



Submission to ENERGY COMPETITION COMMITTEE

**Electricity Full Retail Competition:
Methodology of Annual Indexation of Notified Prices**

Centre for Credit and Consumer Law, Griffith University with funding from the National
Consumers Electricity Advocacy Panel

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About the Centre for Credit and Consumer Law

The Centre for Credit and Consumer Law is an academic centre, hosted by Griffith University Law School. The Centre for Credit and Consumer Law was established in March 2004 to be a source of expertise, and a centre of excellence, on credit and consumer law issues, and it has the overall objective of promoting the attainment of a fairer, safer, and more efficient marketplace, particularly for low income and vulnerable small end-users.

The Centre for Credit and Consumer Law is funded by the Queensland Government's Consumer Credit Fund (administered by the Office of Fair Trading) and Griffith University. However, this submission is possible because of funding received by the Centre for Credit and Consumer Law from the National Consumers Electricity Advocacy Panel. Without this funding and without the availability of an expert consultant the Centre would not have had the capacity to respond substantively to these proposals.

General Comments

We regret that the Government failed to consult with consumers and other stakeholders before announcing its intention to change the annual adjustments to the uniform tariffs from the CPI to an actual cost estimate.

However, we welcome the retention of the Uniform Tariffs (UT) and the current consultations on the development of a sound methodology for the proposed annual indexation based on actual costs. We wish to make some preliminary comments in the context of the broader policy framework before commenting on the specific methodology.

The Queensland government has made a policy decision to introduce Full Retail Contestability (FRC) to the "small end" of the market. This will include those customers that are disadvantaged relative to the broader community.

The CCCL is concerned that, while FRC appears to have benefited the largest electricity users, it remains unclear whether it will deliver or has delivered in other jurisdictions, benefits to the smaller consumers in the marketplace, especially the disadvantaged.

Of particular concern is whether Australia's FRC policy initiatives have the outcome of further disadvantaging those customers that are least able to secure the benefits expected to be delivered from the marketplace. The CCCL is anxious to ensure that the benefits of FRC can be delivered to all customers as envisioned in the Queensland policy initiative.

Vulnerable customers tend to be relatively unattractive to new entrant retailers (high transaction costs, poor credit history, etc.), making it difficult for them to access the marketplace. So a strategy that relies on a high UT to make the market work will potentially hurt vulnerable customers by imposing a higher default regulated tariff on them, in a market environment that makes it difficult for them to participate. Therefore it remains to be seen how this class of customers will fare in the new FRC environment and tariff arrangements. In our previous submissions to the ECC we have emphasised the need for safety net arrangements to be developed as part of the FRC implementation process.

Methodology of Annual Indexation of Notified Prices

Working out the NEM load

The CCCL is concerned that the mechanics of the indexation formula, which includes electricity load in the denominator of the indexation equation (“L”) risks UT price increases if electricity load falls. Given the growth in Queensland’s economy, this may not seem likely. However, if the indexation is based on state wide load, and the resource boom collapses, there would likely be sharp declines in industrial load, and potentially in state wide load, leading to price increases to the regulated retail tariff.

The CCCL therefore supports the recommended adjustment to use “distribution electricity” (electricity consumed through the distribution system as opposed to all electricity consumed in the state) as the denominator as a sound concept. This will remove any significant variability caused by changes in load to major industry (ie those large users connected directly to the transmission grid). Moreover, we believe it is unreasonable that electricity prices to domestic customers should be beholden to changes in industrial activity in the resources sector.

Using the “distribution load” to index the regulated retail price is in many ways more relevant, as the regulated retail price would not apply to the transmission-connected major industry. While the approach is more elegant, it may have an unintended side effect that may act to the short term price benefit of retail customers.

The CCCL notes that the operation of the indexation formula is such that, if the distribution load grows at a faster rate than the retail cost stack (“R”), the benchmark tariff would fall. It appears possible, based on the rate of growth of Queensland’s population, that the rate of change of “distribution level” load will be higher than the total state load (or, another way, domestic load would grow faster than industrial load).

In contrast, the “distribution level” load is more likely to increase over time with the influx of population to Queensland, increasing the chance that the load growth “denominator” will increase faster than the cost stack, delivering reductions in the regulated retail price. That is, if

$$\frac{\text{Increase in distribution load}}{\text{Distribution load}} > \frac{\text{Increase in state wide load}}{\text{State wide load}}$$

then the change in indexation methodology is more likely to deliver price decreases than using the whole state load in the denominator of the indexation process.

From the perspective of small and domestic customers, this change is supported based on the expectation that domestic and small business load will grow faster than large (transmission - connected) business load.

Consultation process

The CCCL believes that section 2.2 outlines the requirements for a consultation process that are aligned with best practice. But it should be noted that this section simply discusses the consultation process, not the matters for consultation.

Cost of Electricity

LRMC (long run marginal cost) is to be used to estimate the pass through cost of electricity. This appears to be a quite common regulatory approach, but is a problematic concept.¹

The CCCL considers that where a regulator (in this case the Queensland Competition Authority or QCA) is asked to determine the cost of electricity for regulated retail pass through pricing, LRMC is probably the best economic tool available. But it could present risks to the regulated retailer if the QCA's energy pass through cost determination is not mirrored by some form of energy purchase arrangement.

The LRMC measure will not be particularly relevant where the retailer is required to source its electricity supply from the open market. Given that the LRMC calculation (by definition) bases its pass through cost on the optimal mix of generation plant at any given time (and accordingly the lowest possible cost of electricity supply for the regulated load), it will be difficult for the regulated retailer to source its electricity supply from the market at that cost. Unless there is scope for hedge costs to be reflected in the cost of regulated retail electricity, the long term viability of the regulated default retailer could be jeopardised.

Furthermore, it may be impossible for a new entrant retailer to source electricity supply from the market place at a price that will allow it to provide a discount to the regulated tariff and encourage customers to change retailer.

This suggests that further consideration and consultation is needed on how the cost of electricity is calculated for inclusion in the indexation process.

Network costs

The CCCL acknowledges that network costs are a more difficult issue than may appear. The consultation paper appears to suggest that a broad average of network costs should be used in the retail price determination. However, there is a myriad of network tariffs, and that complexity is likely to increase as new tariffs are developed out in response to the roll out of interval meters.

This will present opportunities for competitive retailers to cherry pick those customers charged a retail tariff based on an average network tariff who could benefit from a pass through of the actual (lower) network tariff. This will leave the regulated retailer with a portfolio of customers whose actual network costs are higher than the amount recovered through the regulated UT. This position is unsustainable in the longer term.

There is also considerable work being done in network tariffs to encourage demand management response. It will be very difficult for a bluntly averaged retail tariff to pass these pricing signals on to customers, and will therefore not be effective in adjusting customer behaviour.

Moreover, the network cost is already subject to a rigorous regulatory oversight process, currently undertaken by the QCA and by the Australian Energy Regulator in the future. A blunt averaging tool in the UT would appear to undermine the rigour of the regulator's analysis in approving network tariffs.

¹ Frontier Economics, 2006 'Draft methodology for Energy Cost Consultancy and Retail Costs/Margin Consultancy. A Draft Report Prepared for IPART, Melbourne; Independent Pricing and Regulatory Tribunal, 2006 'Review of the Regulated Retail Tariffs and Charges for Electricity 2007 to 2010'. Issues Paper, Sydney.

The CCCL considers that it may be possible for the UT to address only the retail supply components of the regulated price, and allow the network component to be passed through to the customer directly.

Retailer costs

The calculation of retailer costs in the discussion paper appears to be somewhat confused. The CCCL considers that retailer costs should be calculated on a “per customer” basis, consistent with regulatory practice across Australia. Regulators benchmark these “per customer” retail costs.

It will be more efficient, especially in the short term, to benchmark “per customer” retail operating costs against the research done elsewhere.

Forecast errors

The CCCL notes that the proposed indexing of the UT requires the use of forecasts of the coming year’s costs and load. In practice, this means that the UT charged for the forecast year can be different to that which would have been charged if an ex post approach had been adopted to indexing. It also means that if the forecast year UT is used unadjusted as the basis for indexation in the next year the UT for the subsequent year will be based on an inaccurate UT and an index based forecast cost and load. Clearly, there is a potential for this approach to result in the UT quickly becoming substantially different from that which would be charged if the UT were to accurately reflect actual changes in costs.

Accordingly, CCCL recommends that the indexation process each year include a review of the extent to which the previously calculated UT differs from that which would have been charged if an ex post indexation system were adopted. Where necessary the UT or the indexation factor should be adjusted to accordingly.