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Action Officer RICHARD BEGLEY

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Mr Rajat Sarawat
Executive Director, Economics
Economic Regulatory Authority
PO Box 8469
Perth Business Centre
Perth WA 6849

Email: publicsubmissions@erawa.com.au
Fax: (08) 6557 7999

Dear Sir

Inquiry into the Efficiency of Synergy's Costs and Electricity Tariffs – Draft Report

Perth Energy appreciates the opportunity to provide this submission regarding the Inquiry into the Efficiency of Synergy's Costs and Electricity Tariffs and the Draft Report, released by the Economic Regulation Authority (ERA) on 4 April 2012.

We note that whilst the ERA has identified a "Background to the Inquiry", there is no stated purpose for the Inquiry. This may be due to the ERA being directed by the Minister to conduct the Inquiry and the direction from the Minister containing no stated purpose.

Perth Energy considers that there are two main reasons for investigating the efficiency of Synergy's costs and tariffs:

1. To determine whether energy is being efficiently sourced and supplied to end use consumers and whether the shortfall between the revenue received from non-contestable tariff customers and the cost of supplying those customers is supportable. This is required in order to support the Community Service Obligation payments that Synergy currently receives from the State Government. Perth Energy considers that in general, the draft report adequately considers this aspect, although a number of comments are made in the following paragraphs.

2. To reflect upon the gap between current electricity tariffs and cost reflective tariffs and the capacity of the market to support greater levels of competition. Perth Energy believes that the ERA should expand the report to highlight the opportunities for further competition and, ultimately, full retail contestability (FRC).

Wholesale Electricity Costs

The ERA has identified that Synergy is exposed to potential cost inefficiencies in its wholesale procurement of energy as a result of the replacement vesting contract with Verve Energy. It also identifies that the vesting contract is Synergy's highest cost supply, excluding renewable sources. Entry into this contract was mandated by government and the ERA has cast doubt over whether this is an efficient source of supply for Synergy to hold. The potential inefficiency and lack of transparency regarding the process under which the vesting contract was established is highlighted in the report and Perth Energy supports these comments.

Where Synergy is receiving community service obligation (CSO) payments from the government, it should be established that all wholesale energy is procured from efficient sources, using open and transparent processes. Failure to establish such a discipline reduces the incentives for Synergy to ensure its operations are efficient. This is also likely to negatively impact on new investment in the wholesale energy market which might otherwise deliver improved efficiency for customers.

For example, if Synergy is receiving an inefficient supply from Verve Energy, but is compensated for that supply via a CSO payment, it has no incentive to review that inefficiency and seek lower cost, alternative sources of supply. The removal of the displacement mechanism (which required Synergy to replace a portion of its supply under the vesting contract with supply that was obtained through an open and competitive process) is also detrimental in this regard.

Perth Energy considers the report should highlight the potential for excessive CSO payments to Synergy that result from the potentially inefficient supply via the replacement vesting contract, and further highlight that the CSO payments, combined with the removal of the displacement mechanism, strongly diminishes the incentives for Synergy to seek greater efficiency in its sourcing of wholesale electricity for supply to non-contestable customers.

Perth Energy holds the view that the amount of any CSO payment made to Synergy as compensation for supplying non-contestable customers below the cost of supply should be based on the difference between the actual revenue received from that supply and the efficient costs of supply. Otherwise, Synergy will continue to focus its effort on rent seeking activity (trying to obtain more and more CSO funding) rather than on competitive activity to minimise cost of supply.

The replacement vesting contract is clearly delivering an inefficient supply to Synergy and entrenching perverse incentives for Synergy to avoid seeking more efficient sources of supply in the future.

Retail Operating Costs

The ERA notes in its draft report that retail operating costs are driven by the level of service that Synergy is required to provide. Perth Energy agrees with this comment and regards the current level of service provided by Synergy to be adequate and appropriate.

However, the level of retail operating costs is also dependent on the efficiency with which an organisation is able to deliver the required level of service. The report should highlight the impact that inefficient service delivery can have on retail operating costs. Where Synergy is receiving a CSO payment from the government relating to its requirement to supply non-contestable customers below the cost of supply, this cost of supply should be based upon efficient operating costs.

The ERA has calculated Synergy's depreciation cost at $14.10 per customer and identified that this is significantly higher than for comparable retailers. The cause of the difference is identified as being the recent IT system upgrade. Perth Energy considers that only efficient project implementation costs should be allowed when determining efficient operating costs.

The ERA should examine the IT system upgrade project to determine whether appropriate project management processes were followed and to ensure that unnecessary additional costs were avoided where possible. In the absence of such analysis, there is a risk that the allowance for depreciation will include inefficient additional costs related to poor management of this project.

Failing an internal and thorough analysis of this cost to Synergy, the ERA should use an industry (National Electricity Market included) wide benchmark figure as an efficient depreciation cost for this purpose.

Cross Subsidy between Customer Tranches

The ERA has highlighted the need to ensure that there is no cross-subsidy between tariff groups, or between the electricity retailing business and the gas retailing business. This is particularly important given that some tranches of customers are open to competition and others are not. If the non-competitive segment of the market is subsidising the competitive segment of the market (i.e. a lesser proportion of costs is allocated to the competitive segment than is actually incurred in servicing that segment), then Synergy will be able to offer the competitive segment artificially lower prices than would otherwise be the case and competitors will be at an unfair disadvantage competing for these customers.

Additionally, Synergy may be receiving a higher than necessary CSO payment due to the perception of higher cost to supply the non-contestable market segment. It is therefore critical that cost allocation is performed accurately and objectively.

In Section 4.7 of the Draft Report, the ERA notes that the customers consuming more than 50MWh per annum are likely to have higher costs to serve than customers consuming less than 50MWh per annum. It then acknowledges that the cost to serve for the whole group of customers consuming less than 160MWh per annum (comprising both contestable and non-contestable customer segments) is $81.50 per annum per customer and proposes to apply this rate to all customers consuming less than 160MWh per annum.

Cost to serve should be determined separately for the segment of customers consuming less than 50MWh per annum (i.e. the non-contestable customer segment). To be consistent with the comment on cost to serve between those above and those below 50MWh, the ERA should assign a discount of 10-20% to the $81.50 cost to be associated with those below 50MWh.

Non Controllable Costs

Perth Energy supports the view that non-controllable costs be passed through to end use customers. The exception to this is the Tariff Equalisation Contribution, which is commented on further below. However, it will be important to ensure that costs that are allowed to be passed through directly to end use customers are indeed non-controllable. For example, retailers may have some room for optimising the network charges component for their customers by ensuring they select the most appropriate network charge tariff for their customers.

Synergy should not be allowed to directly pass through inefficient network charges that are due to Synergy not selecting the most appropriate network tariff. This issue is likely to be more relevant for the larger customer segments where some flexibility exists with regard to choice of network tariff.

Retail Margin

Perth Energy considers that the ERA's assessment of the Retail Margin is appropriate.

Electricity Tariffs

A major purpose of establishing cost reflective tariffs in any energy market is to facilitate competition. The benefits of competition are well known and increasing retail competition is in general the preferred mechanism for bringing choice and efficient pricing options to energy consumers across most developed energy markets. Perth Energy believes that the ERA should place greater emphasis on FRC and highlight the benefits of FRC for end use consumers in its final report.

We are particularly concerned that the draft report appears to be linking the glide path to achieving cost reflective tariffs with Synergy's capacity to achieve an efficient cost base. We believe that the establishment of cost reflective tariffs and the subsequent establishment of FRC should not be delayed in order to ensure that Synergy has a competitive cost structure – a condition that is impossible to ascertain.

Delays of this nature are only likely to prolong any inefficient practices, ensure that taxpayers continue to support these inefficient practices and delay consumers receiving the benefits of a competitive retail market.

When considering an appropriate time to commence FRC, Perth Energy agrees that the establishment of cost reflective tariffs is required to ensure that new entrants are attracted to compete for the entire segment of currently non-contestable customers. However, this does not mean that further competition is not possible at present. Whilst some new entrant retailers may not be attracted to the market until retail tariffs increase to a level reflective of <u>their</u> cost of supply, Perth Energy sees significant opportunities in supplying customers who are currently non-contestable at the current tariff levels.

In our view, the last round of tariff increases, plus the earmarked increases in the next year by the Government, are sufficient to recover <u>our</u> cost of supply should we be allowed to compete in the sub-50MWh market.

Perth Energy would therefore welcome opening the remaining customer tranches below the current 50MWh per annum contestability threshold to competition as soon as possible. We do not see any reason whatsoever for the Government not to introduce FRC considering the pressure on cost of living being debated widely in the market.

We would propose that, in order to provide certainty of gain to consumers, the introduction of FRC should be accompanied by Government guarantee that currently non-contestable consumers would have the choice of staying with their Synergy tariff for as long as they would prefer or move to another supplier should they be offered a better deal.

Moreoever, within the first 3 years of FRC, consumers should be able to leave their current tariffs and then return to these tariffs at anytime, subject only to any escalation that had been granted for those tariffs by Government and the practical time frame for Western Power to switch customer accounts between retailers.

Such a move would provide those customers with the benefits of competition and prove up where the true cost reflective tariffs should be. If tariffs were still below costs for all then Synergy would have more evidence to request further tariff adjustment from the Government.

The ERA has highlighted in its draft report that issues of hardship should be dealt with through a separate, targeted measures, rather than through tariff discounts or cross subsidies. Perth Energy supports these comments.

Tariff Equalisation Contributions

Perth Energy understands that the Tariff Equalisation Contribution (TEC) component of the Western Power access tariffs are a result of the Government's policy to provide uniform electricity tariffs throughout the State. The TEC revenue is necessary to flow from SWIS based customers to customers outside the SWIS to make up for the difference between the costs of providing electricity outside the SWIS and the revenue generated from the tariffs charged to customers outside the SWIS.

We consider that the uniform tariff policy is a matter for Government. However, if the policy is to remain it should be implemented in a way that minimises distortions in the markets. In particular, the current explicit subsidy flowing from SWIS based customers to non-SWIS based customers unnecessarily distorts the network pricing signals for SWIS based customers, potentially leading to sub-optimal economic outcomes.

Instead, if the subsidy to non-SWIS customers were to be provided out of consolidated Treasury revenues, no such distortionary impact would take place for SWIS based customers.
We note that the ERA has made recommendations in its draft report that the TEC should be removed from network tariffs and provided directly to Horizon Power from consolidated revenue. Perth Energy supports these recommendations.

Conclusion – Full Retail Contestability

In reading the ERA report it is difficult for Perth Energy to draw any other conclusion than to say that the best way to know whether Synergy is operating efficiently is to introduce FRC.

In our view, efficiency has to mean technical efficiency – the operational efficiency focused on by the ERA in the report – and allocative efficiency, which requires Synergy to supply the quantity and quality of service desired by consumers. It is the second type of efficiency that only FRC could provide answer to. No amount of analysis would be able to do this.

All consumers in the SWIS are entitled to choice of supply. There is absolutely no rationale for denying non-contestable customers of choice simply because the Government does not know where the equilibrium price of electricity is. By definition, no-one would know this but the market. Let the market tell us where the appropriate tariffs should be. The sooner we do this the sooner consumers and taxpayers are spared the burden of inefficiencies.

We would be pleased to provide further details on this submission.

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KY CAO
MANAGING DIRECTOR