



Retail Operating Costs

A REPORT PREPARED FOR THE ECONOMIC REGULATION
AUTHORITY OF WESTERN AUSTRALIA

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1 Introduction

The Economic Regulation Authority (Authority) commenced on 11 July 2011 an inquiry into the efficiency of Synergy's costs and tariffs (Synergy Review). The Synergy Review was referred to the Authority under section 32(1) of the *Economic Regulation Authority Act 2003*, which provides for the Treasurer to refer to the Authority inquiries on matters relating to regulated industries.

1.1 ERA terms of reference

In accordance with the Treasurer's Terms of Reference, the Authority's task for the Synergy Review is to:

1. consider and develop findings on the:
 - a. efficiency of Synergy's operating and capital expenditure;
 - b. efficiency of Synergy's procurement of wholesale electricity; and
 - c. efficiency of Synergy's procurement of Renewable Energy Certificates.
2. determine the efficient cost-reflective level for each tariff under the By-Laws over the period 2012/13 to 2015/16, including:
 - a. developing recommendations regarding the number of regulated electricity tariffs, and whether any tariffs should be amalgamated; and
 - b. taking into account the competitive markets within which Synergy operates and the current operating subsidy arrangements when considering the cost-reflective level of each tariff;
3. develop a methodology to regularly re-determine the efficient cost-reflective level for each tariff and recommend a period for the review of the efficient cost-reflective level of tariffs;
4. consider whether regulated tariffs for contestable large business customers should be phased out, with reference to the competitive nature of this segment of the electricity market; and
5. if regulated, large contestable tariffs are to be phased out, provide recommendations on which tariffs should be phased out and over what timeframe.

1.2 Frontier Economics' engagement

Frontier Economics has been engaged by the Authority to provide advice on the Authority's first task; specifically, to investigate the efficiency of Synergy's retail operating costs for the period 2012/13 to 2015/16. Our advice to the Authority

includes an assessment of the efficient level of retail operating costs in Western Australia over this period.

There are a number of regulated tariffs in Western Australia, which apply to a range of different customers. For this reason, this report considers the efficient level of retail operating costs for a range of different customers.

1.2.1 About this report

This report sets out Frontier Economics' advice to the Authority on the retail operating costs that a retailer in Western Australia would incur in retailing to customers on regulated tariffs over the period from 2012/13 to 2015/16. Benchmarking against other regulatory decisions and assessment of actual cost data are used to determine an efficient retailer's cost. Retail operating costs are estimated separately for tariffs that are primarily contestable and tariffs that are primarily non-contestable, because the evidence suggests that costs for these groups of customers are different.

This report is structured as follows:

- Section 2 provides a brief overview of retail operating costs and the methodology we have adopted to estimating retail operating costs
- Section 3 sets out our estimate of retail operating costs for non-contestable customers
- Section 4 sets out our estimate of retail operating costs for contestable customers.

2 Retail Operating Costs

To estimate retail operating costs, it is first necessary to consider the categories of cost that should be allowed for as retail operating costs in Western Australia. Retail operating costs are generally considered to consist of:

- billing and revenue collection costs;
- call centre costs;
- customer information costs;
- corporate overheads;
- energy trading costs;
- regulatory compliance costs; and
- marketing costs.

These costs reflect the activities that an efficient electricity retailer must undertake in supplying energy to its customers.

In addition, other costs – including depreciation, customer acquisition costs and FRC-related costs – are in some cases included in the allowance for retail operating costs in other jurisdictions. The treatment of these costs is discussed in the sections that follow.

This section provides a brief overview of our approach to estimating efficient retail operating costs.

2.1 Retail operating costs for different customers

The Terms of Reference for the Synergy Review require consideration of all tariffs regulated under the By Laws. The evidence suggests that retail operating costs will vary across different tariff classes. In order to estimate retail operating costs, therefore, it is necessary firstly to identify which groups of customers will have similar retail operating costs, and then to match these groups of customers to particular tariffs.

The evidence suggests that small customers – generally speaking, those customers that are below 160 MWh per annum – have similar retail operating costs. This is reflected in the available evidence from regulatory decisions in other jurisdictions.

For this reason, we will estimate a single allowance for retail operating costs for all non-contestable customers. We recommend that the estimate of efficient retail operating costs for non-contestable customers be incorporated into those tariffs for which a majority of customers are below the contestability threshold: our understanding is that this includes the A1, SmartPower, B1, C1, D1, K1, L1, R1,

W1 and Z1 tariffs. These tariffs represent a mix of residential, small business and charitable organisation tariffs.

Retail operating costs for contestable customers will be separately estimated. We recommend that the estimated efficient retail operating costs for contestable customers be incorporated into those tariffs for which a majority of customers are above the contestability threshold: our understanding is that this includes the L3, M1, R3, S1 and T1 tariffs.

This is the same approach that we used in our advice to the Office of Energy on retail operation costs during the Office of Energy's Electricity Retail Market Review.¹

2.2 Methodology

Frontier Economics' approach to this scope of work involves:

- an assessment of the actual retail operating costs reported and forecast by Synergy; and
- benchmarking retail operating costs against allowances in other regulatory decisions and against public information on these costs.

This approach is consistent with the approach adopted by other retailers in Australia, and is the same approach that we used in our advice to the Office of Energy on retail operation costs during the Office of Energy's Electricity Retail Market Review.

¹ Frontier Economics, *Electricity Retail Market Review – Electricity Tariffs*, Final Recommendations Prepared for the Western Australian Office of Energy, January 2009. Available at: <http://www.energy.wa.gov.au/cproot/1449/2/Frontier%20Tariff%20Report%20-%20Final%20-%20STC%20090109.pdf>

3 Costs for non-contestable customers

Consistent with the Terms of Reference for the Synergy Review, retail operating costs for non-contestable customers will be assessed on the basis of the costs that an efficient retailer would be expected to incur. This section provides our estimate of these efficient costs.

Given that non-contestable customers can only be supplied by the incumbent retailer, the initial focus will be the efficient costs that an incumbent retailer would incur. However, in the event that FRC is introduced, it is also important to consider whether new entrant retailers will be able to achieve similar retail operating costs for these small customers. This will also be addressed.

3.1 Methodology for determining retail operating costs

Regulators in other jurisdictions have tended to determine an appropriate allowance for retail operating costs using one or both of two approaches: an assessment of the actual retail operating costs of existing retailers; and benchmarking against allowances for retail operating costs in other regulatory decisions and against public information on these costs.

The relative weight given to these two approaches is driven, in part, by practical considerations. Where regulators have limited access to useful data on actual retail operating costs, or where there are concerns about the appropriate allocation of common retail operating costs, benchmarking is typically used as the basis for determining an appropriate allowance for retail operating costs.

Benchmarking is also used because it provides guidance on the efficient costs of retailing.² After all, regulators are typically concerned with providing an allowance for retail operating costs that reflects the costs that an efficient retailer would incur. These may not be the same as the actual costs of incumbent retailers. Benchmarking helps ensure that incumbent retailers are neither rewarded for inefficiency nor penalised for efficiency.

² See, for instance, ESCOSA, *2007 Review of Retail Electricity Price Path*, Draft Inquiry Report and Draft Price Determination, August 2007, page A-65:

The Commission observes that, in comparing an actual cost approach to a benchmarking approach, benchmarking is more likely to be consistent with the Commission's statutory objectives of promoting efficiency and providing incentives to reduce costs. The Commission therefore intends to place significant weight on its benchmarking analysis. It will have regard to the actual costs of AGL SA only to ensure that the results of the benchmarking produce sensible outcomes, or where benchmarking is itself not reliable (e.g. due to lack of data).

In estimating the retail operating costs for non-contestable customers, we consider evidence on actual costs in Western Australia, as well as benchmarks from other jurisdictions, assessed for relevance to Western Australia:

- Synergy provided, on a confidential basis, actual 2010/11 retail operating costs and forecasts for 2011/12 to 2015/16.
- Regulators in other jurisdictions in Australia regularly estimate retail operating costs for mass market customers for the purposes of retail price determinations.

3.2 Synergy's forecast retail operating costs

As part of the Synergy Review, the Authority has requested data from Synergy on historic and forecast retail operating costs. In the course of our assessment of efficient retail operating costs we have raised a number of questions with Synergy about their data. Through this process, Synergy has provided us with a number of revisions of their forecast retail operating costs. These revisions have resulted in material changes in Synergy's actual and forecast retail operating costs. By way of example:

- the initial data provided by Synergy reported the following for 2010/11:
 - total electricity operating costs of \$█ million per annum; and
 - operating costs of \$█ per average residential customer.
- the final data provided by Synergy reported the following for 2010/11:
 - total electricity operating costs of \$█ million per annum; and
 - operating costs of \$█ per average residential customer.

There were a number of intermediate revisions between the initial data and final data, each with different cost data. We understand that part of the reason for these revisions is that Synergy do not typically report retail operating costs in the form that was requested for the purpose of this review. While the remainder of this section provides an overview of the latest set of data provided by Synergy, the number of revisions to these forecasts does raise questions about the reliability of the data.

3.2.1 Total operating costs

Synergy has provided internal documents in relation to their actual total retail operating costs between 2006/07 and 2010/11 and their projected total retail operating costs between 2011/12 and 2015/16. These costs are set out in Table 1.

The forecast costs provided by Synergy were reported in nominal terms. We have adjusted these cost forecasts in order to report all costs in real 2010/11 dollars.

We have applied the mid-point of the Reserve Bank of Australia's inflation target of 2.5 percent. Note, however, that our advice on adjusting the allowance for retail operating costs during the regulatory period is set out in Section 3.6.

The difference between total operating costs and total electricity operating costs in Table 1 is accounted for by deductions for gas operating costs and for what Synergy refers to as miscellaneous revenue. These deductions are made from total operating costs to determine the amount to be recovered through electricity tariffs: total electricity operating costs.

It is clear from Synergy's cost data that these deductions are material to Synergy's estimate of retail operating costs for electricity customers. In particular, the substantial real increase in total electricity operating costs between 2010/11 and 2011/12 is not solely a result of projected increases in total operating costs. This is evident by the rate of increase in total operating costs, which is approximately 5 per cent, compared with the rate of increase in total electricity operating costs, which is approximately 12 per cent. Synergy's data reveals that the greater increase in total electricity operating costs over this period is driven in part by a decline of around \$[REDACTED] million in miscellaneous revenue offsets. Given the materiality of these miscellaneous revenue offsets, we have sought further clarification from Synergy as to what is accounted for by miscellaneous revenue. Synergy advised the decline in miscellaneous revenue is a result of a fall in account establishment fees, principally driven by a lower than expected take-up of the Renewable Energy Buyback Scheme and the discontinuation of the PowerWatch product.

Table 1: Synergy's total and electricity operating costs, actual and forecast (2010/11\$)

Financial year	Total operating costs* (\$m)	Percentage increase (year-on-year)	Total electricity operating costs (\$m)	Percentage increase (year-on-year)
2006/07 Actual	█			
2007/08 Actual	█	23.0%		
2008/09 Actual	█	5.0%		
2009/10 Actual	█	13.0%		
2010/11 Actual	█	0.5%	█	
2011/12 Forecast	█	5.3%	█	12.0%
2012/13 Forecast	█	-3.2%	█	-3.9%
2013/14 Forecast	█	0.6%	█	0.7%
2014/15 Forecast	█	1.3%	█	1.5%
2015/16 Forecast	█	0.9%	█	0.5%

Source: Synergy data, SY_n3451924_v4_ERA_Information_Request_Spreadsheet_Incl_Efficiency_Gains

* Total operating cost exclusive of depreciation, amortisation, interest and nomination fees. The total operating costs for the forecasted years includes an allocation of between \$4 and \$5 million for gas and includes miscellaneous revenues.

While a detailed audit of Synergy's costs is beyond the scope of this review, we note that Synergy forecast an increase in total operating costs and in total electricity operating costs over the regulatory period. Synergy's documentation emphasises the recent re-structure of the business as being a major cause for the overall increase in retail operating costs, as it has led to an increase in labour costs, which is a primary contributor to total operating costs. More specifically, Synergy report that total operating costs are projected to increase over the regulatory period in response to external and internal factors.

External factors

External factors include:

- An expected increase in customer complaints driven by tariff increases, which has increased call centre resourcing costs due to increased call volumes,

additional back office tasks resulting from more customer complaints, and increased compliance costs (for example, Ombudsman related costs).

- The implementation of new products and services as requested by Government, which impacts on labour resourcing.

In relation to these factors, we note that retailers in other jurisdictions are also subject to these costs pressures.

For instance, the tariff increases in Western Australia are not unusual in Australia. Retailers in other jurisdictions have also been operating in an environment in which retail electricity tariffs have been consistently increasing.

Similarly, retailers in other jurisdictions are also faced with introducing new products and services, including in relation to renewable energy offerings, new tariff structures and feed-in tariffs.

This suggests that these external factors are unlikely to provide reason to discount the use of benchmarked costs in Western Australia.

Internal factors

Internal factors include:

- Implementation issues of a new billing system which resulted in increased complaints and therefore additional call centre costs and compliance costs (again related to additional Ombudsman resourcing requirements).
- Strategic projects, including the business transformation restructure, in the second half of 2010/11. The restructure led to vacant positions being filled as newly created Departments stabilised to Business-as-Usual.
- The separation of IT functionality from Western Power and out-sourcing to an external service provider impacted IT costs.

Again, these internal factors are unlikely to provide reason to discount the use of benchmarked costs in Western Australia. For instance, an approximate benchmark to account for the impact of costs associated with business transformation and changes in retail market conditions is the QCA 2007 decision reported in Table 4. The QCA decision applied at a time of change in the Queensland retail energy market, immediately post the introduction of FRC in Queensland and the privatization of the Government's retail assets. These market changes in Queensland would be expected to have had a greater influence on business operating costs than Synergy's corporate restructure alone. The QCA decision reports a retail operating cost of \$77 per customer (in 2010/11\$), once adjusted for FRC related costs.

3.2.2 Total customer numbers

Synergy also provided information on total customer numbers. Table 2 shows Synergy's actual and projected non-contestable customer numbers for the regulatory period. Table 2 also shows Synergy's actual and projected total customer numbers (including both non-contestable and contestable customers).

Table 2 shows that Synergy is forecasting that the total number of non-contestable customers will grow at about 2.5 per cent per annum over the regulatory period. Since these customers have no choice of retailer, steady growth over the regulatory period would be expected.

Table 2: Actual and forecast customer numbers by tariff class (2010/11 to 2015/16)

Financial year	Residential (A1, SmartPower , B1)	Percentage increase (year-on- year)	SME (C1, D1, K1, L1, R1, W1, Z1)	Percentage increase (year-on- year)	Total (including contestable)	Percentage increase (year-on- year)
2010/11 Actual	874,195		90,872		979,168	
2011/12 Forecast	896,985	2.6%	90,977	0.1%	1,000,089	2.1%
2012/13 Forecast	920,032	2.6%	92,535	1.7%	1,024,996	2.5%
2013/14 Forecast	943,909	2.6%	94,434	2.1%	1,050,861	2.5%
2014/15 Forecast	967,416	2.5%	96,405	2.1%	1,076,472	2.4%
2015/16 Forecast	991,508	2.5%	98,480	2.2%	1,102,799	2.4%

3.2.3 Operating costs per customer

The allocation of the total electricity operating costs across these forecast customer numbers is the basis for Synergy's forecasts of retail operating costs per customer. Synergy has provided internal documents in relation to this allocation of total electricity operating costs to different categories of customers – including both contestable and non-contestable customers. Synergy's documentation reports that, under their allocation methodology, those costs that can be directly attributed to particular categories of customers are directly attributed to those customers. Costs that are common across customers are, for the most part, allocated to categories of customers based on the number of bill accounts.

In order to test this allocation methodology, and to verify Synergy's estimates of operating costs per customer, we requested detailed information on Synergy's

methodology for allocating total electricity operating costs to tariff classes. This information enabled us to review Synergy's allocation methodology and, more particularly, enabled us to investigate the link between total electricity operating costs and costs per customer.

We have reviewed Synergy's allocation process, investigating forecast retail operating costs, forecast customer numbers and the allocation of costs to customers to determine an operating cost per customer for each tariff.

Based on this review, we have concluded that Synergy's allocation of costs to customers is internally consistent. That is, we have verified that the costs per customer reported by Synergy would, if incorporated in regulated tariffs, result in Synergy recovering its forecast total electricity operating costs.

We have also concluded that Synergy's allocation methodology is reasonable. This is not to say that Synergy's allocation methodology is the only approach that could reasonably be adopted. For instance, we note that under Synergy's allocation methodology the majority of Synergy's retail costs are being allocated based on the number of bill accounts. As such, for a large number of cost centres that are identified as common (for instance, corporate overheads) a residential customer faces the same dollar cost as a large account managed customer. We note that under alternative allocation methodologies, such as allocating these common costs on the basis of energy consumption, residential customers would bear a lower proportion of total retail operating costs and contestable customers would bear a higher proportion. Given that the retail operating cost per residential customer derived using Synergy's allocation methodology is reasonably consistent with regulatory benchmarks (as discussed in more detail in Section 3.3) we consider that there is not a strong argument for pursuing alternative allocation methodologies.

Given Synergy's allocation methodology, Table 3 details Synergy's projected retail operating costs per customer for the regulatory period for non-contestable customers, along with actual costs in 2010/11 and the 2011/12 Energy Market Review Allowance.

Table 3: Average ROCs for regulated tariffs – residential and SME (2010/11\$)

Financial year	Customer class – A1, SmartPower, B1	Percentage increase (year-on-year)	Customer class – C1, D1, K1, L1, R1, W1, Z1	Percentage increase (year-on-year)
ERMR Allowance – 2011/12*	█		█	
Actual ROC – 2010/11	█		█	
Forecast ROC – 2011/12	█	6.1%	█	18.6%
Forecast ROC – 2012/13	█	-6.9%	█	-6.6%
Forecast ROC – 2013/14	█	-1.2%	█	-1.8%
Forecast ROC – 2014/15	█	-1.3%	█	0%
Forecast ROC – 2015/16	█	-1.3%	█	-1.8%

Sources: Synergy, 2011/12 Retail Operating Cost Review, December 2011; and SY_n3460955_v4_Retail Operating Costs_-_2010_11_Actual

* As reported by Synergy.

Synergy reports that, following their allocation methodology, actual retail operating costs for an average non-contestable customer in 2010/11 were:

- \$█ per customer for an average residential customer (in 2010/11 dollars)
- \$█ per customer for an average SME customer (in 2010/11 dollars).

Following a spike in 2011/12, driven by higher total electricity operating costs, they report that retail operating costs for an average non-contestable customer are forecast for 2012/13 at:

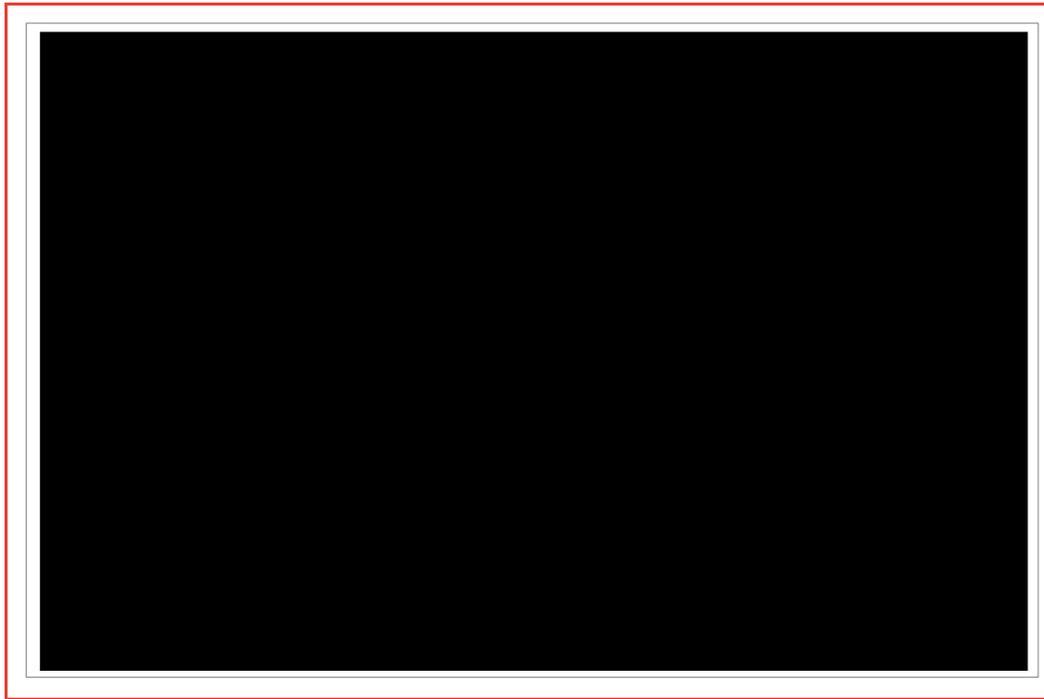
- \$█ per customer for an average residential customer (in 2010/11 dollars)
- \$█ per customer for an average SME customer (in 2010/11 dollars).

Subsequently, as seen in Table 3, retail operating costs per customer are forecast to decrease in real terms over the period to 2015/16.

To a large extent, the decreases in operating costs per average residential customer are driven by forecast customer numbers increasing at a greater rate than increases in total operating costs (and total electricity operating costs). This can be seen in Figure 1, which plots Synergy's historic and forecast total operating costs, forecast total electricity operating costs, and forecast average costs per non-contestable customer. Broadly speaking, the patterns of changes

over time in operating costs per customer are consistent with the patterns of changes in total electricity operating costs given forecast customer numbers. However, there are undoubtedly some differences in the trends.

Figure 1: Historic and projected total operating costs and forecast costs per non-contestable customer



Source: Synergy, 2011/12 Retail Operating Cost Review, December 2011; and SY_n3460955_v4_Retail Operating Costs_-_2010_11_Actual

3.3 Benchmarking against regulatory allowances

Table 4 provides an overview of the assessment of retail operating costs in regulatory decisions in other jurisdictions in Australia.

Table 4: Electricity retail operating costs in other regulatory decisions

<i>Decision</i>	<i>State</i>	<i>Regulatory period</i>	<i>Retail cost per customer (nominal \$)</i>	<i>Retail cost per customer (2010/11\$)</i>	<i>Comments</i>
IPART (2000)	NSW	Jan 2001 to Jun 2004	\$40 – \$60	\$54 – \$81	Based on actual retail costs of standard retailers and relevant benchmarks. Includes an allowance for FRC capital costs of \$5 per customer per annum. Does not include projected increases in marketing costs (above those incurred for a regulated service) because IPART determined that those are not appropriate for a regulated service.
ORG (2001)	VIC	2002	\$50 – \$80	\$65 – \$105	Based on actual retail costs and relevant benchmarks. Includes an allowance for FRC costs of \$5 – \$10 per customer per annum, which was consistent with cost forecasts provided by retailers. Includes only minor allowances for basic marketing, and no allowance for customer acquisition costs (since these are not necessary for customers on regulated tariffs). ORG noted that the potential for larger NSW retailers to access economies of scale may justify a greater allowance for retail costs in Victoria than in NSW.
IPART (2002)	NSW	Aug 2002 to Jun 2004	\$45 – \$75	\$61 – \$101	Based on actual retail costs of standard retailers and relevant benchmarks. This included an allowance for FRC costs, but the amount of FRC costs was not separately identified. This included depreciation costs, but did not include allowances for marketing and promotion.
SAIIR (2002)	SA	2003	\$80	\$101	Based on AGL's actual costs in South Australia and relevant benchmarks. Includes a \$10 per customer allowance for the costs of FRC. SAIIR noted that AGL SA is larger than any Victorian retailer and larger in aggregate than any other electricity company. SAIIR suggested that AGL SA's costs should therefore be lower.
CRA – Victoria (2002)	VIC	2003	\$90	\$114	CRA's cost allowance was based on Victorian retailers' reports of their retail costs for standing offer customers, as reported to ORG during its 2001 investigation of retail pricing.
ICRC (2003)	ACT	Jul 2003 to Jun 2006	\$85	\$107	Based on ActewAGL's actual costs and relevant benchmarks. Includes an allowance for the costs of FRC. ActewAGL claimed FRC costs of \$8.33 per customer, but the ICRC did not separately identify the amount for FRC costs. ICRC considered that diseconomies of scale justified an increased allowance for retail costs relative to Victoria and South Australia.

<i>Decision</i>	<i>State</i>	<i>Regulatory period</i>	<i>Retail cost per customer (nominal \$)</i>	<i>Retail cost per customer (2010/11\$)</i>	<i>Comments</i>
OTTER (2003)	TAS	Jan 2004 to Dec 2006	\$77	\$97	<p>Based on Aurora's actual costs and relevant benchmarks. Aurora reported actual costs of \$77 per customer (in June 2002 dollars).</p> <p>Does not include an allowance for the costs of FRC (as FRC had not been introduced in Tasmania). OTTER considered that only a small proportion of marketing expenses should be allowed, as the returns to these lie in the potential for increased sales.</p> <p>OTTER recognised the importance of economies of scale, but considered that Aurora should be able to achieve comparable costs to a retailer in SA or the ACT, and so adopted the amount from the ICRC's 2003 decision, less FRC costs of \$8.33 per customer.</p>
ESCOSA (2003)	SA	2004	\$82	\$102	ESCOSA considered that its analysis from 2002 remained relevant, but increased the \$80 allowance to reflect inflation.
CRA (2003)	VIC	Jan 2004 to Dec 2007	\$92	\$114	CRA considered that its analysis from 2002 remained relevant, but adjusted this by CPI-1 (to allow for some productivity gain).
ESC (2004)	VIC		\$85	\$105	In assessing net margins in its review of the effectiveness of retail competition in gas and electricity, ESC assumed that retail operating costs were \$85 per customer. This was based on work that the ESC had done for its investigation of retail tariff amendments in December 2003.
IPART (2004)	NSW	Jul 2004 to Jun 2007	\$70	\$86	<p>IPART based its allowance on actual retail operating costs provided by retailers. IPART noted that these estimates were lower than retail operating costs allowed for in other jurisdictions, but considered that the use of higher benchmark costs is inconsistent with determining efficient costs.</p> <p>Includes FRC costs, but there was no specific allowance made for FRC costs. IPART's consultants – NERA – noted that FRC costs continue to be reflected in operating costs such as IT or billing costs. Also includes depreciation costs.</p> <p>Retailers argued that retail costs per customer would increase with FRC as customers churned to other retailers. IPART did not allow for an increase in retail costs to reflect this.</p>

<i>Decision</i>	<i>State</i>	<i>Regulatory period</i>	<i>Retail cost per customer (nominal \$)</i>	<i>Retail cost per customer (2010/11\$)</i>	<i>Comments</i>
ESCOSA (2005)	NSW	Jan 2005 to Dec 2007	\$84	\$102	<p>Based on AGL's actual costs in South Australia and relevant benchmarks. ESCOSA undertook a review of AGL SA's retail costs and concluded that as the results of the cost audit were sufficiently similar to its previous benchmarking exercises there was no justification for replacing the benchmarked results.</p> <p>Includes costs associated with FRC, but excludes depreciation costs (which were considered as part of the retail margin).</p> <p>ESCOSA increased the \$82 allowance from its 2003 decision to reflect inflation. ESCOSA allowed a CPI+2% increase in the allowance for retail operating costs over the determination period, to accommodate increased costs per customer as more customers switched to market contracts.</p>
IPART (2007)	NSW	Jul 2007 to Jun 2010	\$75	\$86	<p>Based on actual retail costs of standard retailers and relevant benchmarks. NSW standard retailers' actual retail costs over the period 2002/03 to 2005/06 were in the range of \$64 to \$84 per customer (adjusted to July 2007 dollars).</p> <p>Does not include an explicit amount for FRC costs, but these continue to be reflected in operating costs. Does not include depreciation costs. IPART allowed a separate amount for recovery of customer acquisition costs (\$33 per customer).</p>
QCA (2007)	QLD	Jul 2007 to Jun 2008	\$78	\$87	<p>Based on relevant benchmarks.</p> <p>This included \$10 per customer for FRC costs. The QCA also separately allowed \$2 per customer for customer acquisition costs.</p> <p>Retail costs were assumed to increase by 3.9% between 2006/07 and 2007/08, reflecting increases in the wage index and the CPI, weighted according to a split of 60 per cent labour costs and 40 per cent other costs. No improvements in productivity.</p>
ICRC (2007)	ACT	Jul 2007 to Jun 2008	\$95	\$107	<p>Based on relevant benchmarks.</p> <p>The ICRC adopted an allowance equivalent to the inflation-adjusted allowance from its 2003 decision.</p> <p>Noting that its allowance is greater than the allowance set out in the draft determinations from IPART and the QCA, the ICRC commented that the recovery of similar fixed costs across a larger customer base could account for some of the difference.</p>

<i>Decision</i>	<i>State</i>	<i>Regulatory period</i>	<i>Retail cost per customer (nominal \$)</i>	<i>Retail cost per customer (2010/11\$)</i>	<i>Comments</i>
ESCOSA (2007)	SA	Jan 2008 to Dec 2010	\$97	\$108	<p>Allowance based on previous regulatory allowance of \$84, escalated at CPI+2% to 2008 dollars.</p> <p>ESCOSA noted that analysis of AGL SA's actual operating costs attributable to the standing contract retail business reveals that the allowance of \$97 is sufficient to cover all AGL SA's retail operating costs and the majority of customer acquisition costs.</p> <p>ESCOSA noted that AGL SA and other retailers are undertaking significant capital expenditure to improve retail operations, and that this will lower retail costs. ESCOSA considers that an efficient retailer would pass on some of these cost savings. Based on information provided by AGL SA, ESCOSA concluded that the allowance for retail operating costs should vary by CPI-4.1% over the regulatory period.</p>
OTTER (2007)	TAS	Jan 2008 to Jun 2010	\$85	\$98	<p>Based on Aurora's actual costs and relevant benchmarks. Aurora advised OTTER that its actual cost to serve in 2005/06 was \$106 per customer (adjusted to 2010/11 dollars), including depreciation.</p> <p>OTTER's allowance for retail costs excludes depreciation costs. OTTER considers that FRC costs are implicitly included, as they are in other jurisdictions. OTTER noted that costs of marketing and customer acquisition are not typically included in allowances for non-contestable customers.</p>
CRAI (2007)	VIC		\$75	\$86	<p>Based on relevant benchmarks, CRAI estimated that retail operating cost for electricity businesses in Victoria are \$75 per customer. This excluded any allowance for customer acquisition costs.</p>
QCA (2008, remade 2009)	QLD	Jul 2008 to Jun 2009	\$80.96		<p>Based on relevant benchmarks.</p> <p>This included FRC costs. The QCA also separately calculated customer acquisition costs of \$18 in 2008/09.</p> <p>Retail costs were assumed to increase by 3.65% between 2007/08 and 2008/09, reflecting increases in the wage index and the CPI, weighted according to a split of 60 per cent labour costs and 40 per cent other costs. No improvements in productivity.</p> <p>The June 2009 remade decision does not report a change in retail costs per customer but, does note a 3.99% change in operating costs between 2007/08 and 2008/09.</p>
WA OOE (2008)	WA	Jul 2008 to Jun 2012	\$75	\$81	<p>Based on actual and benchmark costs.</p> <p>No allowance for FRC and customer acquisition costs.</p>

<i>Decision</i>	<i>State</i>	<i>Regulatory period</i>	<i>Retail cost per customer (nominal \$)</i>	<i>Retail cost per customer (2010/11\$)</i>	<i>Comments</i>
QCA (2009)	QLD	Jul 2009 to Jun 2010	\$83.19	\$86	<p>Based on relevant benchmarks.</p> <p>This included FRC costs. The QCA also separately calculated customer acquisition costs.</p> <p>Retail costs were assumed to increase by 2.8% between 2008/09 and 2009/10, reflecting increases in the wage index and the CPI, weighted according to a split of 60 per cent labour costs and 40 per cent other costs. No improvements in productivity.</p>
QCA (2010)	QLD	Jul 2010 to Jun 2011	\$85.89	\$85.89	<p>Based on relevant benchmarks.</p> <p>This included FRC costs. The QCA also separately calculated customer acquisition costs.</p> <p>Retail costs were assumed to increase by 3.18% between 2009/10 and 2010/11, reflecting increases in the wage index and the CPI, weighted according to a split of 60 per cent labour costs and 40 per cent other costs. No improvements in productivity.</p>
IPART (2010)	NSW	Jul 2010 to Jun 2013	\$75.30	\$78	<p>Based on actual retail costs of standard retailers.</p> <p>Excludes customer acquisition costs of \$36.80. An additional \$2.30 per customer was deducted from the total retail operating cost allowance for double counting of late payments fees. No separate FRC costs were provided for, but these are reflected in retail operating costs. Depreciation was not accounted for, but included in the retail margin.</p>
ICRC (2010)	ACT	Jul 2010 to Jun 2012	\$104	\$104	<p>Based on relevant benchmarks.</p> <p>The ICRC adopted an allowance equivalent to the inflation-adjusted allowance from its 2007 decision. CPI was estimated at 1.82% from 2009-10 to 2010-11.</p> <p>The retail operating cost estimate includes FRC costs of \$10.57 per customer. No allowance was made for customer acquisition costs.</p> <p>Noting that its allowance is greater than the allowance set out in the determinations from IPART and the QCA, the ICRC commented that the recovery of similar fixed costs across a larger customer base could account for some of the difference. Once adjusted for economics of scale, the ICRC considered its allowance for retail operating costs is consistent with those in other jurisdictions.</p>

<i>Decision</i>	<i>State</i>	<i>Regulatory period</i>	<i>Retail cost per customer (nominal \$)</i>	<i>Retail cost per customer (2010/11\$)</i>	<i>Comments</i>
OTTER (2010)	TAS	Jul 2010 to Jun 2013	\$94	\$94	Based on Aurora's actual costs and relevant benchmarks. Aurora sought \$105 per customer for 2010/11. OTTER's allowance for retail costs excludes depreciation costs, which are accounted for in the retail margin. OTTER considers that FRC costs are not appropriate as FRC is yet to be adopted in Tasmania. OTTER noted that costs of marketing and customer acquisition are not typically included in allowances for non-contestable customers.
ESCOSA (2010)	SA	Jan 2011 to Jun 2014	\$115	\$115	Based on AGL's actual costs in South Australia and relevant benchmarks. Customer acquisition costs are not explicitly provided for, but included in the retail operating cost estimate. ESCOSA's consultant, LECG, estimated retail operating costs at \$76.60 and separately estimated customer acquisition costs at \$41.90 per customer. Excludes \$12.55 per customer for the Renewable Energy Efficiency Scheme.
QCA (2011)	QLD	Jul 2011 to Jun 2012	\$88.83	\$85.71	Escalated benchmark approach applied since the 2007-08 decision. Retail operating costs estimated to increase by 3.43% based on increases in the wage index and the CPI, weighted according to a split of 60 per cent labour costs and 40 per cent other costs. No improvements in productivity. The retail operating cost estimate includes FRC-related costs. Excludes \$41.91 per customer for customer acquisition costs and a further \$1.16 per customer for regulatory fees.

Note: * IPART allowed \$75 per customer for retail operating costs and \$35 per customer for customer acquisition costs, but considered that there may be some double-counting and so reduced the total amount to \$105 per customer. Since customer acquisition costs are not appropriate for non-contestable customers in Western Australia, double-counting is not an issue.

In order that the benchmark values for retail operating costs set out in Table 4 provide guidance as to efficient retail operating costs for non-contestable customers in Western Australia, it is important to consider whether depreciation, customer acquisition costs and FRC-related costs have been included.

Depreciation

Depreciation costs can be included as a line item in retail costs, or as a component of the retail margin. For the purposes of this report, depreciation will be treated as a component of the retail margin.

The treatment of depreciation is important for the benchmarking exercise. Where depreciation is treated differently, the retail operating costs in Table 4 should not be directly compared.

For some of the determinations considered in Table 4, the treatment of depreciation is clear:

- IPART's earlier determinations explicitly include depreciation in retail operating costs;
- the most recent determinations by IPART and OTTER exclude depreciation from retail operating costs; and
- ESCOSA's determinations exclude depreciation from retail operating costs.

For other determinations the treatment of depreciation is unclear. Due to this uncertainty, the allowances for retail operating costs set out in Table 4 will not be adjusted to account for differences in the treatment of depreciation. However, it is important to recognise that those regulatory determinations that include depreciation as a line item in retail operating costs – including IPART's early determinations and likely including other determinations – overstate the retail operating costs that are relevant for this assessment.

An indication of the magnitude of this overstatement is provided in work undertaken for IPART's 2007 retail pricing determination. In advising IPART, Frontier Economics noted that the average cost of depreciation reported and forecast by the standard retailers in NSW over the period 2002/03 to 2009/10 was between \$8 per customer and \$9 per customer.³

Customer acquisition costs

Customer acquisition costs are incurred by retailers in competitive markets, with new entrants endeavouring to attract customers away from incumbents, and incumbents endeavouring both to retain existing customers and to attract new customers. Customer acquisition costs are primarily marketing costs (typically

³ Frontier Economics and SFG Consulting, *Mass market new entrant retail costs and retail margin*, Public Report prepared for the Independent Pricing and Regulatory Tribunal, March 2007.

direct marketing costs), but also include the costs of transferring customers between retailers.

In the past, customer acquisition costs were not explicitly included in regulatory allowances for retail operating costs (although some allowance was typically made for general marketing costs). This has changed, with IPART including an allowance for customer acquisition costs in its recent determinations, and the QCA and ESCOSA following suite in allowing for customer acquisition costs.

Importantly, retailers face customer acquisition costs only in competitive markets. Where markets have not been opened to competition, retailers do not face the same costs of marketing to customers or transferring customers. Clearly then, customer acquisition costs are not relevant to the retail operating costs for non-contestable customers in Western Australia.

In Table 4 the specific allowances for customer acquisition costs have been excluded from the retail operating cost allowances in IPART's 2007 and 2010 determinations and the QCA's 2007 and 2011 determinations. For ESCOSA's 2007 and 2011 determinations, in which customer acquisition costs were allowed, but the magnitude of these costs was not specified, no adjustment has been made. As a result, the retail operating cost allowance from ESCOSA's 2007 and 2011 determinations overstate the costs that are appropriate to Western Australia.

FRC-related costs

FRC-related costs are the additional capital and operating expenses that retailers face as a result of the introduction of FRC. Costs to retailers associated with FRC include project management costs, capital costs associated with updating retail systems and enabling retail interfaces, and additional operating costs.

While FRC has not yet been introduced in Western Australia, retailers in Western Australia may nevertheless be preparing their retailing systems for the introduction of FRC. While FRC-ready retailing systems may not be necessary at this stage, there are likely to be benefits to making these investments at this stage – in particular, while broader investments are being made to retailing systems to improve efficiency, it is likely to be less costly to also ensure that the retailing systems are FRC-ready.

Certainly there are some FRC-related retailing costs that incumbent retailers in Western Australia will not face at this time – in particular, the costs of transferring customers.

The result is that allowances for FRC-related costs in other jurisdictions will be in excess of the costs that incumbent retailers in Western Australia would face. However, since regulatory benchmarks do not separately identify the capital costs of FRC-ready retailing systems from the operating costs of transferring customers, we will not attempt to adjust retail operating costs in other

jurisdictions to remove allowances for FRC costs. The result is that regulator benchmarks from jurisdictions in which FRC-related costs are included are likely to overstate the retail operating costs of an efficient retailer in Western Australia to some extent. With allowances for FRC-related costs in the more recent determinations in the order of \$10 per customer per annum (including both the capital costs of preparing for FRC and the costs of transferring customers), the extent of this overstatement will not be too substantial.⁴

3.4 Relevance of benchmarks to Western Australia

An important part of benchmarking retail operating costs is considering the relevance to Western Australia of cost estimates from other jurisdictions. Section 3.2 addressed the question of the extent to which incumbent retailers in Western Australia face the same categories of retail operating costs as do retailers in other jurisdictions. This still leaves the question of the extent to which retail activities in other jurisdictions, and the costs of these activities, are similar to Western Australia.

Broadly speaking, retailing activities are similar across different jurisdictions. This accounts for the wide use of the benchmarking approach for determining an appropriate allowance for retail operating costs. Nevertheless, there can be differences between retailers in terms of the customers to whom they supply energy and the scale and scope of their activities. These differences may lead to differences in costs. There may also be differences in retail operating costs across jurisdictions if the costs of inputs into retailing vary across jurisdictions.

Scale of retailers

Regulatory decisions in other jurisdictions suggest that there are some economies of scale available in electricity retailing. With some retail operating costs being fixed,⁵ the average retail operating cost per customer is likely to fall as customer numbers increase.

Economies of scale available to retailers in other jurisdictions will be reflected in the retail operating costs allowed in pricing determinations in these jurisdictions. In benchmarking retail operating costs, therefore, consideration must be given to the scale of retailers in each jurisdiction. The available evidence suggests that an efficient incumbent in Western Australia, retailing to non-contestable customers,

⁴ See for example, ICRC (2010) and QCA (2007).

⁵ For example, in work undertaken for IPART's 2007 retail electricity pricing determination, Frontier Economics estimated that 75 per cent of retail operating costs are fixed costs. This was based on cost data provided by the standard retailers in NSW. Frontier Economics and SFG Consulting, *Mass market new entrant retail costs and retail margin, Public Report prepared for the Independent Pricing and Regulatory Tribunal*, March 2007, pages 8-9

would be able to achieve the same economies of scale as incumbent retailers in other jurisdictions.

First, it is clear that the retail market in Western Australia is sufficiently large that an incumbent retailer can operate at a comparable scale to retailers in other jurisdictions. Synergy currently supplies approximately one million small retail customers. This is comparable to the number of small retail customers supplied by the standard retailers in New South Wales (between approximately 600,000 and 1,000,000 in 2008/09) and the number of customers supplied by the incumbent retailers in Queensland prior to the introduction of FRC (PowerDirect had approximately 430,000 customers at the time of its sale to AGL, and Sun Retail had approximately 830,000 customers at the time of its sale to Origin Energy). In other jurisdictions, the number of customers supplied by retailers is significantly less: AGL SA supplies approximately 200,000 small retail customers on regulated tariffs in South Australia, Aurora Energy supplies approximately 270,000 small retail customers in Tasmania and ActewAGL supplies approximately 165,000 small retail customers in the ACT.⁶

Second, the evidence suggests that the average cost curve for retailing activities is quite flat over a wide range of customer numbers. For instance, evidence from NSW indicates that, despite differences in the scale of standard retailers, their actual retail operating costs per customer were similar.⁷ That the average cost curve is flat over a wide range of customer numbers is also supported by the entry and survival of smaller retailers operating, apparently profitably, for some time. In the NEM, for instance, several new entrant retailers are operating successfully at a scale below the incumbent retailers: Australian Power & Gas in 2009/10 reached 145,000 customers;⁸ Lumo Energy has reached over 400,000 customers⁹; Simply Energy has 300,000 customers; Red Energy 200,000

⁶ Retailers in the NEM increasingly supply customers in several jurisdictions, enabling them to increase their customer base beyond that achievable in any single jurisdiction. In particular, both AGL and Origin Energy have substantial customer numbers: AGL supplies approximately 1.9 million electricity customers and 1.4 million gas customers across the NEM, and Origin Energy supplies approximately 4.6 million electricity and gas customers across the NEM. This may enable these large retailers to achieve greater economies of scale in retailing than other retailers. However, there is little to suggest that any economies of scale achieved by retailers of the size of AGL and Origin have been reflected in regulatory decisions.

⁷ See, for example: IPART, *Regulated Retail Prices for Electricity to 2004*, Final Report, December 2000; IPART, *Mid-term Review of Regulated Retail Prices for Electricity to 2004*, June 2002; Frontier Economics and SFG Consulting, *Mass market new entrant retail costs and retail margin*, Public Report prepared for the Independent Pricing and Regulatory Tribunal, March 2007, pages 8-9.

⁸ Australian Power & Gas, FY 2010 Investor Presentation, 18 August 2010, page 3. Available from APG web site: <http://apk.live.irmau.com/IRM/Company/ShowPage.aspx/PDFs/1747-88890162/FY2010InvestorPresentation>

⁹ Lumo Energy (formerly Victoria Electricity, Queensland Electricity, NSW Electricity and South Australia Electricity) web site: <http://www.lumoenergy.com.au/about-us>

customers; and Momentum and Our Neighbourhood both have less than 100,000 customers.¹⁰ As has been recently noted by the QCA,

“smaller retailers may also gain the benefits of economies of scale that would naturally flow to a retailer with a larger customer base by outsourcing many back office functions to a third party. On this basis size may not be as important an issue as it might otherwise appear...”.¹¹

Scope of retailers

As well as economies of scale, there may be some economies of scope available to retailers in other jurisdictions. Economies of scope may be particularly relevant where retailers are able to provide their customers with dual-fuel offerings and thereby reduce the variable costs of retailing.

However, the available evidence suggests that regulatory benchmarks from other jurisdictions do not reflect economies of scope. This is because regulators have tended to base their cost estimates on stand-alone electricity retailers. For instance, in Queensland, the *Electricity Industry Act 1994* (as amended by the *Electricity and Other Legislation Amendment Act 2006*) requires that the allowance for retail costs is based on an efficient retail business that “is carried on separately from any other business”. In its report for the QCA, CRA International note that this is likely to result in a cost allowance that is in excess of the actual retail costs of the incumbent retailers in Queensland, which have retailing interests outside Queensland and are dual fuel retailers in Queensland.¹² More recently, as part of its new retail electricity pricing methodology, the QCA has proposed defining a representative retailer as an incumbent stand-alone business that retails across the NEM. In New South Wales, IPART’s final report on 2010-13 regulated retail prices aimed to establish the costs of an incumbent stand-alone retailer serving customers across the NEM.¹³

Synergy is also unlikely to benefit from economies of scope because it is subject to the gas market moratorium, which prevents it from supplying gas to customers that use less than 0.18 TJ/a of gas until the introduction of FRC in electricity.

In any case, economies of scope in retailing are unlikely to be substantial. Frontier Economics, in advising IPART on its 2007 retail price determination, noted that a dual fuel retailer might enjoy some economies that are not available to a stand-alone electricity retailer, but concluded that the available evidence

¹⁰ APG, FY 2010 Investor Presentation, 18 August 2010, page 7.

¹¹ QCA, *Draft Methodology Paper, Regulated Retail Electricity Prices 2012-13*, November 2011, page 13.

¹² CRA International, *Calculation of the Benchmark Retail Cost Index for 2006-07 and 2007-08*, Final Report, May 2007, page 42.

¹³ IPART, *Final report 2010-13*

indicated that these economies would be unlikely to have a material effect on costs.¹⁴

Costs in Western Australia

In past submissions to the Office of Energy (OOE) regarding its review of electricity tariffs as part of its 2008 Electricity Retail Market Review, some stakeholders raised the cost of labour in Western Australia as an issue that would affect retail operating costs in Western Australia. Certainly, labour costs are an important element of retail operating costs. In work on behalf of the QCA, CRA International estimated that labour costs account for up to 60 per cent of retail operating costs.¹⁵ Similarly, Synergy projects labour costs will account for 40 per cent of total operating costs over the regulatory period.¹⁶

In terms of the appropriateness of benchmarks from other jurisdictions, the relevant question is whether labour costs in Western Australia are comparable to labour costs in other jurisdictions. One indication of whether this is the case is provided by considering whether labour costs in Western Australia have recently increased relative to labour costs in other states to such an extent that there is reason to expect that retail operating costs would be higher in Western Australia than in other states. Certainly the focus of comments in response to the OOE's review back in 2008 tended to focus on increasing labour costs in Western Australia.

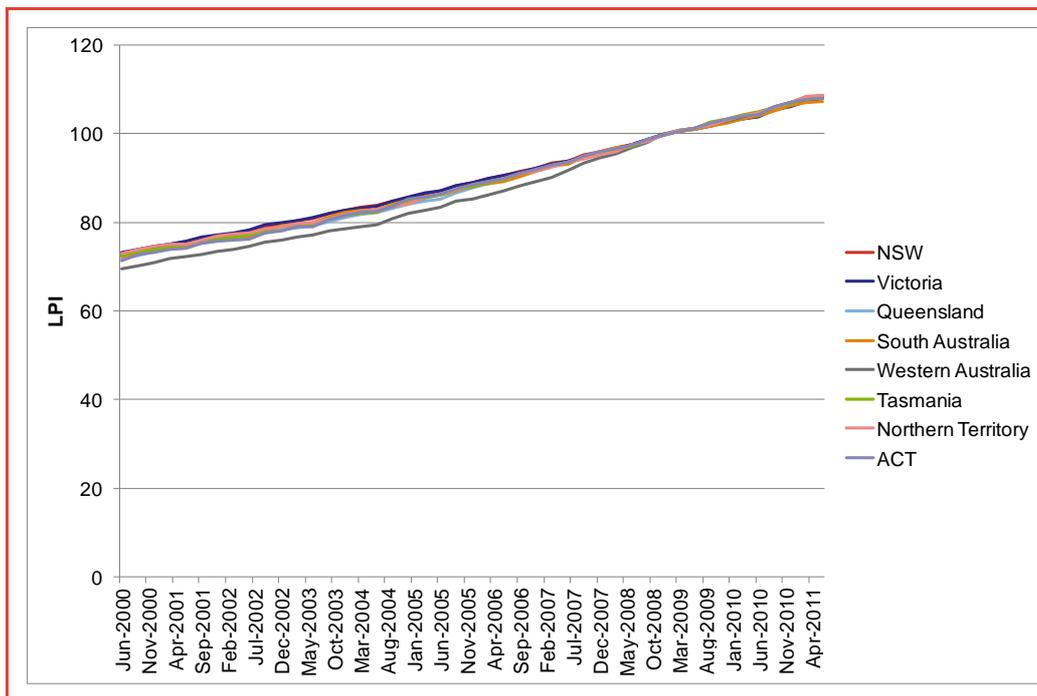
The labour price index reported by the ABS is illustrated in Figure 2 and provides a comparison of relative movements in labour costs in different states. Considering the period over which the regulatory benchmarks in Table 4 are drawn suggests that labour costs in Western Australia have not increased substantially more than labour costs in other states.

¹⁴ Frontier Economics and SFG Consulting, *Mass market new entrant retail costs and retail margin*, Public Report prepared for the Independent Pricing and Regulatory Tribunal, March 2007, pages 8-9.

¹⁵ CRA International, *Calculation of the Benchmark Retail Price Index for 2007/08 and 2008/09*, Draft Report prepared for the QCA, 24 January 2008.

¹⁶ Synergy data, SY_n3451924_v4_ERA_Information_Request_Spreadsheet_Incl_Efficiency_Gains2

Figure 2: ABS Labour Price Index, June 2000 to June 2011



Source: ABS, Labour Price Index, 6345.0, September Quarter 2011, table 2b (original, all industries).

The labour price index for total hourly rates of pay excluding bonuses increased by 56 per cent in Western Australia from June 2000 to June 2011.¹⁷ Over the same period, the index in other states increased by between 47 per cent and 51 per cent. This suggests that retail operating costs may have increased at a slightly faster rate over the period from 2000 to 2011 in Western Australia compared to other states, but a difference of less than one per cent in the rate of increase in labour prices over this period is not sufficiently large to suggest that benchmarks from other jurisdictions are inappropriate to Western Australia.

3.5 Retail operating costs of new entrants

While the focus in this report has been on the retail operating costs that an efficient incumbent would face in retailing to non-contestable customers, it is also important to consider whether a new mass market retailer would be able to achieve similar costs. In the event that FRC is introduced, new entrants will find it difficult to compete for customers if the regulated tariff is based on an allowance for retail operating costs that they cannot achieve.

¹⁷ ABS, *Labour Price Index*, 6345.0, September Quarter 2011, table 2b (original, all industries).

The principal issue in regard to the retail operating costs of new entrant retailers is whether they would have the scale to achieve retail operating costs that are comparable to those of the incumbent. The available evidence suggests that they would be able to do so.

New entrant retailers have been able to enter the retail markets in other jurisdictions without investing in systems that are as complex as the incumbent retailers' legacy systems. One strategy that smaller retailers have successfully adopted is to out-source key retailing functions and, in this way, avoid some of the fixed costs that incumbent retailers have traditionally incurred in developing customer information systems and billing and revenue systems. For instance, Australian Power & Gas reports that it out-sources to third-party service providers the following functions: sales, customer transfer and billing, and service and payment functions.¹⁸ Australia Power & Gas pays for these outsourced services on a per customer basis, meaning that these costs are variable rather than fixed.

That smaller new entrants are able to achieve cost levels comparable to incumbent retailers is indicated by the ability of smaller retailers to successfully compete with incumbents. As discussed in Section 3.4, several smaller new entrant retailers have been successfully operating in the NEM at a much smaller scale than the incumbent retailers: Australian Power & Gas has reached 145,000 customers; Lumo Energy has reached over 400,000 customers; Simply Energy has 300,000 customer; Red Energy 200,000 customers; and Momentum and Our Neighbourhood both have less than 100,000 customers.

This suggests that an allowance for retail operating costs that is based on the costs that an efficient incumbent would incur is likely to also be relevant for new entrant retailers in the event that FRC is introduced in Western Australia.

3.6 Conclusion on retail operating costs for non-contestable customers

Retail operating costs for 2012/13

Based on the benchmark decisions on retail operating costs set out in Table 4, we estimate that an efficient retailer in Western Australia would incur retail operating costs of \$78 per customer per annum in 2012/13 (in 2010/11 dollars) for non-contestable customers, both residential and SME. Frontier recommends that this amount be adopted as the allowance for both residential and SME customer

¹⁸ See Australian Power & Gas Investor Presentation, 5 December 2007. Available from Australian Power & Gas web site: <http://www.australianpowerandgas.com.au/index.cfm?s=5C8592F0-157E-DAE8-81305CC2A2D1CF85&m=E9442EC1-C2D1-AB8B-CECB10D32F6F4000>. Outsourcing business model also noted in APG's, Investor Presentation, 18 August 2010, page 8.

classes, consistent with the approach undertaken by other regulators. This estimate is considered the most reasonable estimate for the following reasons.

First, we consider that \$78 per customer per annum is a reasonable reflection of the most recent retail operating cost benchmarks from other regulatory decisions. As seen in Figure 3, the range across the benchmarks from 2010/11 is from \$78 per customer to \$115 per customer (including FRC costs), with an average of \$94 per customer. However, the benchmarks from the lower end of this range – from IPART and the QCA – are the more relevant benchmarks once adjusted for their inclusion of FRC costs:

- Allowances for FRC-related costs in the more recent determinations are in the order of \$10 per customer per annum. Once FRC costs are excluded from IPART's 2010 and QCA's 2011 estimates the range across the two benchmarks from 2010/11 is between \$68 and \$75 per customer.
- ESCOSA's estimate of \$115 per customer includes an amount for customer acquisition costs, which are not relevant in Western Australia.
- The estimates from the ICRC and OTTER reflect, in part, the smaller scale of retailers in these jurisdictions, with both regulators having explicitly recognised economies of scale as accounting for the higher costs in these jurisdictions. As discussed, an efficient retailer in Western Australia need not operate at this smaller scale.

As seen in Figure 3, the estimated retailer operating costs for an efficient retailer in Western Australia are slightly below the lower end of the range across these most recent benchmarks, reflecting the fact that retailers in these other jurisdictions face greater FRC costs.

Second, \$78 per customer per annum is within the range across all the benchmarks set out in Table 4. The range across all the benchmarks is from \$68 per customer to \$115 per customer, with an average of \$94 per customer. While \$78 per customer is significantly below the highest benchmarked costs, these higher benchmarks are of less relevance to Western Australia:

- CRA (2002 and 2003) acknowledged that its benchmarks for Victoria were adopted in the absence of other better information, and CRA (2007) subsequently revised downwards its benchmark for Victoria.
- Both the ICRC and OTTER acknowledge that their allowances for retail operating costs are higher than in other jurisdictions as a result of the relatively small scale of retailers in these jurisdictions.
- ESCOSA's (2010) estimate includes an amount for customer acquisition and retention costs. ESCOSA's consultant estimated retail operating costs would be approximately \$77 and separately estimated CARC at around \$42 per customer.

Third, the first three decisions in Table 4, IPART's 2000 and 2001 decisions and ORG's 2000 decision, are in some ways the most relevant for an efficient retailer in Western Australia. These decisions exclude marketing costs associated with competitive markets and costs associated with customer acquisition and retention, which should be appropriately excluded from efficient retail operating costs in Western Australia in the absence of FRC. A retail operating cost of \$78 per customer in 2010/11 dollars is consistent with the average across these three decisions of \$72 per customer (once adjusted for FRC related costs and excluding depreciation).

Fourth, estimates of efficient retail operating costs for Western Australia that have been provided by Synergy are broadly consistent with the view that \$78 per customer (in 2010/11\$) is an appropriate estimate of retail operating costs. Synergy's forecast costs for residential customers are initially a little higher than \$78 per customer, but fall over the regulatory period and end up at \$█ per customer by 2015/16. Taking account of the fact that Synergy's forecast costs for non-contestable business customers are higher than their forecast costs for non-contestable residential customers, Synergy's forecast costs remain a few dollars higher than the \$█ per customer benchmark when considered on an equivalent basis.

Finally, the limited market evidence that is available suggests that large efficient retailers are able to achieve operating costs lower than \$78 per customer. For instance, Origin Energy reported a cost to serve of \$63 per customer in 2009 (or \$66 per customer in 2010/11 dollars).¹⁹

¹⁹ Origin Energy Limited, 2010 Half year results, February 2010, page 45.

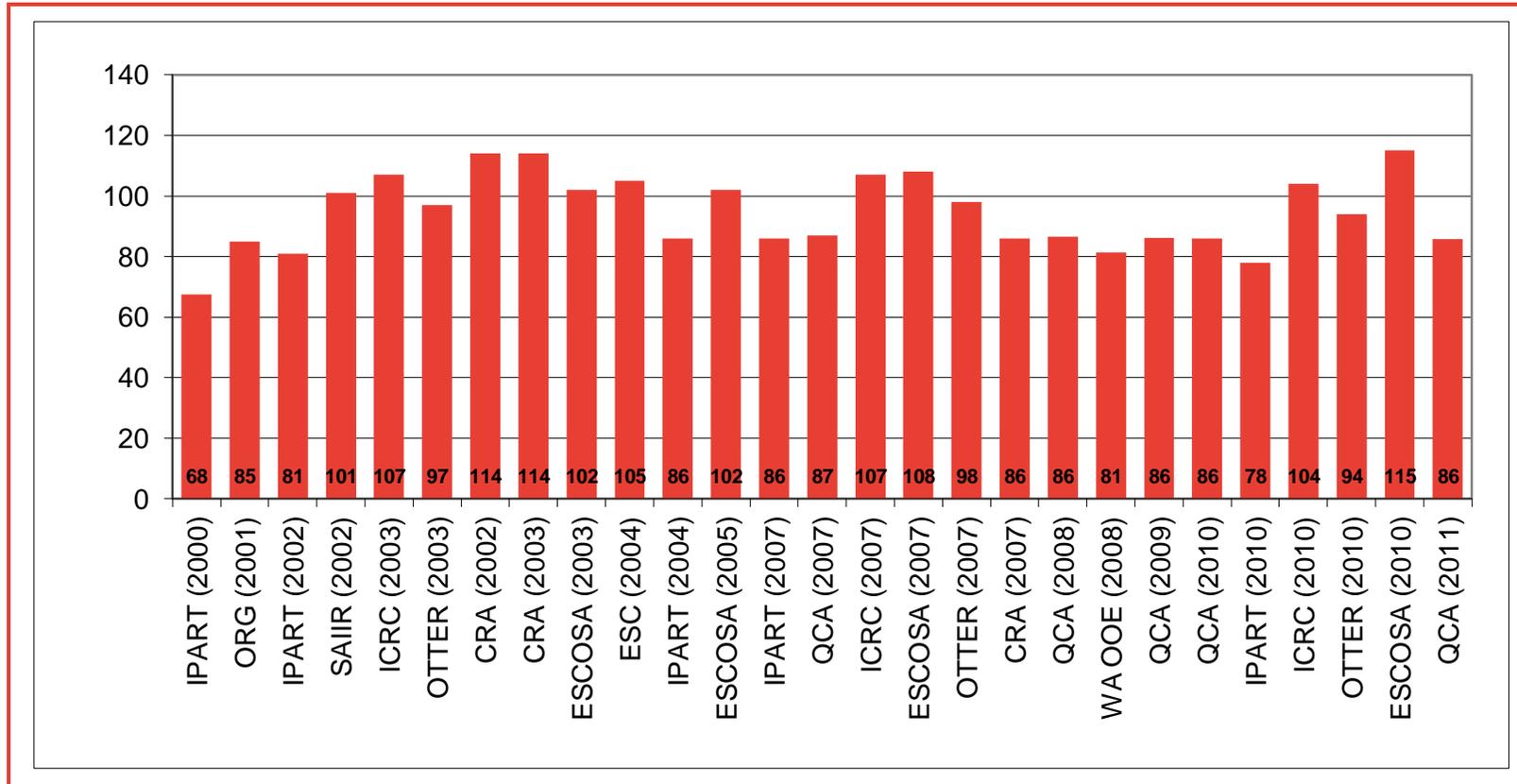


Figure 3: Retail operating cost benchmarks (\$/customer, 2010/11)

Retail operating costs over the regulatory period

Having formed the view that \$78 per customer per annum in 2012/13 (in 2010/11 dollars) is an appropriate allowance for retail operating costs for non-contestable regulated tariffs, it is also necessary to consider how retail operating costs are likely to change over the regulatory period.

The starting point for considering how retail operating costs are likely to change over the regulatory period is to consider how the costs of inputs into retail activities are likely to change. The major input into retail activities is labour: CRA International have estimated that 60 per cent of the cost of retail activities is accounted for by labour costs.²⁰ Similarly, Synergy projects labour costs will account for 40 per cent of total operating costs over the regulatory period.²¹ As labour costs change, therefore, retail operating costs will also change. Furthermore, since labour is the principal input into retail activities, the change in retail operating costs will more closely reflect changes in labour costs than changes in other cost indices. For this reason it is appropriate that the allowance for retail operating costs be adjusted each year over the regulatory period by the labour price index for total hourly rates of pay excluding bonuses in Western Australia. The use of the index for Western Australia will ensure that the allowance for retail operating costs more closely reflects changes in labour costs that retailers will face in Western Australia.

In considering how retail operating costs are likely to change over the regulatory period, it is also important to consider whether a retailer would be expected to achieve efficiency gains over the regulatory period. A retailer may become more efficient if there are expected to be changes in the technology of production over the regulatory period that would allow a reduction in costs. However, it is difficult to foresee what efficiency improvements would be available over the regulatory period that would enable a reduction in costs from the existing efficient benchmark of \$78 per customer per annum.

A retailer may become less efficient if it loses scale, so that its' cost per customer increases. However, as discussed above, the evidence suggests that the average cost curve for retailing activities is quite flat over a wide range of customer numbers, so that an efficient retailer is unlikely to face diseconomies of scale.

For these reasons, we consider that retail operating costs should not be adjusted over the regulatory period to reflect any changes in efficiency. This approach is the approach most commonly used in other jurisdictions.

²⁰ CRA International, *Calculation of the Benchmark Retail Price Index for 2007/08 and 2008/09*, Draft Report prepared for the QCA, 24 January 2008.

²¹ Synergy data, SY_n3451924_v4_ERA_Information_Request_Spreadsheet_Incl_Efficiency_Gains2

4 Costs for contestable customers

For the purposes of the Authority's determination, Frontier Economics is estimating retail operating costs for all classes of customers, not just small residential and business customers.

Determining an appropriate allowance for retail operating costs for contestable customers in Western Australia – which will be appropriate for the L3, M1, R3, S1 and T1 tariffs – is more difficult than determining an appropriate allowance for retail operating costs for non-contestable customers. The reason is simply that there is much more publicly available information available on the retailer operating cost for the mass market than there is for the retail operating costs of medium and large businesses. The regulatory benchmarks from other jurisdictions do not provide useful information because these deal only with the cost to serve small retail and business customers. There is also a lack of market information on retail operating costs for medium and large businesses.

Synergy provided information on retail operating costs per customer for contestable customers in two forms.

First, Synergy has provided a breakdown of their actual retail operating costs, allocated to different classes of customers (although not to different tariffs). The information provided by Synergy indicates that retail operating costs for an average contestable customer in 2010/11 was:

- approximately \$■■■ per customer for an average unmanaged business customer;
- approximately \$■■■ per customer for an average managed business customer; and
- approximately \$■■■ per customer for an average account managed customer.

Second, Synergy has provided actual and forecast retail operating costs, allocated to each contestable tariff class, for 2010/11 to 2015/16.²² As would be expected, these cost estimates are based on the same forecasts of total electricity operating costs, and the same allocation mechanism, as were used for forecasting retail operating costs for non-contestable customers (as discussed in Section 3.2). As discussed in Section 3.2, Frontier has been provided with a number of iterations of this data, with varying estimates of costs in each iteration.

²² Actual 2010/11 costs per customer are based on the most up-to-date information Frontier has on electricity operating costs reported in *SY_n3460955_v4_Retail Operating Costs - 2010_11_Actual*. Synergy has provided updated electricity operating costs but has not reported these across contestable tariff classes.

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Table 5: Average ROCs for regulated tariffs (2010/11\$)

Financial Year	L3	R3	M1	S1	T1
ERMR Allowance – 2011/12 *	█	█	█	█	█
Actual ROC – 2010/11	█	█	█	█	█
Forecast ROC – 2011/12	█	█	█	█	█
Forecast ROC – 2012/13	█	█	█	█	█
Forecast ROC – 2013/14	█	█	█	█	█
Forecast ROC – 2014/15	█	█	█	█	█
Forecast ROC – 2015/16	█	█	█	█	█

Source: Synergy, 2011/12 Retail Operating Cost Review, December 2011; and SY_n3485696_v1_Forecast_account_numbers_by_tariff_used_in_2011_12_Retail_Operating_Cost_review_(from_DM_344.xls)

Note: Actual 2010/11 costs per customer are based on the most up-to-date information Frontier has on electricity operating costs. Synergy has provided updated electricity operating costs for 2010/11, but has not reported these across contestable tariff classes.

* As reported by Synergy.

The information provided by Synergy indicates that actual retail operating costs for contestable customers in 2010/11 were:

- \$█ per customer for the L3 tariff (in 2010/11\$)
- \$█ per customer for the R3 tariff (in 2010/11\$)
- \$█ per customer for the M1 tariff (in 2010/11\$)
- \$█ per customer for the S1 tariff (in 2010/11\$)
- \$█ per customer for the T1 tariff (in 2010/11\$).

For 2012/13, Synergy forecast large increases in costs per customer across all of these tariffs. Forecast retail operating costs for 2012/13 are:

- \$█ per customer for the L3 tariff (in 2010/11\$)
- \$█ per customer for the R3 tariff (in 2010/11\$)
- \$█ per customer for the M1 tariff (in 2010/11\$)

- \$ [REDACTED] per customer for the S1 tariff (in 2010/11\$)
- \$ [REDACTED] per customer for the T1 tariff (in 2010/11\$).

These large increases in costs are not driven by forecast increases in total electricity operating costs (which increase only moderately between 2010/11 and 2012/13, as shown in Table 1) but forecast decreases in customer numbers. Synergy has provided information on forecast customer numbers for the regulatory period disaggregated across the tariff classes.

Table 6 shows Synergy's actual and forecast contestable customer numbers for the regulatory period. It is clear from Table 6 that Synergy is forecasting a substantial reduction in customer numbers between 2010/11 and 2011/12 for all contestable customer segments. Thereafter, Synergy is forecasting moderate growth in customer numbers across all contestable customer segments.

Table 6: Actual and forecast customer numbers by tariff class (2010/11 to 2015/16)

Financial year	L3	% increase (year-on-year)	R3	% increase (year-on-year)	M1	% increase (year-on-year)	S1	% increase (year-on-year)	T1	% increase (year-on-year)	Total (including contestable)	% increase (year-on-year)
2010/11 Actual	7,239		4,909		32		209		72		979,168	
2011/12 Forecast	6,226	-14.0%	4,222	-14.0%	28	-12.5%	180	-13.9%	62	-13.9%	1,000,089	2.1%
2012/13 Forecast	6,381	2.5%	4,327	2.5%	28	0.0%	184	2.2%	63	1.6%	1,024,996	2.5%
2013/14 Forecast	6,426	0.7%	4,358	0.7%	28	0.0%	186	1.1%	64	1.6%	1,050,861	2.5%
2014/15 Forecast	6,494	1.1%	4,404	1.1%	29	3.6%	187	0.5%	65	1.6%	1,076,472	2.4%
2015/16 Forecast	6,577	1.3%	4,460	1.3%	29	0.0%	190	1.6%	65	0.0%	1,102,799	2.4%

The forecast step reduction in contestable customer numbers is directly responsible for the forecast step increase in retail operating costs per customer for contestable customers. Figure 4 compares Synergy's real projected retail operating costs for the regulatory period for each contestable tariff class with Synergy's real projected total operating costs and total electricity operating costs. This figure shows that the forecast movements of retail operating costs per customer (for contestable tariff classes) are significantly different to the forecast movements in total operating costs and total electricity operating costs. This is particularly the case for the M1, S1 and T1 tariffs in 2011/12,²³ with increases of up to approximately 70 per cent forecast for 2011/12. In subsequent years, increases in forecast costs per customer are more consistent with forecast total operating costs and total electricity operating costs.

²³ T1 tariffs are not plotted in Figure 4 for presentational purposes due to problems of scale.

Figure 4: Historic and projected total operating costs and forecast costs per contestable customer (2010/11\$)



Source: Synergy, 2011/12 Retail Operating Cost Review, December 2011; and SY_n3460955_v4_Retail Operating Costs_-_2010_11_Actual; and SY_n3485696_v1_Forecast_account_numbers_by_tariff_used_in_2011_12_Retail_Operating_Cost_review_(from_DM_344.xls)

Note: T1 tariffs are not plotted for presentational purposes due to problems of scale. The T1 costs per customer are projected to increase substantially and their absence from the figure does not alter our findings.

Note: Actual 2010/11 costs per customer are based on the most up-to-date information Frontier has on electricity operating costs reported in SY_n3460955_v4_Retail Operating Costs_-_2010_11_Actual. Synergy has provided updated electricity operating costs but has not reported these across contestable tariff classes.

Unless all costs are fixed, it would be expected that a significant reduction in contestable customers would result in a reduction in some of the costs attributable to these customers. Clearly, given the significant forecast increases in costs per customer for contestable customers, Synergy is not expecting this to occur. In order to determine the efficiency of Synergy's forecasts, it would be necessary to undertake a detailed audit of Synergy's cost forecasts and Synergy's customer number forecasts. In particular, it would be necessary for this audit to establish the link between customer number forecasts and cost forecasts. Such an audit is beyond the scope of this review.

As a result, and because of the number of revisions of forecast data that Synergy have provided, it is difficult for us to recommend an efficient cost for contestable customers by relying on Synergy's forecast data.

As such, and given the lack of regulatory benchmarks or public information on retail costs for large customers, Frontier is of the view that allowances for retail operating costs from the Office of Energy's Electricity Retail Market Review provide the best guide to efficient retail operating costs for contestable customers.

In 2007/08, as part of Office of Energy's Electricity Retail Market Review, Synergy provided Frontier Economics with assumptions as to the new entrant retail operating costs for customers on particular tariffs. For the purposes of their tariff modelling, Synergy assumed that the retail operating costs for R3 customers was \$700 per customer (approximately \$760 per customer in 2010/11 dollars) and that the retail operating costs for S1 and T1 customers was \$2,000 per customer (approximately \$2,170 per customer in 2010/11 dollars).

Consequently, and in the absence of additional information, we recommend the following retail operating costs for contestable customers:

- For the L3, R3 and M1 tariffs, retail operating costs are estimated to be \$775 per customer in 2012/13 (in 2010/11 dollars). This reflects Synergy's estimates that the majority of customers on these tariffs are unmanaged business customers (for whom the actual cost in 2010/11 was \$■■■■), and is below Synergy's retail operating costs for managed business customers.
- For the S1 and T1 tariffs, retail operating costs are estimated to be \$2,212 per customer in 2012/13 (in 2010/11 dollars). This reflects Synergy's estimates that the majority of S1 customers are business managed (for whom the actual cost in 2010/11 was \$■■■■) and most T1 customers are account managed (for whom the actual cost in 2010/11 was \$■■■■).

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