



27 May 2011

Independent Pricing and Regulatory Tribunal
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Via email: ipart@ipart.nsw.gov.au

Regulated retail prices for electricity 2011

The Energy Supply Association of Australia (esaa) welcomes the opportunity to comment on the Independent Pricing and Regulatory Tribunal's (IPART) Draft Report on Changes in Regulated Electricity Prices from 1 July 2011.

esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of over 40 electricity and downstream natural gas businesses. These businesses own and operate more than \$120 billion in assets, employ 52,000 people and contribute \$16 billion directly to the nation's Gross Domestic Product.

In reviewing the March 2010 price determination, the Draft Report indicated that regulated electricity prices were to increase from 1 July 2011 relative to initial estimates, largely as a result of increased network costs and changes to the Government's Renewable Energy Target (RET) scheme. Coupled with increases in 2010 of 7 to 13 per cent, this seems to have raised a number of concerns for IPART in relation to energy affordability in the future, with the Draft Report noting that the policy settings behind these cost drivers should be reviewed. Accordingly, the Draft Report makes a number of recommendations with respect to alleviating consumer cost pressures.

esaa acknowledges the importance of ensuring appropriate policy settings to facilitate a genuinely competitive electricity market that is capable of servicing customers at least cost. Furthermore, the Association considers that the implementation of any policy recommendations that may potentially limit cost pass through will ultimately constrain the level of competition within the electricity retail sector, and thus compromise efficient electricity prices in the long term. In this light, and in the interest of ensuring economically efficient outcomes, the Association has provided comment on three of the recommendations outlined within the Draft Report, namely: the review of network regulatory frameworks; the Solar Bonus Scheme (SBS); and flexible price setting beyond 2013.

Review of network regulatory frameworks

It is well understood that network charges, particularly in some states, have had to rise (and will continue to rise) at a significant rate in order to undertake necessary expenditure on replacement, upgrade and augmentation of both the transmission and distribution networks. Notably, as outlined within the Draft Report, the extent to which these increasing network charges are contributing to overall retail price rises has raised some concern, principally in relation to energy affordability and the efficiency of network regulation. As a result, it was recommended within the Draft Report that the Australian Energy Market Commission (AEMC) initiate a review of the National Electricity Rules to address concerns that these rules may bias the Australian Energy Regulator's (AER) decisions in favour of higher network prices and inefficient outcomes.

The Association considers that there may be merit in periodically reviewing the efficacy of the regulatory framework to ensure a continued movement toward a light-handed least cost approach to regulation.. However, significant changes to the regulatory framework for setting network revenues - or even the threat of them, have a cost. By increasing the uncertainty associated with the networks sector, they run the risk of increasing the returns required by investors in the sector, which will ultimately be funded by consumers.

It is worth reiterating that the National Electricity Rules – under which the NSW and most other Australian network service providers (NSP) operate – are broadly similar to those used in many other countries to cap the revenue of natural monopoly utilities such as electricity networks. These rules and their application are designed to facilitate stable and predictable returns and are recognised to be:

- **Transparent:** The rules are published, along with the AER's consultations and decisions, as well as stakeholders' submissions to the process (except in a few cases where they contain commercially confidential information).
- **Objective and evidence-based:** Significant resources are committed by both the regulator and the NSPs to determining reasonable estimates of costs for each five year review period. In addition, opportunities exist for different stakeholders (not just the NSPs themselves) to appeal decisions with which they do not agree.
- **Incentive-based:** NSPs are incentivised to meet their obligations to customers efficiently, which in turn provides the regulator with the opportunity to set future allowances at a level that sees customers get a share of those efficiency gains.

Accordingly, esaa considers that any claim that electricity customers are paying more than necessary for their network services should be backed by robust evidence to be credible and avoid unnecessary destabilisation. Furthermore, while it is convenient to immediately consider the adequacy of the current network regulatory framework in light of rising costs, it would seem prudent to investigate the actual drivers of capital expenditure in the first instance. For example, given that a significant proportion of the observed network price increases is attributable to the costs associated with servicing peak demand while also meeting more stringent

reliability standards, improving capital utilisation could be a priority more worthy of investigation.

Finally, it should be noted that the AER has recently signalled that it is conducting its own internal review of network regulation. The internal review intends to focus on whether the National Electricity Rules strike the right balance between the interests of consumers and the needs of network businesses. While the Association reiterates its earlier observation in relation to the merits of such a review, this should be sufficient to address IPART's concerns.

Solar Bonus Scheme costs

As previously outlined, the costs of complying with various mandated government green schemes has emerged as a new driver of retail price increases, with the RET scheme adding 6 percentage points to regulated electricity prices in 2011-12. While this increase is indicative of the pitfalls associated with pursuing cost-inefficient Federal and State Government schemes, the Association considers that it also highlights the importance of ensuring adequate cost pass through mechanisms where regulated retail pricing is maintained. Exposure of participating retail businesses to scheme compliance costs adversely impacts the financial viability of all businesses and by extension, the overall level of competition within the sector. As such, the Association is not supportive of any recommendation which may potentially inhibit cost pass through and thus financially burden retail businesses.

esaa is not supportive of premium feed in tariffs (FITs) as they do not, as designed, deliver cost effective abatement and generally result in inequitable cross subsidisation among energy consumers. As a result, the Association agrees with the recommendation to close the NSW Solar Bonus Scheme (SBS) to new participants. However, the subsequent recommendation that electricity retailers should be required to contribute to the costs of the SBS for existing participants is unnecessary.

It is suggested within the Draft Report that retail businesses may be benefiting financially from the SBS. This potential benefit arises as a direct result of the structure of the scheme, which requires retail businesses to pay the Australian Energy Market Operator (AEMO) on a net consumption basis – that is after netting off energy supplied by the solar panels – despite earning revenue from customers for gross consumption. While the materiality of these gains was not outlined within the Draft Report, it should be recognised that retailers typically offer scheme participants 6 to 8 cents/kWh for the value of their energy in addition to the scheme payments. Such payments negate any potential financial benefit to the retailer.

As a result, esaa considers that inefficiencies in the structure of the State Government mandated SBS should not be used as justification for burdening participating electricity retail businesses with the cost of the scheme. In the event that IPART considers these gains to be material, this issue should be treated separately.

Flexible price setting beyond 2013

esaa acknowledges the difficulties associated with trying to determine the most appropriate energy cost estimates. However, the Association considers the Draft

Report recommendation to provide IPART with more flexibility to determine retailers' efficient costs from 2013 onwards to be both premature and unwarranted.

The Association supports the development of open competitive energy markets free from distortions such as retail price regulation. Competition in retail electricity markets, as in other sectors of the Australian economy, provides incentives for businesses to improve service, develop products that meet consumer demands and find ways to lower their costs and to pass those costs on to consumers. As a result, markets naturally encourage prices to be efficient; that is, as low as is sustainably possible while businesses can still make an appropriate return.

Retail price regulation is an inherently fallible and risk-laden exercise that can be self-fulfilling. Regulating prices in potentially competitive markets whereby regulated tariffs may be set below the cost of supply impedes the efficient operation of the market. It creates financial pressure for industry participants forced to absorb costs that cannot be passed on and removes incentives for energy companies to enter the market and compete for small-use customers. Conversely, in the event that prices are set above the cost of supply, (including an appropriate retail margin), competition will erode margins back to efficient levels. The risks are thus asymmetric, with greater adverse consequences arising from setting the regulated price too low.

This asymmetry is appropriately reflected in the current methodology for determining the wholesale cost allowance whereby IPART is obliged to take the greater of two different estimates, namely: the long-run marginal cost (LRMC) of building a Greenfield system to meet the aggregated household load curve; and a market-based cost of contracts to match the aggregated load curve. As such, the Association considers it an appropriate methodology. However, the government can avoid the risks of setting a price either too high or too low by removing electricity retail price regulation and allowing the competitive market to find the efficient price.

If you require any further information in regard to this submission please contact Kieran Donoghue, kieran.donoghue@esaa.com.au or 03 9670 0188.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Brad Page', with a stylized flourish at the end.

Brad Page
Chief Executive Officer