OPTIONS FOR THE REVIEW OF STANDING OFFER TARIFFS FOR VICTORIA'S RETAIL ELECTRICITY

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Submission to the ORG:
Options for the Review of Standing Offer Tariffs for Retail Electricity

Introductory Comments

Markets and Efficiency

Promotion of efficiency in markets is predicated on two features: strong property rights and vigorous competition.

Strong property rights are essential to ensure that sellers are able to keep the profits their activities generate. As a corollary, they must also face the likelihood of losses from taking the wrong decisions, losses that can lead to bankruptcy in extreme situations. This property rights perspective forces sellers at every stage of the market process to ensure that customers' needs are researched and met at the lowest cost.

Competition is essential as a discipline on this process. Without a competitor fully able and anxious to step in to supply the incumbent's market, the latter's motivation to continually search out new needs and cheaper ways of meeting them is blunted. Indeed, a seller with an entrenched monopoly will raise prices and reduce sales beyond the level at which additional revenue covers costs, secure in the knowledge that a rival would be unable to undercut the price.

This process of competition is now generally accepted as offering the best means of setting the price and quality mix that gives consumers the best value. It operates in both the static sense of bringing about the lowest cost outcomes for a given set of demand and supply configurations and in the dynamic sense of encouraging a ceaseless search for improving upon this in the light of shifting demands and input costs.

All regulatory bodies claim that they are seeking to replicate this competitive outcome in the context of a market in which there are some natural monopoly elements that require synthetic costs to be developed. Hardly any authority would nowadays claim that regulatory overrides offer superior outcomes to those of a free and competitive market. Regulators simply do not have the capability to assemble and process the information that profit-driven suppliers routinely undertake.

Hence, in the light of regulatory deficiencies, to legitimise intrusions, not only must there be such imperfections but the regulator must also be able to bring improved outcomes. As Epstein[1] puts it,

> "….regulation must be justified on the grounds that any monopolist charges too much and sells too little relative to the social – that is the competitive – optimum. But even when true, the case for regulation is hardly ironclad. The

[1] Richard A. Epstein *Principles for a Free Society*, Perseus Books, Reading Mass, 1998

> situational monopoly may confer only limited pricing power, and its durability could be cut short by new entry, or by technical innovation. Regulation could easily cost more than it is worth, especially if the regulation entrenches present forms of production against the innovation needed to undermine its economic dominance." (p. 284)

Importantly, these remarks, and much of the literature counselling caution in introducing regulation, as well as Part IIIA of the Trade Practices Act and Australian State based regulation concern situations where there is a monopoly underpinned by an "essential facility". The case for regulation where there is no such natural monopoly is even more controversial. Regulation in such situations rests on market dominance buttressed by some means by which new entrants are prevented.

These situations pertain to where a firm has gained for itself a dominance over a market as a result of its superior long-term performance or through having been given some initial legislative monopoly. The obvious means of countering them are to ensure a market opening or to require the dominant firm to be divided. In either case there are dangers to efficiency: splitting up a firm that has gained a dominant position may mean reducing productivity and raising prices, while forcibly opening a market can disadvantage the incumbent firm, again to the detriment of economic efficiency.

Regulatory Interventions in Networks

Some background to the present reference stems from the treatment of electricity and other formerly integrated networks in Australia and other jurisdictions.

Where tranches of larger customers were opened in electricity and gas markets and retail competition commenced in telecommunications, other than to ensure that customers were properly informed and could transfer effortlessly to competing suppliers, there were no particular measures taken by governments to reinforce the natural rivalry that profitable opportunities bring. In other cases, as with the opening up of US long distance telephony to new carriers, the dominant incumbent was at first obliged to take actions like publishing prices in advance and not being able to amend those prices to respond quickly to competitive reactions. These measures, designed to give an advantage to new players, were strongly criticised.

A price cap on the incumbent has accompanied the recent UK electricity and gas retail deregulation at the household level. As with US telecom openings this was motivated by the wish to promote competitive responses. The concern has also been to prevent the dominant firm from being able to unfairly exploit its position with the incumbent customers.

Other intervention has been motivated by concerns about market distortions that may result from a market structure that falls short of monopoly. This has been prominent in the US, where analysis has focused on the degree of concentration in markets. A measure of market power, the Hirfindahl-Hirschman index, was first applied by the United States Department of Justice following its 1986 report on gas pipelines (see Laine[2]). This takes as a proxy the existence of four similarly sized firms as providing a low risk of the exercise of market power.

While the existence of many players offer better competitive pressures than few, the application of oligopoly based analysis is highly controversial. The requirement of a large number of players has often proven to be unnecessary. This is evidenced in the vigorous competition in the soft drink industry where Coke and Pepsi are clearly dominant worldwide. In Australia's domestic airline industry, the existence of just two competitors, periodically challenged by new entrants has (once the Government exited from the industry's control) proven sufficient to ensure highly competitive prices and services. Similar conditions are found in the beer industry, while sales of distilled spirits in Australia are dominated by one firm without this bringing evidence of monopolistic practices.

Hence, even if there are only two firms or a single dominant firm operating in a market which can be readily contested, this is often sufficient to ensure against monopoly and prevent price gouging and other forms of consumer exploitation. As Epstein and others have maintained, the onus is on the regulatory authorities to demonstrate they can ensure a superior outcome.

The Role of the Electricity Retailer

Under competitive circumstances, the retailer is the *de facto* agent of the consumer. That role is assumed of necessity–if abandoned or neglected a rival will step in. The retailer's activities, to ensure its on-going success and even its existence, must extend far beyond passively breaking down bulk and ensuring products are delivered at convenient locations. It must extend to assisting in discovering what the consumer wants. Unlike self selected (and often government financed) consumer "representational" bodies the retailer is *compelled* to be the agent of the consumer, as long as the consumer can move to an alternative agent if the retailer provides unsatisfactory service.

The retailer is an agent in a far more comprehensive sense than any representative body because it needs to weigh up the needs against the available product inputs–and to do so correctly or face replacement. The retailer is under great pressure to seek out inputs from all sources.

The homogenous nature of electricity does not negate this. Electricity may be undifferentiable but its supply is from highly variable sources. In terms of assembling

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[2] Laine, C. (1995), *The H-H Index: A Concentration Measure Taking the Consumers' Point of View*, Antitrust Bulletin, Summer, pp. 423-32.

inputs, the retailer must decide, based on its customers' requirements (and those of its target customers):

- how much power to contract rather than buy at pool
- how much of different sorts of power (baseload, regular peak, needle peak) to buy
- how much price risk to take for the needle peak.

In addition, this basic product has to be metered correctly, bundled in profitable packages, promoted to consumers who may have little awareness of their needs and options, and priced appropriately. The retailer also needs to examine economies of scope (or synergies) in bundling his goods together with other similar products, sharing services of specialists like meter readers, back office functions etc..

Competition between retailers does tend to ensure that, for a given quality, products are purchased from the cheapest producers and sold on to customers at margins that are not excessive in relation to efficient retailers' costs. Competition is also, and perhaps fundamentally, a discovery process, whereby the competitors set out to ascertain the needs of customers, where those needs are not well defined nor even fully understood by the customers themselves.

The foregoing indicates the dangers of simply treating electricity retailing as an automatic function that can be easily replicated by a smart regulator. Joskow, Hogan and others[3] have suggested that we can make do with a simple pass through tariff from wholesale and line charges to the customer. This proposition has drawn a sharp response from Littlechild[4].

Electricity Retailing in Victoria

Structural separation of the former Victorian electricity monopoly left the retailing and distribution businesses as jointly owned. The two arms were required to observe a strict accounting separation in the form of a ring fence. Two of the five businesses have since made ownership separations while two others have formed distinct businesses. In the absence of any claims that the host distributor favours its retail arm (and no such credible claims have ever been made) there are no natural monopoly conditions. This distinguishes retailing in the FRC era from the conditions that give rise to regulation, e.g. those under the distribution price re-set or the oversight of prices for franchised customers generally.

Two ways of viewing electricity retailing to the household customer in Victoria are either as five dominant firms with market power over their (former) exclusive

[3] For example, Paul L Joskow, "Why do we need electricity retailers? Or, can you get it cheaper wholesale?" Center for Energy and Environmental Policy Research, Massachusetts Institute of Technology, revised discussion draft, 13 January 2000
[4] Littlechild, S.C., Why we need electricity retailers: A reply to Joskow on wholesale spot price pass-through, The Judge Institute of Management Studies, University of Cambridge, September 2000.

territories or some form of oligopolistic competition dominated by six or seven firms who may not compete strongly with each other. The former calls for action to protect the consumer while the latter requires measures that promote additional competition. Neither of these views is persuasive. The market is not an oligopoly: the energetic steps already being taken by retailers, including non-incumbent retailers, to attract customers are evidence of this.

Procedures are in place to effect a speedy and costless transfer of a customer from its host retailer to another that is able to offer a superior price or service. Retailing competition across the Victorian market includes the five host retailers plus two dozen others. Competition for the household market once it becomes contestable will include all five host retailers and at least two from interstate as well as several new players. These conditions would satisfy the Hirfindahl-Hirschman index threshold for workable competition.

There is, in short, no lack of experienced competitors and few barriers to entry. Indeed, as in the UK, serious concern is moving to the problem of over-aggressive sales techniques and the development of a code of ethics.

The notion that the incumbents are able to exploit their current monopoly is not plausible in the Victorian retailing situation. Hence, even if there were no trade practices legislation as an insurance for consumers, the case for regulation either to combat monopolistic pricing or promote competition is extremely slender. Indeed, the downside rests with regulatory not market failure.

The Rationale for Price Controls in Victorian Electricity Retailing

Successive tranches of retail customers have been freed to choose their own retailer in Victoria. The process has progressed smoothly and been an integral part of the great improvement in efficiency. It has brought reduced prices while generation was over-supplied and minimised price increases as supply/demand dynamics change. Given this experience, there should be a strong presumption against regulated prices in the household sector. After all, energy retailing, though it requires sophisticated systems has no entry barriers and many capable providers. With load profiling and FRC, any attempt by an incumbent retailer to raise prices above underlying costs would invite vigorous rival entry.

However, a case can be mounted along the lines that the household sector is less well informed at the present time about the options and, having been protected by a government determined tariff for many decades, some safety net is justified for a short period. This was certainly the view taken in the UK and has been adopted for the 40-160 MWh customers in Victoria. It rests on a theoretical foundation somewhat akin to the provisions regarding consumer protection codified under Part V of the Trade Practices Act.

The possible exploitation rests on consumer inertia. But unlike, say the banking industry, where there are real inconveniences to the customer changing retailer, in electricity the process is straightforward and costless. Even so, many would argue that since the host retailer at "Day 1" has a monopoly of the current franchise customers. This could give rise to short-sighted opportunistic behaviour[5]. That said, it would surely need to be acknowledged that the underlying ability of the consumer to shift to any one of a great number of actual and potential alternative retailers, could never justify such oversight beyond a very short period.

There are clear dangers in overriding the forces of competition, dangers that intensify with the length of time the controls remain. These dangers of seeking to replace or improve upon the market outcomes are adverted to in the ORG's paper. They can be distilled into two primary failings related to where the regulator sets the controlled price too low. Setting prices too low will:

- require cross subsidies and either bring an unravelling of the market balance and/or lead to financial distress among retailers and inadequate incentives for new investment; an extreme outcome of these developments is evidenced in California; and
- crowd out the competitive provision that is being sought forcing (reluctant) host retailers to continue serving unprofitable customers.

These considerations underline one matter on which pricing controls or guidelines must be ruled out: the prevention of price increases on the grounds that consumers would prefer not to pay higher prices. Already in Victoria we have put prices in place that have been regulated over the past six years with little provision having been made for the changing costs–absolute and relative–on which the prices were first justified. Unless prices are allowed to adjust to the underlying cost shifts, retailing will be seriously harmed and the consumer the eventual loser. As the minister recognises in her Terms of Reference and as the ORG is amply aware, the danger of price controls is a general competitive paralysis and even with a milder form of fixing, price capping, some risk of this remains.

It may be that the Government would wish to shield some consumers from the true market price. If so, there are well-established means of doing so. Requiring cross subsidies from other consumers of the product is not one of these. The preferred approach is direct provision of support to targeted customers through CSOs. The industry has developed procedures to deliver such support, for example with pensioner rebates. Though far from a sound policy approach, the CSO route would be less structurally damaging than forcing retailers to bear costs or cross-subsidise.

Compared to setting the price too low, the dangers of allowing excessive prices are considerably less. This is not the least because excessive prices bring their own remedy–competitors find ways of winning the ostensibly captive markets. The recent

[5] In fact the so-called Cournot model of oligopolistic competition predicts that the markup of a supplier depends not only on demand elasticity but also on the supplier's share of market output. The larger the share, the more market power a supplier has and the greater its markup.

Productivity Commission draft report on Part IIIA of the Trade Practices Act drew attention to this asymmetry in the context of "essential services" and advocated erring on the side of allowing a higher price rather than risking an excessively low price. These approaches are even more appropriate in retailing which does not have the long lived capital assets of network services and consequent ability temporarily to serve customers at marginal cost.

Indeed, as soon as full retail competition is in place, it is difficult to see any scope for price setting. Any price that is set above market levels will mean customers will be won away from the incumbent supplier by a rival seeking to take advantage of a profitable opportunity.

In fact, an existing retailer may be vulnerable to a rival who is able to better its price because the target customers are complementary to others that it presently serves. This might allow a rival to make price offers below the cost of the incumbent even if the latter is technically efficient.

Specific Questions Raised by the ORG

1. Whether "effective competition" and "outcomes consistent with those expected in a competitive market" indicate that standing offer tariffs should reflect underlying costs

Effective competition delivers the ideal outcomes in terms of price/quality mix, diversity of product offerings consistent with the costs involved.

Contrary to some paradigms, the issue is not just to arrive at the lowest cost as a result of competition driving down prices. To be sure, the tendency towards the lowest possible price is one important outcome of competition. But this takes place in the context of shifting needs of consumers that are often inadequately understood even by consumers themselves. And it is a continuous process with the availability of product constantly changing.

Hence 'standing offer tariffs' or the eventual price to consumers in a competitive market will only reflect underlying costs in a rough-and-ready way.

To the extent that suppliers are able to buy inputs on favourable terms, or gain insights into consumer needs not shared by their competitors, they can set prices above a stylized notion of those of a 'competitive market'. However, the nature of competition means any such gains are transitory as the innovatory approach that made them possible will be quickly imitated by rival firms and the benefits passed on to consumers through competition. The prospect of making such gains should not be eliminated as it defines the dynamics of a market.

Attempting to estimate firms' costs and use the estimate as a means of setting prices will not be successful, at least beyond a short time scale, since the costs and customer needs have to be constantly re-estimated in the light of changing needs and conditions. It goes without saying that estimating these costs and setting consequent required price ceilings prices at too low a level will severely prejudice the operations of the host retailer.

2. Extent to which the reference point or process for any review should be adjusted to take account of the risk that standing offer tariffs set close to or below efficient costs may hinder the development of effective competition in electricity retailing.

There is increasing documentary evidence about the effects of retail price setting in liberalised industries. This shows that tariffs set below efficient costs will completely frustrate the development of competition.

This outcome was seen in California's retail opening in 1998 where the host retailers were obliged to buy from the Power Exchange at spot, and a competitive transition charge meant there was no customer advantage in locking in future prices. In addition, mandated price cuts, which hindsight demonstrates were set at highly optimistic levels, increased the unattractiveness of the market. Although there was considerable interest, and Enron was aiming to take 10 per cent of the market, insignificant entry was sustained and fewer than two per cent of residential customers switched retailer. Enron subsequently withdrew from the market in a highly public manner.

Negative margins were also seen in Massachusetts between the wholesale price and the standard offer. Again little switching took place.

In the UK, in 1997 even though the reserve prices for the main household tariffs were set at rates below previous levels, there was an influx of competition. The incumbent retailers in the main did not price below the maximum rate specified and on average the best offers from rival retailers bettered this by 10 per cent[6]. This was possible because the wholesale price fell leaving considerable headroom. The fact that the retailers set prices at the maximum permitted level might indicate that the incumbent retailers did have some transitory market power. However, the fact that this brought them to cede share to new rivals also showed them to be exercising commercial choices. Neither the regulator nor the government has taken the view that the community would be better served by having prices permanently regulated.

The actual rates specified after March 2000 were lowered still further (although the regulator's initially suggested reduction was pared back considerably). The OFGEM consultation paper argued that the price restraints need to reflect the benefits being seen in the competitive market. It has already been noted that there is wide

[6] Littlechild, op. cit. P. 47

recognition in Australia that this carries grave risk of shutting out new players and exposing the protected customers to rate shock. The regulation of UK prices has taken place during a fall in the main cost component and about 27 per cent of customers have actually switched retailer. However there are thought to be few prepayment meter customers who have switched since the 2000 re-set because the price has been lowered to a level that makes competitive offers difficult. Aside from inhibiting new competition, this is likely to store up difficulties at next year's scheduled lifting of the price restraints, since it implies that prices for this (mainly low income) segment are set too low.

In Victoria, the five host retailers are all active in each other's territories, and there are at least two inter-state retailers plus a start-up retailer actively seeking business in the household sector. Indeed, the concerns have shifted from inadequate interest to inhibiting the zeal of the sales people seeking to win consumers from their host retailers.

There should be no serious consideration of any proposals to hold tariffs below or even close to the regulator's view of what comprises efficient costs.

3. Assessing the effectiveness of competition through proxy indicators

Setting hard and fast rules to determine whether competition is effective is impossible. It is certainly true that where there are many competitors, as in classic commodity markets, the competition is intense and the conditions bear comparison with the classic "perfect competition". However, highly idiosyncratic products or products that require considerable capital investment or skills often have few rival suppliers but still face considerable competition for the consumer's dollar. Reference has already been made to certain air transport markets and the soft drinks market that are highly competitive with only one or two rivals.

The main criteria for a competitive market hinge on the concept of contestability. The concept itself is usually credited to Baumol[7] and his associates. Contestability refers to the ease of entry into a market and the subsequent ease of exit in the event of failure. Where firms not presently active within a market are able to enter it without incurring large sunk costs a market is likely to be competitive. The most extreme form of contestability is hit-and-run. Under this model, the monopolist can find the entire market lost, and the new competition can exit without loss in the event of the previous monopoly or another supplier offering superior value.

The number of competitors, average number of competitive offerings and the rate of customer churn are measures often used to assess the effectiveness of competition in markets. While these might offer some evidence of competition, the real measure is

[7] Baumol, W., Panzar, J., and Willig, R., *Contestable Markets and the Theory of Industry Structure*, San Diego, Harcourt Brace Jovanovich, 1982

how easy is it for firms to attack an incumbent (monopolist's) position. The answer in electricity retailing is very easy as long as regulatory restraints do not prevent it.

In the electricity retailing market, there are some dozen or so firms of reasonable size and skills contesting the market in Australia at present. There are others, often with considerable resources and internationally honed skills, that stand ready to move in where profitable market opportunities present themselves. It should not be presumed that these contestants would be willing to eschew opportunities for half the total electricity market that is represented by households.

Electricity retailing, unlike poles and wires businesses, does not require a heavy capital expenditure or a commitment to employing a large labour force. Moreover, experience has been gained into the means of winning new customers in previously de-monopolised industries. This has been pioneered in the deregulation of telephone retailing with a mixture of media advertising (though this has proven too expensive in the UK) door-to-door selling and internet and direct mail.

The best measure of the extent to which competition is effective is to examine the costs and the inconvenience to customers of changing supplier. Customer churn or the number of offers are poor and potentially misleading substitutes for this. The most effective task the regulatory authorities can perform in enhancing this is to ensure retail shifting is cheap and seamless. Added to this, the ORG should consider establishing a central repository of price offers to facilitate consumer choice.

All this boils down to the familiar refrain that even the best intentioned regulator cannot process the information necessary to ensure efficient performance, and that the difficulty in doing so rises with the rate of technological and market change within the industry. The literature on this can be traced back to Hayek (1945) through Averch and Johnston (1982).

It is also true, as all this economic theory has shown, that the power of government agencies is greater than almost any commercial power in distorting markets. This returns us to the need to be very sure that the outcome will be one of improvement before we impose any regulation. In this respect, the distortions resulting from the long standing regulation of household electricity prices are already becoming apparent in the earlier applications for price increases by TXU and Origin. In particular those submissions suggested that, aside from general price movements, some fixed tariffs rates especially to rural and for off-peak have become artificially low. Procrastination on allowing these prices better to reflect the market will intensify the later price rises and bring considerable rate shocks to consumers.

4. Circumstances where it may be appropriate for the Minister to seek a review of market tariffs

It would be a most retrograde step if the electricity market were to revert to control over those tariffs that have been freed up. Such action is not only unnecessary and at variance with competition policy (including agreements between the Commonwealth and the States) but it would undermine the market structures that are in place.

Reversion to control, or even threat of control, over tariffs that have been liberalised would signify a reversal of the past decade's policies. This would cause considerable loss of value within the industry, a loss of value that would be translated into reduced levels of investment in all parts of it and a degraded service.

5. Circumstances where price oversight may prevent the passing through of efficient wholesale costs

This question encapsulates the risks inherent in placing price caps on firms. These include:

- insufficient risk margin to cover load
- sudden movement in costs
- lack of recognition of costs of hedging
- inadequate attention to load shape and seasonality (especially relevant in view of the increased peakiness of the summer load due to air conditioning)
- incorrectly setting the load to consumers due to the deeming provisions
- delays in price changes.

In addition, the regulator might take an inappropriate view of the costs to retailers.

The matter of the appropriate cost to use has already been considered in the context of the ORG's review of the proposed tariff increases for Origin, TXU and CitiPower. The ORG indicated that the actual prices on the spot will be important in determining the allowed pass through. The regulator suggested[8] that additional peak capacity becoming available is likely to dampen prices in the coming summer peak. This presents retailers with a dilemma. If they were to seek price pass through on the spot basis at the time this would surely not be accepted (its corollary would be a highly volatile price to consumers).

A rigorous determination of costs to establish price levels would require the regulator to duplicate the procedures undertaken by each retailer, namely to

- match the energy levels with the available flat, peak and off-peak swap products, although with some shape mismatch even on the average demand profile; and
- protect most of the remaining exposures up to the maximum demand levels using cap products (rather than purchasing extra swaps for the maximum load, because the cap contract is a better match for volatile load spikes).
- allow the extreme load spikes, occurring for only a few hours per year, to be exposed to pool pricing

[8] For example in the CitiPower report p. 28.

Such a procedure, which was arguably necessary in the first distribution price re-set, has no possible justification for retail pricing. Unlike with the poles and wires, there is no natural monopoly and, indeed, a key policy goal is to foster not pre-empt competition.

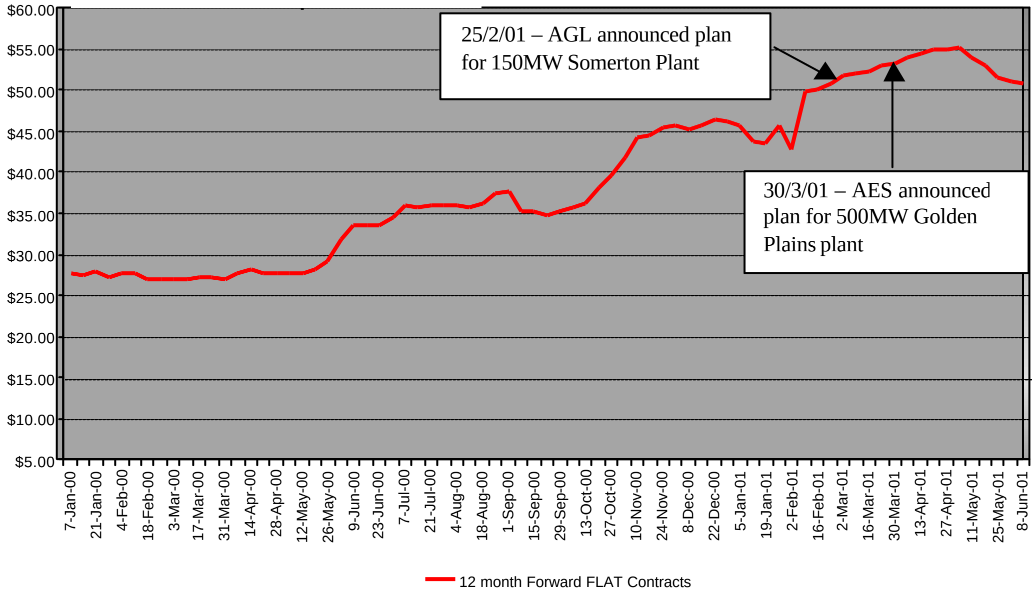
Having stressed the pitfalls of attempting a precise price estimation process, should some form of cap be introduced, the regulator will wish to estimate some key costs. In obtaining some broad fix on businesses' energy costs, the regulator must use contract rather than current prices, though these can be difficult to establish. In addition, a price index rather than the actual prices that retailers pay should be used to avoid creating moral hazard–an indifference on the part of the retailer to the prices actually paid.

The forward prices of the standard forward products can be obtained from a variety of sources:

- brokers' prices, based on market bids and offers, published on Reuters screens;
- AFMA forward prices based on polling of market participants; and
- survey of actual contracts bought and sold by retailers.

Pulse have developed the following chart of baseload prices in Victoria over the past year.

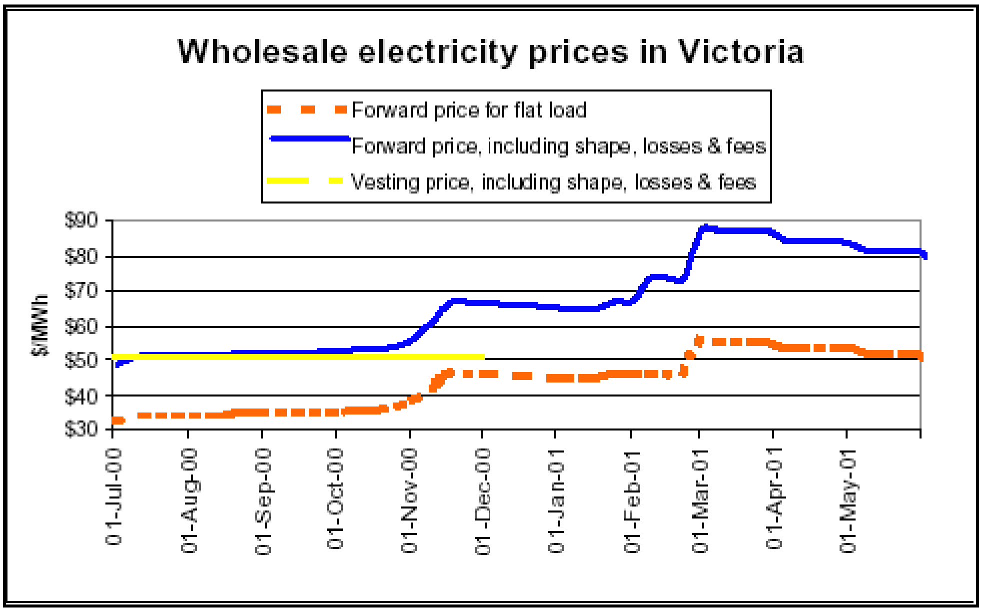
Chart 1 – Wholesale Market



Source: Pulse Energy Pty Limited, Comments on the Office's Special Reference June 2001

TXU have also set out their analysts' estimates of prices in the Victorian contract market adjusted for the peak and off peak components in a submission to the ORG. The TXU estimates are shown in Chart 2 below.

Chart 2 TXU's Estimate of Forward Prices



Source: http://svc116.bne022u.server-web.com/TXUSubPricesJun01.pdf

It would be essential for the regulator to construct such a schedule in formulating a view of the appropriate cost base. Even so, as the foregoing has made clear, this would not be a substitute for allowing the market to set the prices. Indeed, setting any price cap will inevitably cushion some consumers from the need to take their own decisions, an outcome that will blunt the efficiency-promoting market processes.

If the government (on the regulator's advice) decides to impose price caps on sales to small users, these should leave considerable room for new competition. Equally importantly, they should be transitory since they cannot be justified other than on the basis of the household consumer's lack of familiarity with the notion of retail competition in electricity. Any such lack of awareness will very soon be removed by competitive offerings and government publicity.

6. Interpretation of "light handed" regulation and attributes of a review framework that would or would not be consistent with the principle

The terms of reference stress the need to have the on-going review of standing offer tariffs to be light handed and require that the regulation itself be light handed. Light handed regulation was a term used to describe the regulation of distribution prices. Whatever the precise meaning of the term, few would consider the outcome of the first review during 2000 to have fitted that description. The ORG used the term sparingly with respect to the distribution price re-set as the procedure unfolded.

Light handed regulation may have had its derivation in the New Zealand shift from a planned economy. In that country it applied to:

1. the use of existing competition provisions (i.e. the Commerce Act 1986) rather than specific regulations to cope with the essential facility features

of the network industries; this allowed private parties the possibility of taking court action;
2. extensive information disclosure so that there was transparency in the performance of the electricity and gas industries; and
3. the threat of further regulation such as price controls if market dominance was abused.

Light handed regulation in the retailer context would seem to mean reserve power regulation: setting prices and service quality levels that act as backstops rather than standards to be achieved. This would exclude the ORG from certain activities either because they are non-core to the primary goal of ensuring people are not exploited or because to do so would duplicate existing institutional arrangements. It should also be seen as a short term staging post to the full removal of the ORG from retail price oversight.

Light handed regulation should avoid prescriptive measures. It should concentrate on:

- Ensuring the market is informed so that consumers can take their own decisions on their electricity retailer just as they do with other intermediaries in the goods and services they buy.
- Removing any barriers to competition meaning that the cost of and the procedures for changing retailer should be minimal.
- Assisting commercial or charitable bodies to set themselves up advising on the best deals to be had for each customer (several such bodies already exist). The ORG might also consider setting up such a service itself (but should bear in mind that in doing so it might "crowd out" alternative commercial services). It should, as now, also be ready to step in to address consumer complaints (but not to duplicate the work of the Ombudsman and another body, the Essential Utility Services Consumer Advocacy Centre, that is in the process of being established).
- Avoiding addressing supplier collusion since the ACCC is well funded and has the expertise to undertake this.
- Setting prices, as in the UK, for just one or two common tariffs; and setting these prices, as occurred by good fortune in the UK, at levels that give considerable scope for new competition to establish themselves especially where the incumbent is high cost or seeking to benefit from prices above costs.

7, 8 and 9 Processes and procedures that retailers presently have that could avoid unnecessary duplication and procedures to reduce compliance and administrative costs. Insights to be drawn from the oversight of other, excluded services

No comments

10. Extent to which regulatory options for standing offer tariffs should have regard to historical trends in wholesale market prices and to forward contract

prices; the ORG also seeks comments on sources of information on forward contract prices

Historical trends are not relevant to the prices that need to be charged. A business will always base its prices on costs (though they can deviate below costs from time to time, e.g. for promotional purposes, and can be above cost where the seller has bought or managed more skilfully than its competitors).

Constraints on price changes that can operate to the disadvantage of efficiency. The average cost of energy exhibits a distinct seasonal trend. This is due to the summer air conditioning load, a load that is progressively leading to a peakier demand and an increased requirement for higher cost peaking production. An efficient response requires the elimination of cross subsidies and replacement by prices that are cost-reflective. A cost reflective price is vital in most industries in bringing an efficient consumer response. Electricity's notorious demand inelasticity tempers this but does not eliminate it. Indeed, it would cause some considerable rethinking of the decision to install air conditioning and to seek out lower cost units and generally operate more frugally if the increased costs were made known to consumers in the form of price offers.

At some point in time it is likely that, even without sophisticated metering, prices will be set on a seasonal basis. They should be so set if they are to efficiently transmit information to consumers that costs differ by time of day and time of year.

And a business that neglected to make such a tariff would tend to be stuck with the less profitable customers as result of "adverse selection". Of course, accurate time of day metering is required for this to operate most effectively but even without this, the marked average difference in cost of energy between summer and winter should be reflected in prices.

Information on forward trends is readily available to the market participants through Reuters, AFMA and other sources.

11. Expected outcomes on the energy component of retail tariffs from a competitive energy market

As discussed under question 5, the energy component of retail tariffs would be expected to closely follow the costs of energy for that particular segment.

Retailers who did not price according to their cost curves would face "adverse selection"–and a deluge of demand from those who were priced too low and desertion from customers who were initially cross-subsidising them. Eventually this would drive the retailer out of business.

This process will emerge from market forces. Any attempt by the government to *impose* the market outcomes it expects to emerge from this process risks severely harming retail competition.

12 Outcomes that might be expected from a competitive market in relation to the market fees component of retail tariffs and issues that should be taken into account in investigating retail tariffs that use this cost component as a reference point

The market fees cover management fees for NEMMCO and NECA, plus some specific fees for the smelter contracts. In addition fees are required to cover costs of ancillary services, for the renewable legislation and for the cost of prudentials.

A monopoly would seek to levy these and other costs on the parties whose demand was least affected by the additional impost (Ramsey pricing). In a competitive market the fees would need to be spread among all users to the degree they could not be identified against particular categories of user or against particular firms.

At some future time ancillary services may well be measurable by users and retailers would then find it necessary to charge in a cost reflective manner. With the ancillary services market due to come into effect shortly, retailers may also find ways to offer services or reduce costs and these would form a (negative) part of the cost structure. With load profiling for the under 40 MWh customers this is not possible at present and it seems likely that the approach will be a straightforward allocation by energy usage.

Some aspects of these fees are likely to impact on some market segments more than others. Costs of the Ombudsman and costs to defray the charges to finance the Essential Utility Services Consumer Advocacy Centre and the NECA end-user advocacy facility (presently under consideration by the ACCC) are likely to be related overwhelmingly to the under 40 MWh household market. These costs should be loaded onto this segment's tariffs and augmented by the additional burden they place on the suppliers in terms of in-house resources needed to co-ordinate with them and contest the issues they raise.

In the interests of transparency and to improve public awareness of them, consideration should be given to separately identifying these fees on bills.

13. Expected outcomes in relation to the network services component of retail tariffs

Market forces will mean network service costs will be automatically passed through. They will vary between distribution network service providers' host territories.

Indeed, they will vary within each distribution area due to such factors as differences in line losses.

Some averaging is inevitable since there would otherwise be an unmanageable number of tariffs. But the danger is that a retailer could subject itself to a competitor's cherry picking strategy if the averaging were too great.

Even assuming the ORG issues broad price ceilings designed to leave considerable headroom for rival retailers, there would be a need to establish different reference prices for each distribution business area and probably several prices for the two rural host retailers. In the initial period, this might only need to take line losses into consideration, but eventually all costs of lines and service need to be allocated properly and to form the basis of price offers.

14. Outcomes of retail service costs on competitive markets and issues to take into account in retail tariffs

It is essential that no attempt be made to set a price that does other than very broadly incorporate the costs of retail services. To do other would be to micro-manage the whole competitive system. It would totally destroy the information search and the diversity of retail service approaches that the market is likely to require. These retail services, together with energy costs are the key arenas in which retailers will compete.

Retailer cost structures will differ in respect to the customer groups they intend to target and the service levels they offer. Analogous market situations can be seen to be playing out with banking. In electricity, some retailers will seek to press personal service, others hightech service, still others may promote new products like automatic telephone induced switching on and off of heating, ovens, water sprinklers etc.

15. Practical implications of striking a balance between not hindering the development of effective competition and protection of consumers from market or monopoly power

The objective of the electricity retailing regime is not to encourage increased numbers of suppliers *per se* but to encourage greater efficiency and lower prices to consumers. Just as second tier retailers are free to make rapid adjustments in the prices they offer, so should the incumbent retailer. To do otherwise would be tilting the playing field and risking the profitability and future viability of the incumbent retailers.

In establishing approval criteria for tariff applications, the ORG should limit itself to establishing backstop tariffs with a view to their rapid phase out. It might adopt the following procedures:

- determine indicative rates for only one or two, common tariffs;

- adopt rates covering the entire territories of the three urban distributors and engage in consultation with the rural distributors to agree on a minimum practical number of rates in each of their areas;
- fix prices, ideally on a summer quarter/rest of the year basis;
- establish the capped prices for a short period only (probably one year) so that they are reserve prices rather than prices that seek to second-guess competitive outcomes; they should be based on:
  - the contract price for the baseload, peak and needle peak energy requirements with the contract price established at a time to be determined after consultation with retailers, allowing retailers to select an alternative basis only if they can show good cause;
  - Retailers' risk exposure, including force majeure, pricing of ancillary services, distribution loss factors, and the risk of being associated with a retailer of last resort event;
  - FRC related costs, including marketing and information systems to allow customer switching;
  - allocate other costs based on volume; and
  - determine retail costs based on the retailer with the highest current margin.

16. The extent to which the framework for light-handed review of standing offer tariffs should address the question of whether existing tariffs are consistent with the outcomes that could be expected from a competitive market

The review has only two alternatives in establishing these prices: roll forward the existing MUTs or set new cost related price caps. There is no case for rolling forward existing prices. After six years and considerable recent market turbulence they bear little relation to the underlying prices they were originally intended to reflect.

While a capping process for the household sector is not intended to fix prices, some movement towards cost reflective caps is necessary in order to prevent the retail electricity industry in Victoria from facing strained financial conditions.

17. Whether it would assist the consultation process if the ORG were to undertake a preliminary assessment of the existing tariffs levels, at least for the most popular standing offer tariffs; whether and how the framework for review of standing offer tariffs should, where necessary, address arrangements for moving tariffs towards a level that recovers their efficient costs.

If it is determined that the government (with the advice of the ORG) should impose a price cap, it would be necessary to undertake some preliminary assessment of the current tariff levels, at least the most popular of those. In addressing question 15 above a skeletal outline of the approach considered most appropriate was offered. It is important that the ORG avoids this process becoming a means to set the actual prices. To reiterate, the need if it exists at all is to establish backstop prices that leave ample room for new players.

Reviews of the current tariff levels are important to ensure better understandings of the underlying costs that must be passed on. At the same time, the ORG has a role in avoiding stimulating public expectations that the Government controls the market price of electricity. Retail costs, even contracted costs, change rapidly as can be seen in Charts 1 and 2. Where those costs were falling, there was a corresponding fall in prices for the contestable customers. It is likely that these contestable customer prices are now rising. The process for these customers was handled by market arrangements and with minimal fuss.

The danger with the present review is that the spotlight is placed on electricity prices and the public is given unreasonable expectations that electricity prices are under the control of the Government. This, together with the natural agenda of the publicly funded consumerist agencies, is likely to put pressure on the Government to moderate market related price increases. Such pressures would be far more damaging than those following on decisions to hold down prices of essential services like power lines, because the impact is more immediate.

18. Preliminary views on the options that seem most likely to meet the various objectives and principles set out in the terms of reference

Many of the options offered fall well short of the “light handed” notion and others are pregnant with considerable intervention. One set of options ((iii) and (iv)) that should be summarily dismissed are those that involve rolling forward existing prices. This would be especially the case where considerations of reducing prices are being made.

The option that most closely corresponds to the general approach advocated in this paper is option (vii). This is the only one that offers explicit recognition of the need for the caps to allow headroom, that is for a cap that is an insurance for the less alert consumer but not a means that can result in the strangling of competitive responses. This option needs to be tied to a strict time limitation and be sufficiently flexible to avoid financial distress to retailers caused by changing conditions that result in an unrealistic cap. It could also be accompanied by a public promotion campaign about small users’ freedom to select their own retailer.