

ETROG CONSULTING COMMENTS – 5 FEBRUARY 2010

1. FINAL REPORT – REVIEW OF ELECTRICITY PRICING AND TARIFF STRUCTURES (REPT) PHASE 2

The Queensland Competition Authority (QCA) released the REPT Phase 2 report to the State Government on 30 November 2009. The report examines alternative retail tariff structures which may assist in the long term management of peak demand and provide an incentive for customers to use electricity more efficiently. Key conclusions of the report include alignment of retail and network tariffs; voluntary time of use tariffs for consumers with interval meters; and consideration of seasonal components to some tariffs. The Consultant will:

- Conduct a review and analysis of the REPT Phase 2 report, to:
 - Identify what may be key issues for consumers, particularly low income consumers; and
 - Identify advocacy strategies related to the identified issues
- Prepare dot points outlining the key findings of the Consultant's review and analysis
- Arrange to meet with the Manager, Policy, QCOSS to discuss the findings on or before the date of delivery.

Project Deliverable: Dot points outlining key issues and advocacy strategies relating to the REPT Phase 2.

2. KEY ISSUES FOR CONSUMERS, PARTICULARLY LOW INCOME CONSUMERS, AND ADVOCACY STRATEGIES

2.1. COST-REFLECTIVE PRICING

2.1.1. Cost-reflective pricing is a key aim

The report aims to put into effect "cost-reflective pricing" as a key aim. The cost-reflectivity only applies to South East Queensland (Energex area). There is no attempt even to educate customers in the Ergon Energy area as to what cost reflective pricing would be, even if, due to the Government's Uniform Tariff Policy, those customers do not face those prices. MMA mentions the Uniform Tariff Policy and restriction of its analysis to the Energex region in its report (page 13).

It will be important for the Government to affirm its ongoing Uniform Tariff Policy and means of implementation of that policy, before consideration is given to tariff reform. There are means of retaining the Uniform Tariff Policy while still bringing competitive pricing to customers in the Ergon Energy area, but further consideration of these would be outside the scope of this document.

Cost-reflective means “cost-reflective to the retailer”. Thus the network charges to the retailer are assumed to be non-negotiable costs. Network charges are not necessarily “cost-reflective”. See further points in regard to the alignment of retail and network tariffs in section 2.3 below. Note also that MMA mentions this issue in its report (page 12).

See also section 2.4 below in relation to demand management incentives.

We also note that there is probably no industry where all pricing is “cost reflective” at all times. There are many reasons why pricing might not be cost reflective in any industry, including the desire to smooth pricing changes over time, marketing reasons, competitive pressures, and for controlling demands for different products and services at different times. Further, if retailers can pass through all costs into cost reflective pricing, there may be little incentive on the retailers to control their costs. There is nothing inherently “wrong” with an industry where pricing is not fully cost reflective.

2.1.2. Prices are not currently cost-reflective

It is certainly true that prices are not currently fully cost-reflective in South East Queensland, let alone in the rest of the State. They were not fully cost-reflective before the BRCI framework was introduced, and the BRCI framework does nothing to improve cost-reflectivity. Wording at the top of page 4 of the QCA report acknowledges that there are “flaws” in the BRCI methodology and the prior history of retail electricity pricing in Queensland, which were identified in the QCA’s stage 1 report.

Notwithstanding, we have some specific concerns regarding some of the calculations of cost reflectivity that have been undertaken by MMA. Page references in the following bullet points are to pages in the MMA final report:

- Energy costs have been based on [one year’s] NEM costs rather than hedging costs (pages 5 and 39).
- Electricity contract prices may have been based on the quotes obtained on a single day? (page 40)
- Network costs are based on current costs and structures. No future network tariff directions have been considered (page 7). This is a significant limitation, given particular the emphasis that QCA puts on retail and network tariff alignment (see section 2.3 below).
- Retail costs include customer acquisition costs (page 8).

- Assessment of cost reflectivity of fixed components assumes that “a key aspect of cost reflectivity is the extent to which the service charge or minimum charge in the retail tariff covers the fixed costs to the retailers, namely the fixed network charges and retail costs, plus a 5% margin on these” (page 23). We do not accept that it is necessary for the retailers to achieve the 5% margin on the network charges (or on the retail costs). Seeking to achieve an overall 5% return does not require each individual component to give that return. It may for example be reasonable to expect 10% return on energy costs, where there are real risks, and 0% on network charges (averaging 5%), without compromising true cost reflectivity.
- In section 6 of its report, MMA assumes that if electricity prices decrease, consumption will increase, based on price elasticity of demand which would appear to have been treated as symmetrical for price increases and decreases. This might not be the case.
- A TOU tariff has been modelled (page 41), based on a network TOU tariff being made available to domestic users. However:
 - The network tariff applied is one that is currently available only to small business users, without any apparent consideration of its applicability to residential users.
 - MMA did not test whether the network tariff applied would be revenue neutral for Energex. In the absence of that test, it is difficult to see any value in the results.
 - It is unclear over what period MMA considered the energy costs to be modelled in the tariff. The energy costs are anyway based on NEM costs rather than hedging costs.
- MMA recommends removing the controlled load tariffs 31 and 33 and moving instead to a cost-reflective flat tariff (page 43), on the basis of “cost-reflectivity”. There is no apparent recognition of the value that these tariffs have to the network to be able to control load on these tariffs using ripple control, and thereby avoid congestion on the networks. This shows a significant omission in the analysis, which probably stems from the decision to model only retailer’s costs, and not to step back to look at what underlies these controlled tariffs and other aspects of pricing from a network perspective.

2.2. WELFARE CONSIDERATIONS

The QCA says that “any welfare considerations for vulnerable customers are best handled via a targeted approach by Government and not via general tariff adjustments” (page i). QCA refers to a previous QCOS submission: “These comments appear to mix social policy objectives with the (economically) efficient use of electricity.” Remarks of this kind appear throughout the report.

QCA also acknowledges in regard to its objective of achieving cost reflectivity (page 15): “The Authority recognises that meeting this objective may impact adversely on low consumption low income customers and vulnerable customers who may face higher fixed charges (and hence total electricity costs) and that this may affect their capacity to pay their electricity bills.”

Advocacy strategy: Clearly this is intended to open up the advocacy opportunity for representatives of low income consumers and others in hardship to advocate to Government to ensure that Government does put in place an appropriate set of welfare and hardship policies. There must be some concern with the implementation of the NECF that Queensland should retain appropriate policies.

QCA says (page 13): “Regulated tariffs essentially provide a safety net for electricity customers. Those who prefer not to enter into a market contract or who live in areas where competition is weak or non-existent, rely on the regulated tariffs to provide them with an option for obtaining an essential service.”

On that basis, there is a case for tariffs to include a social/welfare policy component – so that those who rely on regulated tariffs have a safety net to obtain electricity at an affordable price. Even where competition is effective, regulated tariffs set the basis on which market offers are then made to encourage consumers to move away from regulated tariffs.

However, QCA recognises that there may be a social need to continue existing tariff arrangements for irrigators and farmers (page i): “in response to questions raised by farming and irrigation representative groups, the Authority has clarified that those customers currently able to access time-of-use irrigation or farming tariffs would continue to be able to access that style of tariff while those currently on a flat rate would continue to have that option available to them”. This willingness of QCA to allow irrigators and farmers to continue to have access to existing tariff structures is in marked contrast to the Authority’s view of how low income customers should be treated.

QCROSS has previously noted that higher fixed charges will disadvantage those who consume small amounts of energy relative to those who consume large amounts. This is also clearly an area for advocacy to Government in regard to those low income consumers who will be adversely affected by large increases in fixed charges.

This advocacy may be more appropriate than advocacy for Inclining Block Tariffs, which would provide increased costs to low income customers with relatively high consumption. Social policy should be directed at those in need, rather than those with low usage who may not be in, while missing out on helping those with high usage who may also be in need. Better to distinguish between customers on the basis of their financial needs rather than just on the basis of their energy consumption.

2.3. ALIGNMENT OF RETAIL AND NETWORK TARIFFS

A key finding is that network and retail tariffs should be aligned. Key quotes include:

- “Network and retail tariffs should be aligned” (page i); and
- “It is critical that network and retail tariffs are structurally aligned” (page 32).

There are many points in the report where the report almost bewails that the network charges are not of a particular favoured structure, so that those could then be passed through to consumers.

We do not agree that network and retail tariffs should necessarily be aligned as precisely as suggested by QCA:

- Energy costs do not necessarily align with network costs. Energy costs tend to be higher when demand exceeds supply (or is expected to exceed supply). This can happen because demand is higher than “average” or supply is lower than “average”. It is the supply-demand ratio that affects energy costs. In contrast, network costs are highest when demand is highest, irrespective of the supply-demand balance. The discussion at the bottom of page 4 of the QCA report somewhat glosses over the fact that peak energy prices may not coincide with peak network costs.
- Network costs are not necessarily “cost-reflective”.
- Probably because network charges are not generally passed on to residential and small business customers, network charge structures do not have to take into account the need for simplicity. There is no AER obligation on network operators to take into account end-customer applicability of the network charges. We can provide an example from Victoria of a very complex network charge structure which would be extremely difficult to explain to consumers or to justify any such attempt. If attempts were made to pass through complex network tariffs in retail tariff structures, it would negate the value of simplicity. As QCA says on page 6: “Complex tariff structures may better reflect costs than do simple tariffs but may also create confusion amongst customers and cloud the price signals to which it is hoped they will react. In contrast, simple tariff structures may promote greater achievement of the objectives outlined above by allowing customers to make easy decisions about their consumption.”
- Network charge structures can change from one regulatory period to another, and to some extent from one year to another, and sometimes at short notice.
- Due to the Uniform Tariff Policy, the retail tariffs in the Ergon Energy area will be exactly the same as in the Energex area. Alignment of Ergon Energy area retail tariffs with Energex network makes very little sense. This is somewhat acknowledged on page 32 of the QCA report.

There is some interesting logic on page 20 of the QCA report: “Ergon Energy suggested that seasonal tariffs have the potential to deliver better pricing signals and assist with demand management, even if introduced solely for the retail component of notified tariffs.” Yet QCA’s response is: “As achieving cost reflectivity in South East Queensland is one of the key aims of this review, the introduction of a seasonal retail tariff would preferably be underpinned by a seasonal structure in Energex’s network tariffs.” While QCA goes on to acknowledge that there may be benefits in having seasonal retail tariffs, this illustrates that QCA prefers to see retail tariffs as reflections of network tariffs, even while admitting that other arrangements could provide material benefits.

We propose advocacy to Government to go easy on network-retail tariff alignment for all these reasons. Besides the other points, it must be borne in mind that network costs are simply the costs for “delivery” of electricity, not the costs of the product itself. Conceptually, it is difficult to see why the structure of the charges for a product should be tied exclusively to the structure of the charges for delivery of the product. We cannot think of any other product where the charging structure for the product itself is based solely on the delivery charge structure.

Though network charges currently comprise a large proportion of the end-user’s overall electricity bill, this may not always remain the case. Consideration may be given to further educating customers on what makes up their electricity bill, so that they can understand the sources of changes to their overall electricity bill.

2.4. DEMAND MANAGEMENT INCENTIVES

QCA report page 6:

“QCOSS suggested that the Authority had prioritised the achievement of cost reflectivity above all other policy objectives, including the encouragement of more efficient use of electricity.”

“QCOSS also suggested that the achievement of better price signals may require a deviation from cost reflectivity as higher fixed charges may better reflect the costs of energy supply, but they will tend to mute other price signals to consumers to encourage energy efficiency.”

QCA dismisses these comments, and largely this is because QCA is interpreting “efficient use of electricity” as being that which is reflected through economically efficient pricing. However, the Ministerial Direction to QCA asked QCA to “examine alternative tariff structure options to ... enable customers to manage electricity consumption more efficiently, including through demand side management incentives” as a *separate objective* to achieving cost reflective tariffs (see QCA report page 43, section 1.2.2 of the Ministerial Direction).

Advocacy strategy: Perhaps the Minister can clarify to QCA that demand side management incentives were intended to be considered apart from cost reflective tariffs, and that it is not sufficient to assume, as QCA has done (see QCA page 6 and elsewhere), that cost reflective pricing will automatically lead to the most efficient use of electricity.

Advocate for alleviating some of the effects of QCA’s proposals on low income consumers by pointing out that QCA’s proposals do not fully reflect the Ministerial Direction.

2.5. DEVELOPMENT OF A NEW SET OF TARIFFS

QCA proposes (page i):

- A new set of cost-reflective tariffs should be developed; and
- A voluntary time-of-use tariff should be introduced for those customers with interval meters.

Each of these is considered in turn below.

2.5.1. Seasonal components and other changes to tariffs envisaged in the absence of interval meters

Issues here have been discussed throughout earlier sections of this paper.

We note that: “The Authority does not foresee any need to introduce complex or obscure pricing structures” (page 35).

Advocacy position: Note that network tariffs may (in future) include complex and/or obscure pricing structures, and this is a reason why retail and network tariff structures should not necessarily be aligned (as discussed in section 2.3 above).

2.5.2. Voluntary time of use tariffs for consumers with interval meters

Should interval meters be rolled out in Queensland?

A key issue here will be if smart meters are rolled out to support TOU tariffs, will that be cost effective, who will pay for the meters, and how much will they pay? In reflection of these concerns (QCA report, page 34):

Consumer groups such as QCROSS and the Queensland Consumer Association did not support introducing a time-of-use tariff until the results from pilots and trials of smart metering technology in Queensland and other jurisdictions were available. Both consumer groups suggested that there should be a thorough cost/benefit assessment of a roll-out of smart meters along with consideration given to customers’ price elasticity of demand and the required peak and off-peak prices before any time-of-use tariffs utilising the features of interval meters were introduced. In particular, QCROSS suggested that there is significant uncertainty around residential customers’ price elasticity of demand at peak times.

In response, QCA accepted that “it would be sensible to conduct a cost/benefit analysis before mandating any accelerated rollout of interval meter or smart meters”, but added that no accelerated roll-out of interval meters is being contemplated. Rather, interval meters are gradually replacing accumulation meters as part of the normal replacement cycle.

Advocacy strategy:

- Reiterate that interval metering should only be rolled out where benefits exceed costs.
- Advocate that those interval meters that are installed should be used for pilots and trials and other research to gain a better understanding of customers’ price elasticity of demand and other customer usage information.
- Advocate that these findings should be taken into account in any future consideration of interval meter roll-out.

Further issues regarding implementing TOU tariffs when interval meters have been installed are discussed below.

Other TOU tariff issues when interval meters have been installed

- “With time-of-use tariffs, customers have the opportunity to make informed choices about when they use electricity” (QCA, page 33).
- Consumers should have access to their interval data before choosing a TOU tariff, so that they can make an informed choice.
- It would be useful if customers could see on their bills before they move to a TOU tariff what their bill would have been had they been on a TOU tariff, before they choose to switch.
- QCA notes (pages 6-7) that TOU tariffs “need to be associated with measures which enable the customer to make easy decisions, such as through real time in home price displays”.
- How easy will it be for a consumer to switch back to a non-TOU tariff?

An alternative is that you don't make people choose between a flat or voluntary TOU tariff. Rather, you simply work out what their bill would have been under both tariffs, and charge them the lower amount. This has the following advantages:

- It rewards those customers whose usage is predominantly anyway in low-cost periods – that is appropriate for cost-reflectivity.
- It gives an incentive to those customers who can modify their behaviour to use a greater proportion of their electricity in low-cost periods to have a go to do so and thus to save money.
- It does not punish those who are high peak users and are unable to modify their behaviour, perhaps for welfare reasons.
- It anyway only reflects the charges that all customers would have paid had they made an informed and wise decision as to whether to go for a flat or voluntary TOU tariff. It neatly prevents retailers from gaining “windfall profits” from customers that make the “wrong choice”, and thus accidentally end up paying too much.
- It allows TOU tariffs to be trialled in a “production environment” and analysed to confirm their relative advantages and disadvantages compared to existing tariffs, as suggested previously by QCOSS, without disadvantaging any customers.

Proposed advocacy strategies:

- Advocate for customers being charged the lowest of all available tariffs, without having to choose in advance between flat, voluntary TOU or some other tariff.

- In the second instance, as a back-up strategy, voluntary TOU could be acceptable, provided that:
 - It is truly voluntary – and other non-TOU reasonably priced tariffs are always guaranteed to be available;
 - Customers can have interval data in advance of choosing the tariff in order to make informed decisions;
 - Customers can monitor their usage and bills, perhaps with an in-home price display as suggested by QCA;
 - The initial TOU tariffs are regarded as a trial, and data is made available for analysis to confirm their relative advantages and disadvantages compared to existing tariffs; and
 - Customers can move back to a non-TOU tariff at their next bill on request.

2.6. GUARANTEED SERVICE LEVEL PAYMENTS

Note the comment from Integral Energy (page 37), that “there may be a need to allow retailers a limited moratorium on the payment of Guaranteed Service Level payments should there be insufficient lead-times for necessary system changes, testing and customer communications.”

Advocacy strategy: Resist attempts for introduction of new tariffs to be used as an excuse for reductions in the quality of any aspect of customer service.