale value), or an industry maximum or average? The figures quoted by the Commission on prices paid for retail businesses in recent times range widely between \$200 per customer to over \$600 per customer.
- There is a risk of establishing precedent based on the purchase price – how should the Commission deal with return expectations on a purchase price which is at a higher end of the range?
- The current valuation of a business based on future cashflow is an option, however this requires an assessment of the appropriate rate of return and a timeframe for the calculation of the net present value. This assessment is problematic in the current circumstances and can become circular;
- This approach requires an assessment of the rate of return to be applied, and the allowances for expectations on the risk free rate (and matching risk free rate to the timeframe of asset), market return, business risk (and technicalities of measuring risk eg. beta levering and de-levering), gearing, treatment of tax etc. – Can the risk to a business that achieves low margins and is subject to increasing competition and customer churn be sufficiently accommodated over the medium term?
- There can be significant financial risk to a retail business from a fundamental change to the regulatory arrangements.

The ERAA believes that the return on investment approach to setting retail prices is untested in the Australian context and urges the Commission to continue with its margin on sales revenue approach as the basis for setting retail margins.

Retail margins based on fixed \$ amounts per customer or \$/MWh have also not been a practice in the Australian context. A \$/customer approach will result in a higher margin contribution on revenue from small users. Further, this approach also does not recognise that business risk is related to supply costs that vary with consumption. A \$/MWh margin does not provide for an adequate return from customers who are very low users such as holiday homes, and places an increased burden on other customers.

Finally, bad debts have always been treated as an operating cost in the context of the energy market in Australia. Where allowances for bad debts are made in the margins, these would be to reflect the potential for increases in bad debts in future. In practice, allowances for increases to bad debts have generally been included in the operating costs.