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13 September 2011

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

The Energy Supply Association of Australia (esaa) welcomes the opportunity to comment on the Economic Regulation Authority's (the Authority's) Inquiry into the Efficiency of Synergy's Costs and Electricity Tariffs Issues Paper.

esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of over 40 electricity and downstream natural gas businesses. These businesses own and operate more than $120 billion in assets, employ 52,000 people and contribute $16 billion directly to the nation's Gross Domestic Product.

esaa acknowledges the Authority's work, in accordance with a direction given by the Treasurer of Western Australia in July 2011, to undertake an inquiry into the efficiency of Synergy's costs and electricity tariffs. As outlined within the Issues Paper, this inquiry will address two critical inter-related matters. Firstly, it will consider and develop cost-reflective retail tariffs for Synergy. Secondly, it will establish a methodology to regularly re-determine the efficient cost-reflective level for each tariff over time.

Western Australia's energy sector has historically been subject to extensive government involvement and regulation. In 2009, the Office of Energy published a report which indicated that, at the time, regulated residential retail tariffs had not increased since 1997-98, thus allowing retail tariffs to fall significantly below the cost of supply. This issue effectively came to a head in the Verve Energy Review, where losses in the order of $454 million were estimated to have been incurred by Verve Energy over the period between 2006 and 2009.

Since this time, the Government has moved to raise electricity tariffs from 1997-98 levels. However, given the magnitude of the increase required, the transition to cost-reflectivity has not been immediate. As a result, electricity tariffs remain below the cost of supply – which is constantly increasing – with the Government funding the shortfall between electricity revenue and supply costs through the introduction of a 'tariff adjustment payment' in 2009-10 payable to Synergy. Notably, these payments are not limited to non-contestable residential and business customer tariffs, but also apply to business customer tariffs in contestable portions of the market, thus creating barriers to competition.

Furthermore, despite recognition of the importance of transitioning electricity tariffs to cost-reflective levels, Western Australia is the only state (excluding the Northern Territory) yet to establish and implement an independent price setting methodology for deriving cost-reflective retail tariffs. Instead, prices are determined largely on an ad hoc basis from year to year, giving the regulated retail sector no real certainty beyond a 12 month horizon.

esaa is firmly of the view that the most appropriate way to address the risks associated with non-cost-reflective tariffs is to establish full retail contestability (FRC) and remove retail price regulation. However, given the lack of cost-reflective prices or a transparent price-setting methodology as noted above, the Association acknowledges that a number of fundamental reforms must first be implemented to ensure that these broader objectives can be realised in the future. Accordingly, this submission provides comment on a number of reforms which should be considered in the context of facilitating a competitive and market driven retail sector over the long-term, namely: independent regulation, the importance of cost-reflective pricing and the development of a flexible price setting methodology; and the treatment of social policy objectives.

Independent regulation – Retail price regulation should be applied by an independent body such as the Authority, through a formal, transparent and consultative process

The independent application of retail price regulation creates a foundation upon which competition can be established in the future. In the event that contestability is permitted, independent regulation gives potential new market entrants confidence that the Government is committed to a market-based energy sector free from unwarranted government direction. Where this is not achieved, potential new market participants may be deterred from entering the retail market, thus stifling the evolution of competitive markets in the future.

Cost-reflective retail tariffs – Regulated prices should be cost-reflective and derived from a consistent and predictable price setting methodology.

Cost-reflective retail tariffs allow businesses operating within the retail sector to recover the costs of electricity supply, as well as an appropriate return on investment. Accordingly, where cost-reflectivity is achieved, appropriate market conditions should evolve such that potential new market entrants may welcome an opportunity to enter the retail market. Conversely, regulated retail tariffs set below the cost of supply inhibit full cost recovery, potentially compromising the financial viability of businesses operating within the retail sector, and by extension, the electricity supply industry. A prime example of this is the significant financial losses incurred by Verve Energy as a result of the originally imposed Vesting Contract arrangements between Verve Energy and Synergy and the suppression of electricity retail tariffs below cost.

Importantly, cost-reflective pricing is also critical in the context of providing efficient and transparent price signals. Price signals are powerful tools to shape behaviour and are a fundamental aspect of resource allocation in almost all aspects of the Australian economy. Price signals have the potential to improve the efficiency of the energy system, including improving system utilisation by providing signals for time of use consumption, informing rational decisions on energy efficiency or responding to emissions reductions through carbon pricing. Notably, where energy prices are set below cost, those users cannot be expected to make rational energy efficiency decisions as the information they have is distorted. More specifically, below-cost prices will lead to the levels of energy efficiency being too low.

The task of setting appropriate retail prices that are competitive but still allow retail businesses to meet their costs and manage risks is becoming increasingly complicated, largely as a result of uncertainty surrounding: rising fuel costs; the costs of meeting federal and state government policies that mandate more expensive forms of renewable energy; and the impacts of the Federal Government's recently announced Clean Energy Future package. While specific detail relating to the carbon price trajectory to be included in the package has been released, the direct impact of the carbon pricing policy on wholesale energy costs remains to be seen. Furthermore, it is likely that this uncertainty will be particularly acute until effective financial instruments to hedge carbon costs emerge.

esaa considers that the risks to the electricity market from the under recovery of the costs identified above far outweigh the risk of over recovery in a contestable electricity market. Accordingly, the Association considers that any price setting methodology considered by the Authority: should be sufficiently flexible such that any significant deviation in costs is able to be reflected in the level of regulated tariffs; and include an appropriate retail margin commensurate with the risks that a retail business faces. Furthermore, a mechanism allowing the cost of carbon to be passed on efficiently and promptly, during both the fixed price and subsequent floating price periods, should be implemented.

Social policy measures – Social welfare outcomes should be decoupled from energy prices

Access to energy is an important social objective. In the past, governments have tried to achieve social objectives with respect to energy by limiting the price of energy. However, as has been clearly demonstrated in Western Australia, this approach is self defeating as costs must ultimately be recovered. Holding energy prices to levels below cost is a very blunt measure that benefits all energy consumers receiving the discounted rate, even those that do not require assistance. Further, as discussed above, setting prices at artificially low levels prevents signals being used to create a more efficient energy system in general, creating a road block to any form of pricing reform.

The Association considers that a superior approach is to decouple social welfare outcomes from energy prices. This approach has two general steps. Firstly, energy prices should be transitioned to cost reflective levels in both the South West Interconnected System (SWIS) and North West Interconnect System (NWIS). This would necessitate the removal of the states Uniform Tariff Policy (UTP) and thus the need for:

- 'tariff equalisation payments' payable to Synergy and funded by the state Government; and

- ‘tariff equalisation contribution’ payments payable to Horizon Power and collected through network tariffs in the SWIS.

Secondly, to the extent that the ‘right’ prices that emerge from the operation of the market are considered beyond the capacity of certain consumers to pay, such consumers should be supported by purposely designed, budget funded measures. The Association understands that the Office of Energy is currently undertaking a Tariff and Concessions Framework Review and notes that this may provide a vehicle for addressing these matters further.

esaa supports the development of a fully competitive and financially viable retail sector. Accordingly, given the capacity of independent regulation and cost-reflective pricing to deliver these outcomes, the Association considers that the Inquiry has the potential to form the foundation of significant future reform.

If you require any further information in regard to this submission please contact Kieran Donoghue, kieran.donoghue@esaa.com.au or 03 9670 0188.

Yours sincerely

Clare Savage

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