Submission No 43

INQUIRY INTO ELECTRICITY SUPPLY, DEMAND AND PRICES IN NEW SOUTH WALES

Organisation: Grattan Institute

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Energy markets: a mess with many causes. State governments can contribute to the fix.

Tony Wood, David Blowers, Grattan Institute response to the Select Committee into Electricity Supply, Demand and Prices in New South Wales

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There are no restrictions on publication of this submissions or requirements for anonymity. The submission contains no personal information of third party individuals.

Summary points

- Recent large increases in retail electricity prices have been driven by increasing generation costs driven by the increasing price and use of gas, tight supply in the market and, potentially, non-competitive behaviour by some generators.
- The increase in wholesale costs appears to have been offset by falling network costs. As a result, IPART finds that prices are now five per cent lower in real terms since price deregulation occurred. However, this analysis provides limited evidence of the impact of deregulation on retail prices.
- There is now far greater price dispersion in the market. Some consumers are now likely to be paying far more for electricity than they were under regulated prices. Some will be paying less.
- A range of recent reports from ourselves, John Thwaites, the AEMC and the ACCC question whether deregulation has delivered the outcomes that were envisaged. Evidence from these reports suggest that the retail component of the bill has increased since deregulation, contrary to expected outcomes.
- We are not aware of any evidence that there is collusion or explicit price gouging by retailers. Yet there are a range of characteristics of the existing retail market and retailer practices that mean consumers may end up paying far more for their electricity than they could.
- There are a series of reviews that are either underway or completed on electricity pricing. The Committee should consider the findings of these reviews in developing its own conclusions. The findings of the ACCC *Retail Electricity Pricing Inquiry,* due mid-2018, should be considered owing to the ACCC's unique powers of discovery.
- Recommendations from the Inquiry should be consistent with a national approach to energy and climate policy as agreed by the COAG Energy Council.

Introduction

This submission from Tony Wood of the Grattan Institute responds to the Terms of Reference released by the NSW Legislative Council's Select Committee Inquiry into Electricity Supply, Demand and Prices in New South Wales.

Grattan Institute is an independent think-tank focused on Australian domestic public policy. It aims to improve policy outcomes by engaging with both decision-makers and the community.

We understand that the Committee is seeking comment on the Terms of Reference of the Inquiry. In doing so, this submission focuses on those elements of the Terms of Reference where we have specific and relevant views and knowledge. Accordingly, we have not attempted to address all the matters raised in the Terms of Reference.

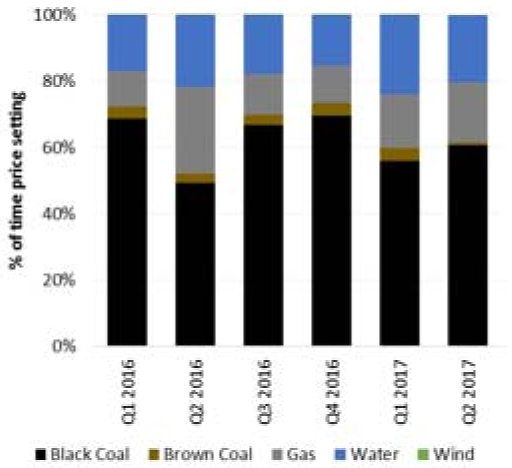
Specific Issues and Institutions

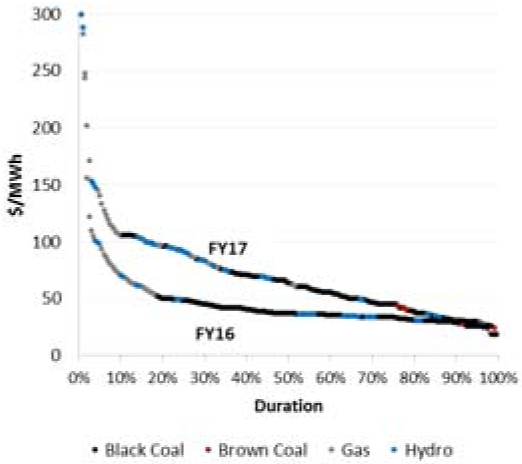
1.1 The reasons for recent large price increases in the price of electricity

On 17 October, the Independent Pricing and Regulatory Tribunal (IPART) reported in its review of retail electricity prices in NSW, an average 14% increase in electricity prices for residential customers in July this year. This increase offset recent decreases in network charges so that consumers are paying around the same price today as they were prior to retail price deregulation in 2014.

The July increases have been attributed to rapidly increasing wholesale costs, which in turn seem to have been driven by the shutdown or unavailability of coal-fired plant, higher gas prices and the bidding practices of generators.

Prices in the wholesale spot market are driven set by generators bidding and being dispatched by the Australian Energy Market Operator (AEMO). The price received for all generators is set by the marginal bidder for each dispatch period. According to AEMO as illustrated below, compared with FY2016, black coal played a similar price setting role in FY17, setting the price 63% of the time (-4% on FY16). In FY17, gas set the price 14% of the time and hydro 19% of the time, which was relatively steady compared to FY16. Overall, there was a shift upwards in the price curve, with all fuels setting the price at higher levels than in FY16.





There is considerable evidence that gas prices have moved up sharply in 2017. The shutdown of the Hazelwood power station in May, 2017 led to a sharp reduction in supply on the east coast and coal generators in NSW, notably Liddell, have been consistently operating below capacity due to plant problems and coal availability to meet the emerging shortfalls. Finally, in response to reported anomalies in the bidding behaviour of black coal generators, the Federal Minister for Environment and Energy asked the Australian Energy Regulator (AER) to investigate behaviour that was adding $30 to $35 per megawatt hour to spot prices. Specifically, the AER has been asked to monitor behaviours that "may be detrimental to effective competition". The AER is expected to report back to the COAG Energy Council by November.

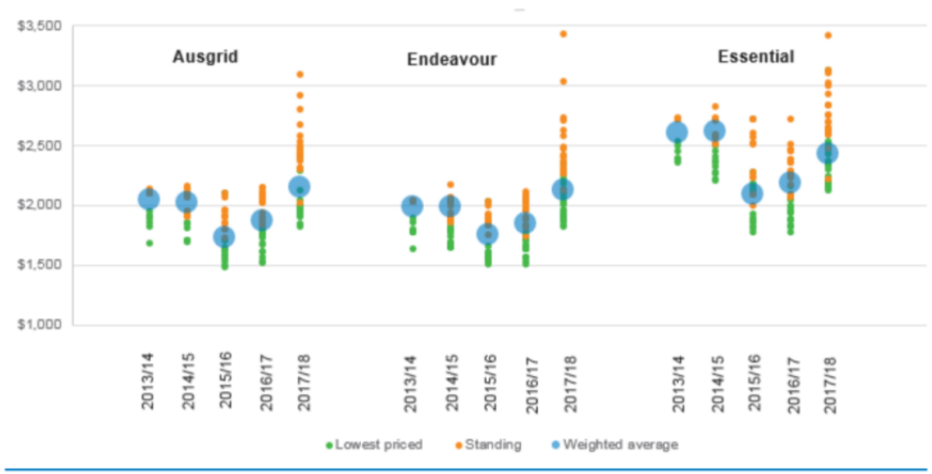
While there have been reports that the availability and the wholesale price of gas are improving, all three of the above factors could or should have been avoided or at least substantially mitigated by governments, regulatory bodies and the industry participants.

1.2 The impact of the deregulation of electricity prices in 2014

Retail electricity prices are deregulated to provide better outcomes for consumers than could be delivered by regulation. The recent draft report by IPART, *Review of the performance and competitiveness of the retail electricity market in NSW*, noted that prices had fallen by 5 per cent in real terms since 2013/14. This suggests that deregulation may have had an impact on prices, although falling network costs are, at least, partly responsible for this reduction in prices.

The findings of the IPART report should be treated with caution. Like many other studies into retail electricity prices, the IPART report suffers from not knowing exactly what prices customers are paying. IPART do a decent job in estimating the amount the average NSW consumer is paying, but this is by no means definitive. It is noticeable that price dispersion – the difference between the highest and lowest offers available in the market – has increased significantly since deregulation. The difference in annual bill for an average consumer appears to be more than $1000 between the lowest and highest offer in the market. Those on the highest offers will be paying a lot more for their electricity than they were in 2013/14.

Figure 4.2 **Spread of offers for residential customers (6,500 kWh, nominal, GST-inclusive)**

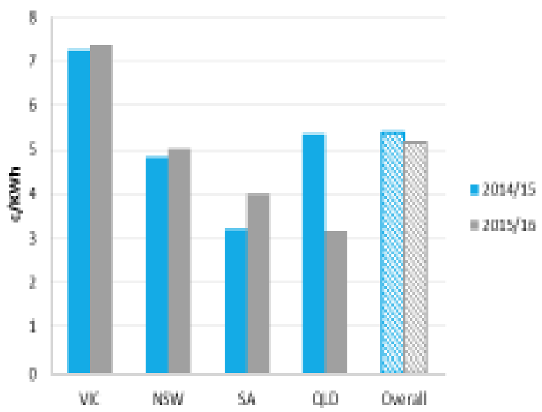


Data source: Information from retailers.

In our recent report, *Price shock: is the retailer electricity market failing consumers?* (https://grattan.edu.au/wp-content/uploads/2017/03/Price-shock-is-the-retail-market-failing-consumers.pdf), we concluded that retail electricity competition had delivered on neither lower prices nor greater innovation. We suggest that, given the competitors in NSW are largely the same companies, the market structure is similar as is the wholesale market, the situation in NSW is likely to be the same.

The AEMC's 2017 Retail Electricity Competition Review showed that (chart below) gross margins for the "Big 3" retailers increased between 2014/15 and 2015/16 in all states except Queensland where the prices were regulated. The ACCC *Retail Electricity Pricing Inquiry – Preliminary Report* found that the retail component of the average NSW residential bill had increased by $183 in real terms over the past decade. It should be noted that the ACCC report does not measure the change in retail component since price deregulation, although Victoria, which has had price deregulation the longest has also seen increases in its retail component of almost $140 over the same period. Again, these are hardly the outcomes that was expected from retail price deregulation.

Figure 2: Retailer data - average gross margins for Big 3 retailers by jurisdiction



1.3 Alleged collusion and price gouging by energy retailers

In our report referenced above, we did not find evidence or reach a conclusion that retailers were engaged in collusion or price gouging. We did find:

- Lower price deals are available, but most consumers find the market so complicated that they have given up trying to find them. Thus, many Australians, including some of the most vulnerable, are paying more than they need to.

- The way retailers advertise their discounts is confusing and possibly misleading. And even consumers who take advantage of discounts can end up paying much higher prices when their contract expires.
- Electricity is an essential service without substitutes, so many consumers feel stuck and simply give up.
- Competition has not yet delivered the promised innovation in customer service. Most offers provide a discount for people who switch their retailer, pay their bills on time, or pay via direct debit; but there has been little real innovation around the service itself. Retailers have been slow to build offers based on the benefits available through smart meters, or the bundling of solar-power and battery-storage systems. Instead they have super-charged their marketing costs for a commodity product that almost every consumer was going to buy anyway.

1.4 The effectiveness or impact of any current regulatory standards or guidelines

We have nothing to add to this topic.

1.5 Options for future government oversight and responsibility in any future re-regulation of electricity prices

We refer the Committee to the recommendations in the report referenced above, noting the more recent report chaired by John Thwaites that recommended an immediate and heavier intervention and the Preliminary Report of the ACCC into the retail energy markets that identified similar concerns but has not made recommendations. The Final Report is due in mid-2018.

1.6 The adequacy of planning to meet future electricity demand

In June, Australia's Chief Scientist, Alan Finkel, delivered his Blueprint for the Future to the COAG Energy Council, *Independent Review into the Future Security of the National Electricity Market.* This report signalled a need for a greater level of planning in the electricity system. We broadly supported the blueprint and its recommendations. In May, we released a report (https://grattan.edu.au/wp-content/uploads/2017/05/889-Powering-through.pdf) that sought to address weakness exposed by the state-wide blackout in South Australia and more recent incidents across the NEM through targeted reform.

We have been, and remain, committed to a view that well-regulated markets, acting through private sector investors and business owners and operators is the best way to deliver on the National Energy Objective. Restoring a level of planning needs to be done in a way that does not abandon this position.

While there is a role for governments to support research and development to address market failures, such a role needs to be prudently exercised and the model adopted by the Australian Renewable Energy Agency seems to be best practice in this regard. While it is easy to be captivated by the promise or vision of various specific technologies, the preferred role for governments is to establish the policy and support framework that internalises externalities such as climate change and addresses specific barriers to technology development and deployment.

Finally on this issue, we are of the view that the changes in the energy market and energy technologies demand a new look at the role of both intrastate and interstate transmission. This was partly addressed in the Finkel Review under the subject of Renewable Energy Zones. However, past practice of decision-making in this area is unlikely to be best practice in the future. This is not a subject where we have well-developed recommendations for the Committee.

1.7 The adequacy of assistance programs

In general, we do not support programs that provide financial assistance for specific goods or services. The impact of electricity price increases is disproportionately heavy for recipients of existing assistance programs. We are strongly of the view that all such concessions recipients should be on the best retail “deals” as a matter of regulation, including various fees and charges.

1.8 Other issues

This inquiry is taking place when other reviews have either been recently completed or are still in process. The commitment of the states and territories to a national approach to energy and climate change policy is being sorely tested. Yet it remains the best approach. Therefore, the Committee’s recommendations, whilst framed in the best interests of New South Wales, should be consistent with the national approach, including the implementation of the Finkel blueprint and the outcome of the COAG Energy Council’s consideration of the National Energy Guarantee as recommended by the Energy Security Board.

For any queries, please contact:

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