Submission to the Economic Regulation Authority

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

Issues Paper released 11 August 2011

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synergy

Background

The Treasurer requested the Economic Regulation Authority to undertake an Inquiry into the Efficiency of Synergy's Costs and Electricity Tariffs ("the Inquiry"). The Inquiry's Terms of Reference and an Issues Paper prepared by the Economic Regulation Authority were released on 11 August 2011.

The Issues Paper requested interested parties to make submissions on ten specific questions. Submissions are due by 9 September 2011.

Synergy is pleased to participate in the Inquiry and will work cooperatively with the Economic Regulation Authority throughout .

In this spirit of cooperation, Synergy submits the following comments on the questions raised.

Submission

1. From the current list of uniform tariffs, which tariffs could be amalgamated and why? What are the benefits (if any) of having fewer uniform tariffs?

Response:

Synergy does not presently recommend the elimination or amalgamation of any of the current tariffs other than the B1, C1 and D1 tariffs.

The B1 Tariff is an off-peak water-heating tariff available to customers for residential water heating during a six-hour period between 11pm and 6am. The tariff dates back to the 1970s. The B1 tariff applies to approximately 550 customers with the vast majority also being supplied at the A1 tariff. A B1/A1 supply arrangement requires a two metered solution with the hot water supply being independently metered.

Given the very low number of B1 customers, its historical application and the fact that Synergy does not promote or continue to offer the tariff to new customers, it is recommended the B1 tariff be abolished. Existing customers would either be offered A1 or SmartPower.

The Office of Energy has previously proposed the abolition of the C1 and D1 charitable tariffs to be replaced with a direct government funded community service obligation (CSO) being paid to the charitable organisation. Supply to these customers would then occur under an existing tariff such as L1/L3 or R1/R3.

Synergy sees merit in this proposal. Removal of these tariffs would mean Synergy does not need to incur the cost of assessing and administering C1 and D1 tariff eligibility.

However if the Office of Energy requires Synergy to administer the charitable CSO arrangements (i.e. eligibility and payments) Synergy does not recommend the abolition of C1 and D1 tariffs as any operational benefits in removing the tariffs would likely be offset by the requirement to administer the new CSO arrangement.

2. Should the uniform tariffs, which are currently subsidised from cost-reflective levels, continue to be available for large, contestable business customers or should these be phased out? Please provide the reasoning behind your response?

Response:

Firstly, Synergy considers it is important that all tariffs available to contestable customers are set at cost reflective levels and include an appropriate margin. Once cost reflectivity with an appropriate margin is achieved, the competitive retail market will drive the offering of market-based contracts to these customers. This does not require the elimination of the tariffs.

It believed that contestable customers should still have the ongoing option to have access to a cost reflective tariff. In fact in other competitive energy markets that have reached a more advanced level of maturity than in Western Australia there is a static segment of customers that prefer to stay on a default tariff.

It should also be noted that the elimination of contestable tariffs and the movement of all customers to market-based contracts would require the installation of time-of-use meters at many of these customers' sites. This may be at a significant cost to the customer and would require the appropriate level of capability and resource from Western Power to successfully implement the necessary meter changes.

3. How should the efficiency of Synergy's wholesale energy procurement be assessed? What are the indicators of an efficient wholesale procurement process?

Response:

There are a range of factors and indicators that should be considered in assessing Synergy's efficiency in its wholesale procurement including:

- Synergy's long term forecast electricity requirements (energy, capacity and renewables) at the time of procurement;
- Demonstration of a competitive, open and fair tender/ selection process or, if not tendered, comparison against valid market benchmarks;
- The fit of any new contract against Synergy's existing supply portfolio (ie. impact of new contract on Synergy's supply portfolio costs);

- Legislative and other requirements at the time of procurement (in particular, Synergy's obligations under the Vesting Contract to displace certain amounts of capacity and associated energy using a tender process within certain timing constraints, during the period when a significant number of the contracts under review occurred);
- Due diligence undertaken by the Office of Energy and the Department of Treasury and Finance on behalf of the Minister for Energy, who in approving transactions assessed the efficiency and cost competitiveness of the arrangements; and
- Allocation of risks arising to Synergy or the independent power producer (eg. market risk, reliability risk, construction risk).

4. How should the efficiency of Synergy's procurement of renewable energy certificates be assessed? What are the indicators of an efficient procurement of renewable energy certificates?

Response:

There are a range of factors and indicators that should be considered in assessing Synergy's efficiency in its renewable energy certificates (REC) procurement including:

- The legislative framework existing at the time of procurement;
- The impact of various Commonwealth and State government policy setting on the short and long term price of RECs;
- The prudency of covering REC exposures with a range of long term, medium and short term procurement strategies;
- The need to hedge the impact of uncertain future carbon prices on REC prices over long-term REC contracts, by bundling of RECs with renewable energy (in markets in which Synergy participates ie. WEM). (Note: As carbon price rises, REC prices will decay towards carbon-inclusive long run marginal cost (LRMC) differential between non-renewable & renewable energy - the rate and extent of carbon price was and is uncertain.)

5. What information can be included in Synergy's submission to assist the Authority in determining efficient levels of operating and capital expenditure for Synergy?

Response:

5a) Efficient Operating Costs

Synergy believes that the most appropriate way to assess the efficiency of its operating costs (at least with respect to its small use [franchise] customers) is through comparative benchmarking against other energy retailers.

As there are no other WA electricity retailers operating in both the contestable and non contestable market, the only possible comparison would be against electricity retailers operating in other markets such as the National Energy Market (NEM).

Appropriate adjustments would need to be made to such benchmarks to account for the fact that Synergy has a significantly smaller customer base than the major electricity retailers operating in the NEM and therefore does not obtain the equivalent level of economies of scale which they can derive.

As a government trading enterprise Synergy is currently subject to a number of unique obligations that do not necessarily apply to other retailers. These include:

- Concessions management affecting approximately 250,000 or around 30% of residential customers;
- An obligation to purchase renewable energy under the Renewable Energy Buyback Scheme and administer the Scheme;
- Administration of the Feed in Tariff schemes applicable to 70,000 or around 9% of residential customers; and
- Regulated fees and charges of which a number do not allow for full recovery of the actual costs such as meter tests.

It is important that analysis of efficiency (including benchmarking) also makes allowances for legislative and other service standards. The number and level of service standards has a direct impact on operating and capital costs.

In addition, Synergy, as a “stand alone retailer” with no generation or network assets, cannot allocate overheads to integrated portions of its business as is available to the major retailers active in the NEM.

Finally, there are additional costs (IMO market costs, Energy Ombudsman costs and costs of complying with Retail License conditions etc) which must be covered which are not necessarily the case, or of a similar magnitude, for retailers operating in other markets.

5b) Efficient Capital Costs

It is noteworthy that as a stand alone retailer Synergy does not incur large amounts of ongoing capital expenditure.

Capital expenditure principally relates to the replacement and updating of IT systems, both software and hardware.

Synergy has recently incurred greater than normal capital investment in IT hardware following the separation from Western Power systems in July 2010 and in the development of a new customer information system. This is a once in ten year level of expenditure.

Planned capital expenditure in future years is at a significantly lower level, once these new systems have met market regulated and commercial compliant standards.

Synergy's view is that capital expenditure, like other investment, must be examined on its merit. As with operating expenses however, after making appropriate adjustments to account for the differences between Synergy and other electricity retailers, some level of "longer term" benchmarking should be used.

6. What issues and risks should be taken into account when determining an efficient retail margin for Synergy?

Response:

Synergy uses the net retail margin measure. This measures revenues minus energy purchase, network, and retail operating costs (but before accounting charges for finance costs, depreciation and bad debts).

The retail margin is required to compensate the retail business for the risks that the business faces. The greater the risk, the greater the margin required to ensure an adequate return on capital invested in the business. An efficient retail margin must compensate the retail business for at least the systematic risks that the business faces.

Non-systematic risks from foreseen but uncertain market and policy developments are normally allowed for through the cost allowance.

Systematic risks include:

- Volume risk - the risk of variation in the regulated load profile due to economic activity that affects the demand for electricity, i.e. the actual load profile or quantum of load is different to that assumed in setting regulated tariffs;
- Energy purchase risk - the risk of variation in wholesale spot and contract prices due to changes in economic conditions and demand such that actual energy purchase costs are different to those assumed in setting regulated tariffs;
- Market and "general" external business risks - from changes in global and WA economic conditions (interest rates, exchange rates, payment default, GFC etc).

Synergy is significantly exposed to volume risk through:

- Changes in its customers' energy usage;
- Contract and contestable tariff customers switching to competitor retailers; and

- Significant energy purchase risk in matching long term fixed supply contract prices to short term sales contract prices that fluctuate according to market demand levels.

The retail margin must provide sufficient return for a shareholder to invest long term in the business and support the business during a significant systematic risk event.

7. Do the current service standards against which Synergy has to report provide a comprehensive picture of its retail performance? If not, what additional service standards would be useful and why?

Response:

Synergy believes the current service standards are appropriate.

8. How often should cost-reflective tariffs be determined for Synergy (please explain the reasoning for any timeframe suggested)?

Response:

The frequency of tariff determinations should balance the requirements for:

- Certainty for customers and other industry participants with regard to future prices;
- Effective risk mitigation for Synergy and customers; and
- Administrative simplicity.

These requirements are potentially inconsistent. For example, fixed prices over a number of years will maximise certainty for customers (but potentially exposes customers to future price shock) and ease of administration, however such a regime would expose Synergy to significant risks related to unforseen cost increases that are not covered by the tariffs.

Similarly, any cost decreases over the determination period would not be reflected in lower tariffs, allowing Synergy to make a greater than anticipated return at the cost of tariff customers. Such cost changes could occur due to shifts in the market, policy or regulatory environment. If the tariffs also apply to contestable customers, variations between costs and tariffs could also limit the extent of competition for other retailers.

On the other hand, ongoing re-determination of the tariffs to ensure continuous cost-reflectivity would allow Synergy's regulated retail margin to be maintained and would promote competition as other retailers would be able to offer prices that are also in line with costs. This will significantly reduce certainty for customers and involve a substantial administrative burden.

These trade-offs are typically addressed in other jurisdictions by establishing base tariffs and the methodology on which they are set for a pre-defined period with reviews throughout the period to allow for changes in specifically defined circumstances. For example, the 2010 IPART tariff review[1] establishes a framework for a three year period with the retail operating cost allowance and the retail margin fixed throughout.

It also provides for annual reviews of the energy cost allowance (based on the maximum of Long Run Marginal Costs and market-based costs) using the same methodology as the base determination and allowing for changes in a limited and pre-defined subset of the input assumptions.

A special review will be undertaken for energy costs in 2012/13 to consider the impact of the carbon tax. Pass through mechanisms are also in place for the incremental, efficient costs associated with defined regulatory or taxation change events.

Synergy supports this approach as an effective means of addressing the requirements of all participants.

9. How should the new carbon price be included in the modelling of cost-reflective tariffs in this inquiry?

Response:

With the primary liability for a carbon tax placed on generators of electricity, as is proposed in the Federal Government's *Clean Energy Bill 2011*, the costs associated with it will be incurred by the generators and subsequently passed on to Synergy and other retailers in the form of higher energy costs.

The actual amounts will depend on a range of factors such as the level of carbon intensity, the fuel type, the operating efficiency etc with different generators facing different cost increases.

These can be included in the modelling of cost-reflective tariffs in the Inquiry by estimating the revised costs for the generators after the carbon tax is in place. In this way, the carbon tax, once it is in effect, will be reflected as a component of the total energy cost for supply to tariff customers and passed through in the same way as the other elements of energy cost.

Until the new arrangements are in place and current uncertainty regarding actual cost increases due to the carbon tax are resolved, cost-reflective tariffs set on this basis will by necessity be estimates only and will depend on the assumptions used in the modelling. Any variations between the actual and estimated results can then be considered in the reviews of energy costs discussed in Question 8.

[1] IPART, "Review of regulated retail tariffs and charges for electricity 2010-2013" March 2010

As noted IPART have allowed for a special review of energy costs to consider carbon costs after the legislation has been enacted.

10. Given the regulatory methodology outlined in this issues paper, are there any other issues for the Authority to consider in conducting this inquiry?

Response:

Synergy as a Western Australian government trading enterprise is subject to a number of service requirements or business constraints which are unique to it and do not apply to other retailers, some of which are detailed in section 5. It is therefore important the ERA recognises and takes into account these differences in a Western Australian context when seeking to determine efficient retail costs.

Provided the above matter is taken into account, the review methodology appears acceptable to Synergy. To the degree that any other issues are raised by other parties Synergy reserves the right to comment upon their appropriateness at a suitable time.