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28 March 2014

Mr Malcolm Gray
Senior Commissioner
Independent Competition and Regulatory Commission
PO Box 161
Civic Square ACT 2608

Submitted online at icrc@act.gov.au

Dear Mr Gray

Response to Draft Report on standing offer prices for the supply of electricity to small customers: 1 July 2014 to 30 June 2017

EnergyAustralia welcomes the opportunity to comment on the Independent Competition and Regulatory Commission's (the Commission) draft report on standing offer prices for the supply of electricity to small customers for the period 1 July 2014 to 30 June 2017.

EnergyAustralia is one of Australia's largest energy companies, providing gas and electricity to over 2.7 million residential and business customers. EnergyAustralia owns and operates a multi-billion dollar portfolio of energy generation and storage facilities across Australia including coal, gas and wind assets with control of over 5,500 MW of generation in the National Electricity Market.

We have long held the view that retail price regulation in contestable energy markets is a net cost to consumers, government and industry. We therefore support recent moves by South Australia to remove price regulation and the announcement by Queensland to deregulate the south east in 2015. We also support the initial recommendations by the Independent Pricing and Regulatory Tribunal that the conditions exist to move to price monitoring in New South Wales.

However, where retail price regulation remains, EnergyAustralia believes there is benefit for consumers and industry to adopt a consistent framework that encourages competition and promotes the eventual transition to price deregulation. Furthermore, it is vital that prices are set at a level to recover the efficient costs of retail operations within a competitive market; this will encourage new entry and innovation on the part of incumbent market participants. This will generate benefits for ACT customers in terms of improved price outcomes and more innovative services that reflect customer needs and expectations, which are observed in other Australian jurisdictions.

If you would like more information on this submission, please contact me on (03) 8628 0971.

Yours sincerely

Geoff Hargreaves
Regulatory Manager - Retail

EnergyAustralia response to the ICRC Draft Report

Standing offer prices for the supply of electricity to small customers 1 July 2014 to 30 June 2017

March 2014

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1. Introduction

EnergyAustralia is the second largest retailer of electricity and gas in the ACT so we welcome the opportunity to respond to the Independent Competition and Regulatory Commission's (the Commission) Draft Report on standing offer prices for the supply of electricity to small customers for the period 1 July 2014 to 30 June 2017.

Our discussion of specific aspects of the Commission's Draft Report reflects our strong view that ACT customers will benefit from the promotion of competition in retail electricity markets and that the ICRC, as a consequence, should seek to promote competition as far as possible through all aspects of its regulatory determinations.

This discussion draws on EnergyAustralia's previous contributions to the Commission's Issues Paper, retail price determinations in other jurisdictions and the AEMC's review of retail price regulation. We are also mindful of the Australia Energy Market Commission's (AEMC) recommendations with respect to retail price regulation, including its preferred methodology, the importance of promoting competition in retail markets and the importance of consistency in regulatory frameworks and administration across Australian jurisdictions.

2. Retention of retail price regulation

EnergyAustralia views the retention of retail price regulation and level of regulated prices as important determinants of the extent to which current and prospective retailers view the ACT as a viable market in which to operate.

Indeed, the absence of effective competition in the ACT retail electricity market – as previously noted by the Australian Energy Market Commission (AEMC) and however measured or assessed now – is primarily a function of the regulatory framework with respect to retail prices. It is no surprise that observers often do not find evidence of effective competition in markets where retail price regulation exists, there is uncertainty about future price determinations and / or there are no other measures in place to promote competition (such as the inclusion of a competition allowance in regulated prices); the prevailing regulatory framework discourages both new entry and innovation on the part of incumbents. This is particularly relevant to the ACT electricity market, which has traditionally been dominated by ActewAGL and where regulated retail prices have been set with reference to its cost structure.

EnergyAustralia continues to hold the view expressed in our submission to the Commission's Issues Paper that while relatively small, the ACT market is comparable to distribution zones in other jurisdictions in which competition occurs. In light of this comparison, EnergyAustralia absolutely rejects the notion that effective competition cannot exist in the ACT and that diseconomies of scale occur due to the size of the market. EnergyAustralia recognises the scope for retailers to achieve some economies of scale but does not believe that ACT customers are best served by a dominant incumbent retailer.

EnergyAustralia also notes the Commission's comprehensive discussion of some specific aspects of the operation of retail electricity markets that contribute to its scepticism of the extent to which ACT consumers might benefit from greater competition. These issues are considered in more detail in our discussion of the need for a competition allowance in the determination of regulated prices. Ultimately, we are not convinced that they will outweigh the benefits generated by a more competitive retail electricity market.

Therefore, EnergyAustralia reiterates the view expressed in its numerous submissions to regulatory determinations and public reviews that retail price regulation limits the ability of and incentive for, incumbents and new entrants to develop an innovative range of price and quality service offerings for their customers, while also having the potential to limit the expected returns to retail operations. As a consequence, Energy Australia does not expect that the full benefits of competition can be realised in an environment of retail price regulation and recommends its removal as a first best approach for the ACT.

Clearly, the ACT Government's preference to retain price regulation means it is out of step with the majority of Australian jurisdictions.[1] Aside from inhibiting the development of competition in the ACT, this raises an issue of inconsistency in regulatory design and administration across jurisdictions. This is considered further in Section 5.

The views of the Commission and the ACT Government will threaten what little competition is currently available in the ACT electricity market for small customers. It appears that there is no intent to evolve this market to a competitive state or to provide the benefits to customers that competition is delivering (or at least starting to deliver) in other states (e.g. better customer service outcomes, downward price pressure, encouraging variety and flexibility in product and service options for customers).

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[1] EnergyAustralia notes that the NSW Government is yet to respond to the AEMC's assessment of competition in NSW and the Independent Pricing and Regulatory Tribunal's endorsement of the removal of price regulation

3. Estimation of efficient retailer costs

EnergyAustralia notes the ACT Government's preference to retain retail price regulation but views its retention – even with appropriate inclusions – as a second best measure. Regulated prices should reflect reasonable estimates of the efficient costs associated with retail operations as a step towards facilitating greater competition.

The challenges of identifying and quantifying efficient costs are significant, particularly in light of the diverse range of actual market participants and potential entrants to the ACT retail electricity market. Regulation of retail prices is unlikely to encourage significant new entry, particularly where those prices are set with reference to a dominant, government owned market participant that operates across multiple industries and has different systems, operating models and strategies, risk profile, governance structure, financing arrangements and as a consequence, cost structure.

EnergyAustralia also notes the AEMC's discussion in its *Advice on Best Practice Retail Price Methodology* of asymmetric risks in price determination, which lead it to recommend that regulators set regulated prices at 'too high' a level rather than 'too low'. In this context, it implies that the Commission should adopt a conservative approach to the estimation of retailer costs and the evaluation of observed outcomes (in terms of the liquidity of markets for large scale generation or small scale technology certificates, for example) when calculating allowances.

As such, EnergyAustralia continues to recommend the estimation of the costs incurred by a hypothetical efficient new entrant electricity retailer, despite some of the challenges the Commission and AEMC have identified. The objective of economic regulation should be to estimate the efficient cost of retail operations, which are not necessarily those of a dominant incumbent. We recognise the challenges – and costs – that this involves but recommend a combination of bottom up analysis of electricity retailer costs and benchmarking of efficient costs with regulators from other jurisdictions.

The remainder of this section focuses on specific aspects of the Draft Report's discussion of the Commission's retail electricity cost index.

3.1. Energy purchase costs

EnergyAustralia strongly advocates a Long Run Marginal Cost (LRMC) floor approach to the calculation of energy purchase costs on the grounds that it represents the least-cost combination of generation plant required to meet forecast load. Under this approach the energy purchase cost has a minimum value based on LRMC and uses market cost in years when this spikes above LRMC. The benefits of this approach are that LRMC is more stable over time than the market cost, providing more regulatory certainty for industry and a more stable price for customers.

A detailed examination of the relative merits of different approaches is contained in EnergyAustralia's submission to the AEMC's review of best practice retail market regulation.

However, the Draft Report states that the Commission has 'always categorically rejected using long run marginal cost, whatever the circumstances', despite the AEMC's acknowledgement of its validity in the absence of robust market data and use of LRMC by regulators and state governments in other jurisdictions.

3.2. Large-scale Renewable Energy Target

EnergyAustralia recommends that regulators adopt a conservative approach with respect to the determination of regulated prices. This includes conservatism with respect to the liquidity of markets for large scale generation certificates (LGCs) under the LRET.

We note the Commission's draft decision, which incorporates a 10 per cent holding and 5.7 per cent retail margin in order to compensate for the various risks that retailers face. However, retailer's obligations under the scheme are largely met through either building large scale renewable generation (predominantly wind farms) or long term contracting of the output of such generators. As the legislated target increases significantly to achieve the 20 per cent renewable energy goal by 2020, significant new capacity will need to be built and will be the main driver of the cost of compliance.

The Australian Government's recent announcement of a review of the Renewable Energy Target scheme creates uncertainty about its future and has driven recent volatility in the LGC price, further undermining the case for basing the price of LGCs on observed market prices. Using a market cost based on current prices could lead to significant over- or under-estimation of the actual LRET costs faced by retailers.

As such, EnergyAustralia continues to hold the view that the LRMC approach better reflects the costs to retailers than observed market prices based on the limited volumes trading through the market. This would also ensure consistency with IPART's 2013 determination and the AEMC's recommendation to employ a LRMC approach where there are concerns about the liquidity of the LGC market.

3.3. Small Scale Renewable Energy Scheme

Similarly, EnergyAustralia recommends conservatism in the assessment of the liquidity of the market for Small-scale Technology Certificates (STC) and therefore recommends the Commission set the price at $40 as it reflects the opportunity cost to retailers of the scheme.

The Small-scale Renewable Energy Scheme is not designed as a free market. It is purposefully designed so that creators of STCs can obtain $40 for each STC. This is done by setting demand to match supply, and through the use of the clearing house mechanism, which guarantees $40 for the seller. In efficient market conditions where supply equals demand, the cost to retailers for STCs will be $40 per certificate.

Historically in the STC market, demand has not matched supply and the market has traded below $40 in response. This has been due to the inability of the Clean Energy Regulator to forecast the effect of market factors such as the Solar Credits Multiplier and various state based feed-in-tariffs when setting the target Small-scale Technology Percentage (STP). These factors have largely been removed from the start of 2013, which will reduce greatly the creation of STCs, and will enable the CER to set a target more accurately in line with supply. The removal of these incentive mechanisms also decreases the overall size of the STC market, which enables demand to be more accurately set in line with supply. With demand equal to supply, sellers will obtain the guaranteed $40 offered by the clearing house.

3.4. ACT Energy Efficiency Improvement Scheme (ACT EEIS)

Consistent with our broad recommendation for the Commission to attempt to estimate the efficient cost of retail operations, EnergyAustralia continues to recommend that the Commission consider the efficient costs of both tier 1 and 2 retailers. As the scheme outlines different obligations for tier 1 and 2 retailers, the allowance should be set at the level of the tier 1 retailer (ActewAGL), except when the price paid by tier 2 retailers is higher, in which case the tier 2 cost should be used instead. It would be detrimental to competition if the scheme design and the price regulation approach were to prevent tier 2 retailers from recovering their full (efficient) costs under this scheme.

4. Inclusion of competition allowance

EnergyAustralia holds the view that regulated prices should include some competition allowance or headroom in order to encourage new entry and innovation on the part of incumbents. As such, we are very disappointed in the ACT Government's opposition to its inclusion and the Commission's decision to exclude the allowance from its draft decision for the period from 1 July 2014. This appears to reflect scepticism about the extent to which competition will ultimately generate benefits for electricity customers in the ACT, a view that EnergyAustralia does not share for the reasons previously identified.

EnergyAustralia notes that COAG through SCER tasked AEMC to develop a consistent methodology for determination of regulated retail prices. AEMC has recommend inclusion of a separate and transparent competition allowance – or customer acquisition and retention costs (CARC) – on top of estimated efficient costs. Furthermore, both IPART and the Queensland Competition Authority have maintained a competition allowance in their most recent determinations, even though they have also concluded that effective competition has emerged in NSW and Queensland and have advocated for the removal of retail price regulation.

EnergyAustralia notes that IPART found evidence of a clear link between the amount of headroom and the level of competition seen in the NSW electricity market (which has been at high levels in recent years).[2] IPART found that it was:

> "reasonable to conclude that the incentives included in regulated prices will significantly influence the level of competitive activity. The evidence suggests that as the incentives in regulated retail prices increase, so does the level of competitive behaviour by retailers and market participation by customers."

Therefore, the question of whether an allowance is necessary will depend on views as to whether effective competition is feasible at some future point. As the Commission notes, inclusion of a competition allowance necessarily increases the cap above what it would be in its absence. This apparent tradeoff appears to be a significant concern for the Commission and ACT Government, based on their scepticism about the extent to which measures to promote competition in the ACT market will actually generate benefits for ACT consumers and the relative magnitude of the incremental costs for retailers.

The incremental costs of participating in competitive markets were well articulated in the Draft Report, with the Commission identifying the following:

- costs of achieving or maintaining a share of the market that increase with the extent of that activity undertaken by competitor firms;
- costs of entry to the market;
- costs increasing with the intensity of competition for market share; and
- failure or slowness of consumers to respond to superior market offers.

As argued in our submission to the Commission's Issues Paper, EnergyAustralia feels strongly that in order to secure optimal outcomes for consumers in the medium to long-term it is necessary to account for these costs in regulated prices. In a competitive market, standard retailers incur higher costs to maintain systems, staff and functions than in a non-contestable market. These costs are ongoing but are a means to drive investment and as a consequence, drive prices to an efficient level that would not otherwise be achieved.

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[2] Independent Pricing and Regulatory Tribunal, *Review of regulated retail prices and charges for electricity 2013 to 2016 – Electricity: Final Report*, June 2013, pages 112-115

EnergyAustralia acknowledges that these costs exist and are material – hence the need for a competition allowance – but queries their persistence and that in themselves, mean that electricity consumers cannot ultimately benefit from greater competition. Participants in all industries incur costs in promoting their service offering to attract and retain customers. Similarly, they must deal with issues of variability in the price, quality and reliability of inputs to their production processes or uncertainties in their supply chains. These factors do not disqualify competition as the most effective mechanism for generating efficient outcomes in majority of goods and services markets.

These costs will differ between different electricity retailers and those businesses best able to minimise them will prosper in a competitive environment, with their customers benefitting as a result. This does not necessarily include the dominant incumbent, whose operations have and continue to be the basis for the Commission's estimation of efficient costs.

A price cap that includes a competition allowance must be viewed as an upper limit and that benefits are likely to include improved offerings on the part of incumbents, new entry and most significantly, market prices that are lower than regulated prices for the majority of customers. Greater competition also encourages innovation with respect to the broader service offering as it encourages retailers to develop products that are suited to their customers' preferences and circumstances. Examples include:

- Improved communication between retailers and their customers so the latter can better understand the profile of their energy use and make efficient choices with respect to electricity consumption.
- Access to a range of tariff structures that enable customers to select a service offering that is best suited to their usage profile and individual preferences. For example, some customers may prefer an initial lower price with an allowance for that price to vary upwards or downwards in line with movements in wholesale energy costs, while others may prefer certainty of a fixed price over the life of a contract.

Greater choice and more innovative service offerings are common features of competitive retail electricity markets, including other Australian jurisdictions where governments and regulators have sought to promote competition through the removal of price regulation and / or other pro-competitive initiatives.

Competition also has dynamic impacts such as the strong incentive for all market participants to further reduce costs – and therefore, retail prices – over the longer term through technological change and other productivity enhancing initiatives; such incentives are diminished under more restrictive regulatory frameworks.

Some consumers may initially take some time to adapt to a more competitive market but will become more sophisticated in their ability to assess competing service offerings over time; government initiatives to promote awareness or other pro competitive measures may assist this process. In general, the nature and extent of these perceived obstacles to competition within electricity markets need to be well understood so governments can respond to them in the most efficient and effective manner rather than inhibiting competition and suppressing prices through regulation.

Therefore, EnergyAustralia views rejection of a competition allowance as short-sighted as it is necessary to encourage competition within the market to improve price and service quality outcomes for ACT electricity consumers.

EnergyAustralia does not understand how the ACT Government and the Commission have come to the view that it is either impossible to achieve a competitive market in the ACT or that competition will not deliver benefits to customers as it in other areas of Australia. In addition, it is hard to understand why the ACT Government is going against the commitment made by all states at COAG/SCER around moving towards price deregulation in retail energy markets.

4.1. Timing of benefits

EnergyAustralia notes the Commission's discussion in Chapter 4 of the Draft Report of the uncertain timeframe over which the benefits of more competitive markets might occur. The precise net impact cannot be quantified with certainty but involves consideration of factors such as the emergence and extent of any discounting below the regulated standing offer, any improvements in service quality and the magnitude and duration of the additional costs outlined by the Commission.

EnergyAustralia again notes that most Australian state governments are sufficiently convinced that their constituents will benefit over the longer term through greater competition that they have removed or announced an intention to remove retail price caps in line with COAG agreements. Furthermore, EnergyAustralia would argue that the longer competition is delayed, whatever the cause, the lower the benefits in present value terms.

As such, EnergyAustralia views the competition allowance as an important element of the COAG Implementation Plan and consistent with the recommendation that jurisdictions should work towards promoting effective competition where it does not exist. Otherwise, EnergyAustralia expects that the ACT retail electricity market will continue to be dominated by a large provider, ActewAGL, who has little incentive to pursue significant improvements in its price and service offering or to minimise costs.

5. Consistency of regulatory administration across jurisdictions

EnergyAustralia's other issue with the Draft Report is its inconsistency in key areas with other regulatory frameworks across Australian jurisdictions. The Commission's decision to exclude a competition allowance and its rejection of a LRMC floor approach for the calculation of energy purchase costs are two examples, although this also extends more generally to retail pricing and the extent to which the ACT Government is implementing measures to promote greater competition in retail electricity markets.

The importance of consistency in regulatory frameworks was recognised by AEMC and by COAG through SCER, which as noted, tasked AEMC to develop a consistent methodology for determination of regulated retail prices.[3] As the AEMC notes:

> "An efficient, nationally consistent and stable method for setting regulated retail prices provides potential new entrant retailers with more confidence when deciding whether to enter a market. This increases the likelihood of entry, resulting in increased competition, and more innovative products for customers while competition develops.
>
> Most retailers in the NEM operate portfolios of retail contracts across multiple regions. Consistency and predictability in the methods for setting regulated retail prices between regions helps retailers to manage portfolio risk. It also reduces administrative costs for these parties, which should result in lower retail prices for customers over the longer term."

EnergyAustralia, as an energy retailer that operates across multiple jurisdictions, agrees that the exclusion of reasonable costs, differences in valuation methodologies and the retention of price regulation in some, but not all, jurisdictions impose additional administrative costs or uncertainty regarding regulatory parameters. EnergyAustralia agrees that this discourages new entry and / or leads to exit over the longer term, the impact of which is to deny ACT customers the benefits of a competitive retail electricity market.

[3] Australian Energy Market Commission, *Final Report: Advice on best practice retail price methodology, September 2013*, page 2