



## **ACT Electricity Consumer Advocates Training Project 2004**

Report - SESSION 3, 22 September 2004.  
'Retail Electricity Prices – Building Block Approach'

### **OVERVIEW**

Most of those attending the third NEMCAP session were familiar with the ICRC decision making processes and were particularly interested in the consumer interest in price setting. Recognition of electricity as an essential service was, at various times, quoted as something that should be in the pricing mix but which is presently lacking.

The second workshop was attended by:

Lyn Griggs – PhD student at Canberra University studying electricity pricing  
Peter Sutherland – Softlaw and ESCC  
David Tennant – Consumer Law Centre of the ACT and Care FC.  
Erika Steller – Conservation Council of the South East Region and Canberra  
Judy Waddington – ACTCOSS  
Ian McAuley – Canberra University

Dr John Logan from the Independent Competition and Regulatory Commission (ICRC) prepared a presentation on the pricing structure and the economic drivers of pricing (Attached). He was joined by Rod Woolley from the ICRC, who helped moderate a lively discussion on pricing mechanisms and consumer representation. Ian McAuley then provided an overview of competition policy and its application to energy markets in general.

### **ECONOMICS AND THE CONSUMER**

The forum quickly raised many issues about the formulaic nature of price setting in a regulated market and the interests of low income consumers. The idea was discussed that, in fact, competition theory (that competition delivers an efficient price for consumers) is in conflict with reality for low income households.

The group discussed the lack of consumer input into decisions and policy making, which stands in contrast to what happens in the UK and United States, which both have national consumer bodies to contribute to utilities debates.

While it was recognized that for most people, electricity costs accounted for 2% of household income, for low income households the proportion of income spent on power is much higher. Reference was made to the Powering Poverty report, recently released by the Western Region Energy Action Group in South Australia, the fuel poverty figures from Victoria and the ACT's own Poverty Task Group report that indicated low income households pay proportionately more of their income for fuel and energy than other members of the community.

Indexation of some pensions was also highlighted as a factor in increasing fuel poverty. Energy prices have risen more than CPI, which affects people whose income is tied to CPI, not average male weekly earnings.

The cost of disconnection was also discussed at length – for some low income households, disconnection cycles can happen two to three times a year, incurring crippling penalties on people already financially disadvantaged.

## **THE MARKET THE MARKET.....**

The issue of the role of regulators also developed into a lively discussion.

It was noted that the UK's OFGEM had recently commented on gearing and the propensity for companies to exaggerate their position to influence the rate of return. Later in the afternoon there was some discussion of the ability of businesses to "featherbed" their costs because of the capital intensive nature of the industry. This was seen as harder to do in labour intensive industries.

The ICRC felt this was not a huge problem in Canberra, but that public ownership of utilities had its own problems, including the potential for conflict of interest. For example, if a government owns a utility for which it also sets prices this can be conflicting.

The issue of research was raised, and the ICRC referred the group to the "Willingness to pay" survey done by ActewAGL in 2002, but released in March 2004. The ICRC was of the opinion that technology has driven the level of service delivery in the past, and that quality of service will be driven by competition. The point was made several times that no one competes for low income households.

There was also discussion that companies often deal with "squeaky wheel" issues above addressing systemic problems. The ICRC issues compliance reports every December which outline how utilities have met their requirements under the customer code. This mainly relates to repairs and outages.

The group had an in depth discussion on some of the finer detail of regulatory pricing, including calculating risk, and the issue of peak generation. There was also discussion of the mooted arrangements if we move to a national regulatory regime.

The discussion then turned to concessions and CSOs, which remain with the state/territory governments. This included the way that environmental goals would be achieved, which the ICRC felt should be the role of the environmental regulators.

There was, finally, some discussion on the issue of business versus residential pricing. In some markets the business sector pays a premium for electricity. Some issues of cross subsidization also arose. Most of the group felt that essential services should still be priced to allow all consumers access to reliable electricity at an affordable price.

The comparison was made to the water pricing regime in Canberra, where fixed costs have been lowered while there are now three tiers of pricing, reflecting increased water use.

The session wound up at 2pm.

## **ANALYSIS**

Again, there was a lot of enthusiastic discussion by the participants. Because most of the participants had some background in electricity regulation and pricing, the level of discussion was quite complex. The forum provided some areas of further exploration for ACTCOSS and its members to pursue opportunities to provide consumer input into decision making processes.



**Electricity Consumer Advocates Training Project 2004**

**Session 3: 'Retail Electricity Prices – Building Block Approach'**

**September 22, 2004, 10am-2pm (incl. light lunch)**

**Canberra CIT Board Room**

**First level, CIT Function Centre, K Block**

**Constitution Avenue**

**REID ACT**

***Training Session Outline:***

- 1. What are "building blocks"? How do they form the retail price we pay for electricity? ICRC*
- 2. Contestability – the building block of the energy market? Ian McAuley.*

***12:15 Lunch.***

- 3. Canberra consumers and their influence on pricing decisions – ICRC, Karen Nicholson and Ian McAuley.*
- 4. Peak demand – when is it, and is it bad, good or neutral? Ian McAuley and ICRC.*

*Discussion:* Can retail contestability deliver better price outcomes for low income households, or people living with illness, disability or other forms of disadvantage?

Does the current method of determining maximum prices impose any burdens on consumers who are disadvantaged in the energy markets?

Energy cooperatives – what is the current state of play?

What will the NEM changes mean for consumers: single regulator – what model?

ACTCOSS encourages participants to share information during the forum, so please feel free to raise any concerns or issues with the group.

***October session: "Non-Price Outcomes" – Consumer protection and hardship issues. Please note there has been a change of date to Monday, 25 October due to clash within ACOSS Congress: The session still runs from 10-2, at the CIT Board Room.***

Further details: Karen Nicholson [karen@actcoss.org.au](mailto:karen@actcoss.org.au) or 6202 7222.  
Please let me now if you have any special requirements, including dietary.

## **Regulating Price and Competition in the Energy Market**

**Dr John Logan & Rod Woolley**

### **Independent Competition and Regulatory Commission Energy Risk and Trading**

- Effective, healthy markets
- Reality of risk in the energy market
- Acceptance of this reality to maximise expectations of all parties

#### **Regulating Prices**

- Competition produces the most efficient price for consumers while providing an appropriate balance between risk and reward for producers/suppliers
- Monopoly/near monopoly markets create need for regulatory intervention
- Regulator must then seek to ensure appropriate risk/reward balance

#### **Price Determination Principles**

- Recovery of efficient cost and prudent capital expenditure
- Appropriate return OF capital (depreciation)
- Appropriate return ON capital
- Recognition of possibility of 'unforeseen events'
- Regulatory certainty in reset principles and practice

#### **Recovery of Operating Costs**

- Efficient costs – whose, when and where?
- Operating requirements – consumer 'willingness to pay' studies
- Maintenance costs – short term gains at long term pain
- Beat the target

#### **Return on Investment (1)**

- Use of CAPM to generate WACC – other options
- Some degree of commonality in selection of values
- Private debt margin
- Equity/debt issuance costs – in WACC or opex component

## **Return on Investment (2)**

- Generation of equity beta – greater than 1? or as low as 0.7?
- Tax rate as a component of CAPM or opex item
  - legislated or effective rate
  - change from one period to another
  - longer term implications

## **Attracting Investment**

- Appropriate rate of return
- Length of the price path
- Structure of regulated prices

## **Investment: Rate of Return**

- Use of an average rate of return to determine price
- Use of specific rates of return to reflect 'riskiness' of the investment

## **Investment: Price Path Length**

- Price path typically five years
- Long life nature of typical energy sector asset
- Financing arrangements and facilitating periodic price/WACC resets
- Settling a 'long term' price path as a 'guarantee' for new investment
- Increasing the WACC on new investment to reflect added risk

## **Investment: Structure of Prices**

- Certain forms of price regulation can limit signals for new investment
- Recovery of new investment costs direct from customers who benefit
  - surcharge costs for certain groups of customers
- Additional revenue from demand growth being captured by business

## **Regulating Competition**

- Energy policy decisions
- Adoption of 'standard' market structures
  - are these still relevant?

- Reform is a gradual, progressive and ongoing process
  - need to match expectations with reality

### **Regulator's Role**

- Policy makers set the parameters
- Regulators actions to be in accord with policy objectives
  - licence conditions and compliance
  - apply the market operation rules
  - administration of enforcement systems
  - wider Trade Practices legislation enforcement

### **Regulator's Role: Ringfencing**

- Setting the ringfencing requirements
- Softening of vertical integration rules may increase the need for ringfencing enforcement
- Interjurisdictional variations

### **Regulator's Role: Licensing and Compliance**

- Licence conditions and requirements
  - gaining a licence
- Enforcement of licence conditions
  - public accountability versus privileged information

### **Regulator's Role: Adequacy of Competition**

- Potential for regulatory intervention
  - what is an effective market?
- Opening of a market to competition
  - balance of benefits and costs
  - internal economy transfer versus economy benefits and costs
  - social/environmental costs/benefits

### **Conclusions**

- Focus upon energy risk and trading
  - risks of price volatility, inadequate market design, uncertain investment

- environment and regulatory practice
- focus on practical application of price control and features of the regulated market

### **Three Main Takeaways (1)**

- Risk is inherent in any market
  - Danger is that through market intervention this risk may be increased
- Regulators are risk adverse
  - No thanks for cheap energy when the lights go out

### **Three Main Takeaways (2)**

- Current market design and regulatory practices may overly focus on the short term
  - at the expense of the long term

### **Australian Energy Regulator**

- Advent of AER and Australian Energy Market Commission may help to redress this problem
  - however, market itself focuses on short term returns to investors
  - ongoing reform is needed to address this significant risk for Australia



## ACT Electricity Advocacy Training

### ACTEWAGL MEDIA RELEASE ON "WILLINGNESSTO PAY" RESEARCH

#### Media release

Wednesday 24 March 2004

#### Service versus lower prices: Canberrans want service

New research by NERA Economic Consulting has revealed that more than 90 per cent of Canberrans are satisfied with their electricity, natural gas, water and wastewater services, and do not want reduced service standards in return for lower prices.

ActewAGL and ACTEW Corporation commissioned the Willingness to Pay Research study in August 2002. Its two objectives were:

1. to measure residential and business customers' attitude towards the supply of electricity, natural gas, water and sewerage services by ActewAGL
2. to determine residential and business customers' willingness to pay for service - for instance, electricity reliability, water quality and dealing with queries - and the reliable delivery of electricity, natural gas, water and sewerage services.

ActewAGL Chief Executive Officer John Mackay said, "The findings clearly demonstrate that ActewAGL and ACTEW are in touch with the needs of the ACT community.

"Satisfaction levels for all four of our services were 'good or better' for 90 per cent of the 1440 customers interviewed as part of the study, and well over in some cases."

The results also show that residential customers would not prefer a lesser quality of service in return for a moderate discount in price.

Customers are willing to pay for existing service levels, and may indeed be willing to pay for higher levels of service and reliability of their electricity, water and sewerage services.

The research was prompted by an enquiry from the Independent Competition and Regulatory Commission about whether customers prefer lower service standards at lower prices, and if, as a result, utilities wastefully over-engineer their infrastructure thereby providing excessive service standards.

More than 1,500 residential and business customers participated in the 12-month project, which

## ACT Electricity Advocacy Training

included focus groups, face-to-face questioning, and computer-aided telephone interviews. Using stated preference choice modeling, an advanced market research technique, participants were offered a range of service standards and pricing options, and chose the option that would provide them with the greatest level of satisfaction as opposed to the next best alternative.

Two world-renowned experts in stated preference choice modeling, University of Sydney's Professor David Hensher and University of California's Doctor Ken Train, worked on the project. The study is acknowledged as being a pioneering exercise as nowhere else in the world has there been an examination of this nature involving electricity, natural gas, water and sewerage services at the one time in the one community.

ENDS

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