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Australian Energy Markets Commission
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Sydney South NSW 1235

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Dear Commissioners

Best Practice Retail Price Regulation Methodology — Issues Paper

Thank you for the opportunity to comment on the Issues Paper of the above review. We first make some broad comments about price regulation in a competitive retail market. We then take the opportunity to comment on three of the discussion areas raised in the paper — proposed objective, proposed principles, and the determination of wholesale energy costs. We have not commented on the other topics raised in the paper.

Price regulation in a competitive market

Simply Energy's preference is for fully deregulated markets so that the market mechanism delivers a price that reflects the cost to produce and deliver energy and delivers ongoing investment to underpin customer reliability.

Where retail price regulation continues to exist, it is important for customer outcomes and the efficiency of market processes that the regulated price does not interfere with the signals being delivered by the market price. This means that the regulated price must be set well above the efficient market price so that the market price has room to move up and down beneath the regulated price in response to cost and competitive pressures.

Setting the regulated price above the efficient level also creates a strong incentive for customers who remain on the regulated rate to pay less by switching to an offer that reflects the market price. As more customers make this choice, the fewer in number are the customers that rely on the regulated price and setting a regulated price becomes less necessary.

We feel that the common mistake made with retail price regulation is to confuse the objectives of regulating retail prices with the objectives of regulating network prices. There seems to be a desire amongst regulators to set the regulated retail price equal to the efficient price. This is the correct approach for regulating monopoly network businesses where the customer does not have the choice of supplier and can thus be at risk of paying more than the efficient price over the long term.

Regulating prices in a competitive market such as energy retailing is different. The customer has a choice and can thus avoid paying too much by switching retailer. This choice disciplines the prices that retailers charge and drives prices toward cost without the need for regulatory intervention. The regulated retail price must not be allowed to interfere with this process otherwise inefficient outcomes emerge.

With these thoughts in mind, we now address some of the key issues raised in the paper.

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Proposed objective of the advice

We suggest that the proposed objective contains mutually exclusive propositions that cannot be reconciled.

The proposed objective states that:

> "… retail price regulation should determine electricity prices for small customers which:
> - reflect the efficient costs of providing retail electricity services, and
> - facilitate the development of competition in retail electricity markets where competition may be feasible."

There is an inherent conflict between these two dot points. Market prices will reflect efficient costs under workable competition. However, setting a regulated price equivalent to efficient costs and thus market prices (dot point 1) stifles competition (dot point 2) because the regulated price is set too low and directly competes with prevailing market prices. This has been the issue with regulated retail prices in Queensland where the regulated standing offer competes directly with market offers and stifles competition in that jurisdiction.

We suggest that it is not the job of regulated price caps to deliver the best that competition can offer. If that were the case competition would not occur. Energy prices should however gravitate to efficient levels through a workably competitive market.

Rather than determining an efficient price, a regulated retail rate should act as a "safety net" that protects those customers who are disinclined, or not sufficiently informed, to switch to a more competitive market offer, while at the same time providing the headroom that encourages competition from a broad range of retail competitors.

The desirable level of a regulated price must exceed current competitive and efficient levels to create headroom to compete. This means that the regulated rate should not reflect efficient costs and instead be set well above the market level.

Principles for the advice

We do not support Principles 1 (cost efficiency) and 2 (cost reflectivity) for the reasons outlined in response to the proposed objective. The regulated retail price should not be set equivalent to efficient costs nor be cost reflective. The market will ensure that the market price is equivalent to efficient costs. If the regulated retail price is also set at the efficient cost level then it competes directly with efficient market prices and there is no incentive for those customers still on the regulated tariff to enter the competitive market.

We agree with Principles 3 (transparency), 4 (open and consultative process), 5 (predictability and stability), 6 (minimising administrative burden) and 7 (appropriate risk allocation).

In relation to Principle 5, we believe there should be transparent triggers for re-opening a retail price path. Maintaining an established regulatory price path creates regulatory certainty about the future operating environment providing confidence to invest and grow our customer base in regulated markets.

Unanticipated actions taken to use retail price regulation as a proxy for the competitive market and make significant changes to the level of the regulated retail price mid-way through an established price path undermines investor confidence, has the effect of reducing competition and is not in the long term interests of customers.

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Wholesale energy costs

Effective competition is crucial to delivering long-term benefits to customers. However, customers will not enjoy the benefits of this competition unless retailers are given sufficient room underneath the regulated price to compete for customers.

As the largest determinant of the regulated retail price (outside of network costs which are the same across all retailers), the level at which the wholesale energy component is set will significantly influence whether retail competition occurs.

We have advocated for a methodology that determines the wholesale energy component using the higher of either long run marginal cost (LRMC) or the forward market contract price of wholesale electricity in each year of a regulatory period. We maintain that this approach offers a number of advantages that should be considered by the AEMC:

- The key advantage is that it ensures the regulated retail price is generally set at a level that provides for effective competition by allowing for a differential with the market offer rates available. This preserves an incentive for standing offer customers to enter the competitive market, and for competition to flourish.

- It provides a mechanism for the wholesale energy component to allow for increases in the forward contract market price. For example for situations where the supply and demand dynamics force market prices to rise above the LRMC for a time, using the higher of either the LRMC or the forward contract market price allows retailers to be able to offer tariffs which represent the true cost of hedging their load. In an environment where uncertainty over national climate change policies is affecting forward market liquidity, a hybrid approach may also be beneficial.

- Allowing headroom minimises the risk that the regulator has to re-open the retail determination to allow for increases in wholesale costs.

Ultimately, the aim of retail price regulation should be to remove customers' reliance on regulated tariffs by ensuring sufficient headroom for competition to develop and providing an incentive for customers still on the regulated tariff to enter the competitive market.

When retail competition was introduced, retail price regulation was used to protect customers while retail competition remained in its infancy. The price controls were considered transitional because the view was that competition provides the most efficient outcome and that competition once fully developed would ensure an acceptable level of customer price protection.

However, customers will be forever reliant on a regulated price if the headroom is not sufficient to allow retailers to offer customers an attractive proposition that encourages them to switch away from the regulated price.

If you would like to discuss this submission with me, please call (03) 8807 1132.

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