

AGL Energy Sales & Marketing
Limited Submission

To

Independent Pricing and Regulatory
Tribunal of NSW

Draft Report and Draft Determination

Review of Electricity Regulated Retail
Tariffs

PREAMBLE

Over the last six years the terms of reference established by the Minister for price reviews has required the Tribunal to:

- Have regard to the State's obligations under the national competition policy (1998)
- Promote competition in the retail market for electricity taking account of international experience with the retail competition and the extent to which a competitive retail market is affected by *the relationship between the level of regulated and competitive electricity retail prices*. (2000)
- Review the system of tariffs to determine whether the tariffs that are currently below relevant target level are likely to materially undermine the effective operation of the competitive electricity market. If the market is adversely affected by these below target tariffs the Tribunal should determine the changes necessary to the system of regulated retail tariffs to ensure the market operated efficiently (2002)
- Recognise that the difference between regulated tariffs and market based prices is the key determinant of how many eligible customers remain on regulated tariffs (2004)
- Consider the government's policy aim to reduce customers' reliance on regulated prices and the effect of its determination on competition in the retail electricity market. The level of regulated prices for small retail customers is a crucial factor in encouraging new entry in the retail sector. If the level is set too low, it is not possible for new retailers to attract small retail customers away from the regulated price. This can reduce scale economies for new entrants, increasing their costs and making it more difficult for them to compete (2004).
- Recognise the customers' ability to adjust to new prices.

In its draft report the Tribunal has stated that NSW electricity tariffs for residential and small business customers have reduced in real terms by 10% since 1992/93 or 15% excluding the effects of the GST.

The Tribunal has also determined that existing electricity prices are much lower than the full costs of supply.

EXECUTIVE SUMMARY

The Tribunal's Draft Report clearly demonstrates that previous decisions on electricity price regulation for small electricity customers have not achieved the objectives established in the Minister's Terms of Reference. Price regulation has:

- not achieved the right balance between the objectives of customer protection and that of promoting competition. The Tribunal has explicitly stated that existing electricity prices are lower than the full cost of supply;
- adopted an approach that has failed to achieve cost reflective tariffs with a consequence that customers are likely to face price shocks in future periods. The Tribunal advises that while electricity prices have fallen by 15% in real terms, current prices are under-recovering revenue by \$84 million per annum;
- used benchmarks which understate the costs of purchasing and supplying electricity to small customers and lead to prices that do not reflect either short term or long term cost of cost of supply;
- adopted price constraints that have precluded an effective transition to cost reflective prices within the regulatory period. The multiple constraints applied to retail tariffs have had a compounding effect and impeded the achievement of cost reflective tariffs. In the context of the significant under recovery from the NSW small customer market, AGL ES&M believes that the Tribunal's decisions to peg average prices below or at CPI have unreasonably compromised the objective of promoting competition;
- delivered a price regime that fails to meet the Minister's desire to reduce the reliance of small customers on regulated tariffs expeditiously; and
- resulted in prices that do not send signals to the market which would lead to additional generation plant being built to meet medium term demand/supply imbalance.

AGL Energy Sales & Marketing (AGL ES&M) urges the Tribunal to revise its draft decision on regulated electricity prices for the period 2004- 2007 to address the above issues. Specifically to:

- Use the evidence from other jurisdictions to establish cost benchmarks that are realistic for a competitive market and in particular that are not a barrier to entry for second tier retailers;
- Establish an "acceptable average price path" which will need to be higher than that proposed, and/or consider alternative innovative approaches that may require support of government policy to achieve expeditious transition to cost reflective tariffs prior to 2007 and to promote competition;
- Change the approach to price regulation from "neutral" to reflect the value provided under the option of a regulated price in comparison to market based prices;
- Simplify the proposed tariff constraints, preferably by implementing one constraint to ensure that the NSW electricity market is not subject to failures of the past regulatory periods; and

- Ensure that the allowance for wholesale electricity costs in the retail prices is sufficient to provide signals to attract medium term investment in intermediate and peaking generation plant.

AGL ES&M is a second tier retailer in the small customer electricity market in NSW and our participation and investment in the market is dependent upon sustainable business outcomes.

Investment in intermediate and peaking generation capacity to meet medium term demand/supply imbalance in the NSW electricity market is dependent on the retailers taking out long term back-to-back contracts with potential generators. Retailers are not likely to enter into such contracts if they are not able to recover costs from the market. Lack of investment in generation capacity will impact on the security and reliability of supply in the NSW market over the next few years. In the absence of private sector participation the government will need to make additional taxpayer funded investments in generation.

The Tribunal's approach to price regulation is flawed in the context of the objectives set out in the Ministers Terms of Reference. The Tribunal's approach to achieve regulated prices that are "neutral" with respect to competition reflects its desire to replicate electricity prices that will be typical in a competitive market. The Terms of Reference envisage regulated prices to be a safety net or an option available to those customers who do not take a fixed term market contract. In our view regulated prices should reflect the value of this option to differentiate it from efficient fixed term market contract to ensure that retailers are able to compete with the regulated prices.

The failure in achieving cost reflective prices over the past regulatory periods and going forward on the basis of unreasonably low benchmarks has the potential to:

- result in a need for significant price adjustment for small customers in the future;
- impact on investment in the NSW electricity market including no additional privately funded intermediate of peaking generation plant;
- be a barrier to entry for non government owned retailers; and
- impact on the government's aim to shift the highly competitive and risky activity of power trading to the private sector¹.

In addition, the majority of customers will continue to rely on the regulated prices. This is contrary to the Government's objective.

¹ A Risk Management Proposal for the New South Wales' Electricity Businesses, Research and Information Paper, Office of Financial Management, NSW Treasury, May 2004.

1. DRAFT REPORT AND DRAFT DETERMINATION – WAY FORWARD

AGL ES&M believes that the Tribunal needs to revise its draft report and draft determination to take into account factors outlined below if it is to deliver on the objectives of the Minister’s terms of reference and of competition reforms. The Tribunal needs to:

- Establish an “acceptable average price path” which will need to be higher than that proposed and consider alternative innovative approaches that may require support of government policy to achieve expeditious transition to cost reflective tariffs prior to 2007 and to promote competition. The Tribunal’s own assessment shows that the regulated electricity prices remain below the costs of supply and are likely to remain so until after the end of the next regulatory period;
- Change the approach to price regulation from “neutral” to reflect the value provided under the option of a regulated price in comparison to market based prices;
- Use the evidence from other jurisdictions to establish cost benchmarks that are realistic for a competitive market and in particular that are not a barrier to entry for second tier retailers; and
- Simplify the proposed tariff constraints, preferably by implementing one constraint to ensure that the NSW electricity market is not subject to failures of the past regulatory periods.

2. ACCEPTABLE AVERAGE PRICE PATH

The Tribunal’s decisions on regulated prices have delivered real reductions in average prices to small customers of around 15% (excluding the effect of GST). In the more recent years variations to average prices to residential customers have been of the order of the annual CPI but are lower than the costs of supply. Regulators in other jurisdictions have balanced the objectives of customer protection and promoting competition more effectively.

AGL ES&M supports the Tribunal’s decision to allow a full pass through of distribution costs. However, we believe that the path for the retail component should be determined on the basis of achieving cost reflective tariffs before 2007 and be based on acceptable retail cost benchmarks.

Using the Tribunal’s benchmarks in the draft report, the Tribunal’s proposed price path results in a cumulative net under recovery of costs of \$152 million over the regulatory period with final year under recovery of \$40 million (Table 5.2). This under recovery is further accentuated if cost benchmarks consistent with the operation of a competitive market are used.

A CPI +3% price path for the retail component is considered more appropriate to meet the cost-reflectivity objective for areas supplied by EnergyAustralia and Integral Energy.

The price paths for Country Energy and Australian Inland would also need to be revised upwards from the proposed CPI+3%.

AGL ES&M believes that where price increases are seen as unacceptable, then the cross subsidies can be identified and addressed in a transparent manner through a declining tariff rebate scheme. Such an arrangement will require the support of government policy on a rebate scheme that can be designed to be cost neutral with funding through the additional revenue. The additional revenue can be directed (through rebates) to the vulnerable customers or those most affected by the price adjustment.

The benefit of this approach is that it will achieve the discipline of a competitive market sooner, remove the barriers to entry for second tier retailers, promote competition and ensure that customers affected by the price adjustment are protected.

Such arrangements have been implemented in Victoria effectively.

3. APPROACH TO PRICE REGULATION

The Tribunal notes that many submissions to the review have insisted that the Tribunal should allow higher operating costs and an additional margin to encourage competition. The Tribunal strongly believes that this is not desirable from an economic efficiency perspective and maintains that regulated retail tariffs should be “neutral” with respect to competition.

Customer groups at the roundtable on the review also argued that prices should not be artificially inflated so that competition can occur.

AGL ES&M agrees with the views of the Tribunal and the customer groups. However, we believe that the Tribunal and the customer groups have misconstrued our submission for the need for “headroom” in the regulated prices.

AGL ES&M’s proposition for headroom was not based on a need to artificially inflate prices to allow competition to occur, but to recognise and differentiate the option of a regulated price from other market based prices.

Regulated prices come with certain benefits to customers that have a higher value than market based arrangements. For example, regulated prices in conjunction with the standard form customer supply contracts do not have a fixed term (customers can come in and out of contract whenever they wish), and they make available all payment options under the customer protection regulations. These options have a value to customers that should be reflected in the price to differentiate it from say fixed term negotiated contracts with only direct debit as an option.

From a retailers perspective, a 2% margin (or \$12 pa. on a \$600 bill) does not reflect an appropriate valuation of the option. The market risks (volume, volatility, hedging etc) to retailers is higher under open-ended contracts.

4. COST BENCHMARKS

The benchmarks established by the Tribunal are based entirely on its assessment of the cost structures of the incumbent retailers and are substantially below the benchmarks established in other jurisdictions (refer table below). It is difficult to understand why the Tribunal's benchmarks would differ markedly from those set by other regulators for retailers participating in the same national electricity market.

These benchmarks also do not reflect the costs of second tier retailers who do not receive the benefits of schemes such as the ETEF. Evidence from other jurisdictions show that the benchmarks adopted in those jurisdictions is delivering effective competition, for example an effectiveness of competition review in Victoria by the Essential Services Commission (ESCV) shows that competition is effective in parts of the market.

As a second tier retailer in the NSW small customer market, AGL ES&M has serious concerns with the level of benchmarks established by the Tribunal. As stated these benchmarks are significantly lower than those in other jurisdictions and risk leaving the market with substantial under recovery of costs at the end of the next regulatory period. The table below shows this anomaly in summary.

Benchmarks	Tribunal 2004	Other Jurisdictions
Energy costs \$/MWh ²	\$54 - \$57 ³	Vic \$65-\$76, SA \$68.50 ⁴
Operating costs \$/customer	\$65	Vic \$92, SA \$82, ACT \$87 ⁵
Net margin %	2%	Vic 5% -8.0%, SA 5%, ACT 3% ⁶

AGL ES&M does not see a reason for significant differences between jurisdictions and believes that they should be revised to be more reflective of costs to second tier retailers if effective competition is to be achieved. We believe that the benchmarks should be revised as follows:

Energy purchase costs

AGL ES&M notes that the Tribunal has revised the forecast of energy purchase costs by its consultants Intelligent Energy Systems downwards from \$47.84 to \$47. Further as highlighted in our initial submission on the IES report, we believe that the following issues remain to be addressed:

- The IES model does not allow for the increasing peakiness of the regulated market;

² Note that some differences are expected due to difference in green energy allowances, specific jurisdictional levies and load characteristics etc. The NSW wholesale energy costs make no allowance for risk.

³ Based on the Tribunal's LRM plus green energy, generator NEM fees and range of losses for retailers excluding Australian Inland.

⁴ 2004 Electricity Standing Contracts Prices, Final Report, Essential Services Commission of SA, December 2004, and Office of the Regulator General, Victoria, Special Investigation – Electricity retailers proposed price increases – Final Report, December 2001.

⁵ Original benchmarks adjusted to reflect changes in CPI (refer p.8 of the submission)

⁶ Recent benchmarks used in other jurisdictions – refer p.46 of the Tribunal's Draft Report on the Review of Regulated Retail Prices for Electricity to 2007, April 2004.

- Rate of return used for investment in generation plant is low compared to market, which is expected to be in the range of 15%-20% for peaking plant;
- Asset life of 30 years is higher than 20-25 years that would be used for financing decisions on such investment;
- The 2002 demand used for analysis is low (12,100 MW) and does not reflect a typical year which would affect plant mix. Historical maximum demand is in excess of 12,500 MW;
- The IES model averages 17,520 half-hourly interval into 40 blocks, thus understates variability of load on a half hourly basis and is likely to understate capacity required for peak demand;
- A LRMC approach assumes perfect market knowledge; and
- The LRMC has been estimated at the station gate for generation, which will require losses to be applied to convert the LRMC to the reference node.

Further, the assessment of the LRMC excludes hedging and other risks faced by retailers who do not have access the ETEF.

Subject to consideration of the issues outlined above, AGL ES&M believes that the energy purchase costs should be determined as follows:

	Amount
Long run marginal cost at station \$/MWh	47.84 plus adjustments above
Station losses + losses to TX reference node %	7-8 estimate
Hedge mismatch %	5
Other risks %	5
Cost at regional reference node \$/MWh	
Pass through costs	
Green energy and generator NEM fees \$/MWh	3 as per Tribunal's report
NEM and Ancillary \$/MWh	1 as per Tribunal's report
Losses %	EA (6%) IE (9%), CE (16%)
Total energy purchase costs \$/MWh	

AGL ES&M is of a firm view that if a competitive electricity market is to be encouraged in NSW then energy purchase costs should be reviewed as a matter of urgency. Energy purchase costs should also reflect the regional load shapes for the small customer markets of individual retailers otherwise it will impact on the operation of a competitive market and on viability of businesses.

The wholesale cost level required to support investment in new generation assets must cover LRMC and market risks because the market does not operate with perfect knowledge which

is an implicit assumption under the current approach to LRMC approach. Investment in generation relies on an appropriate retail price. If the wholesale price is not addressed system reliability will be negatively impacted with likely adverse effect on energy costs for business and residential customers.

Private participation in investment in generation will require prices at levels that incorporate the components above to allow retailers to establish long-term back to back arrangements with generators. Under the current ETEF arrangements existing retailers “contract” short term at prices that are not sustainable in the longer term.

Operating costs

The operating cost benchmark adopted by the Tribunal is unacceptably low compared to other jurisdictions. This appears to be based on the NERA Report that largely assessed changes since the prior determinations and does not accurately reflect operating cost and margin benchmarks that should be adopted in a competitive energy market.

	Tribunal 2004 (NSW)	Other Jurisdictions
Operating costs	\$65	Vic (\$92), SA (\$82), ACT (\$87)

The operating cost benchmarks for other jurisdictions have been adjusted for CPI changes:

- Victoria - \$92 (based on CRA Report⁷ for both gas and electricity)
- South Australia - \$82 (based on ESCOSA 2003⁸ for electricity)
- ACT - \$87 (based on ICRC 2003⁹ for electricity)

AGL ES&M cannot see why the operating cost benchmarks for NSW market should be significantly different to those adopted in other jurisdictions and urges the Tribunal to review retailer cost allocations and the operating benchmarks. It would appear that customer acquisition costs and costs of full retail contestability are not reflected in the NSW benchmarks.

Profit margin

The Tribunal has maintained the net margins at levels initially established for the NSW market. As noted before these were set with reference to the margins established by the UK regulator and do not reflect the evolution of the market in the UK or in other Australian jurisdictions. AGL ES&M is of the view that these margins, which do not include any allowance for market risk on the basis of the ETEF are unacceptably low and preclude effective competition. The Tribunal’s decision is based on the NERA Report which largely

⁷ Electricity and Gas Standing Offers and Deemed Contracts (2004 – 2007), Charles River Associates (Asia Pacific) Pty Limited, 12 December 2003 prepared for the Department Infrastructure Energy and Security Division (p.32)

⁸ 2004 Electricity Standing Contract Price, Final Report, December 2003, Essential Services Commission of South Australia (p.38)

⁹ Investigation into Retail Prices for Non-Contestable Electricity Customers in the ACT, Independent Competition and Regulatory Commission, May 2003 (p.22)

assessed changes since the prior determinations and does not accurately reflect profit margin benchmarks that should be adopted in a competitive energy market.

	Tribunal 2004 (NSW)	Other Jurisdictions
Profit margin	2%	Vic 5%-8.0%, SA 5%, ACT 3%

As outlined in our previous submissions recovery of customer acquisition costs alone will require a net margin of 7% to 10% if allowance for these costs are not included in the operating costs. Further profit margins should provide for market risks.

AGL ES&M maintains that 5%-10% profit margin is required for effective competition consistent with outcomes in other jurisdictions and the UK.

5. TARIFF CONSTRAINTS

The multiple tariffs constraints adopted by the Tribunal in the past have impeded the achievement of cost reflective tariffs. The Tribunal in its 2000 and 2002 reports estimated that many tariffs will be cost reflective by 2004 and that the aggregate under recovery for the small customer market will be of the order of \$24M. The under recovery has now been estimated at \$84M.

AGL ES&M believes that the main reason that cost reflective tariffs have not been achieved under previous decisions is that the changes to regulated prices have been constrained by a number of “side constraints”. Standard retailers have in their submissions confirmed that these constraints have significantly impacted on their ability to move tariffs to cost reflective levels because they:

- constrain average price increases;
- limit individual tariff movements;
- preclude tariff increases where tariffs are above or at target levels; and
- constrain increases to individual customer bills.

The learning from this approach is that multiple constraints have a compounding effect and impede the achievement of cost reflective tariffs.

In this context we are surprised that the Tribunal has chose to again maintain several constraints to retail price changes:

- no increase to tariffs that are above target levels;
- limit on overall bill changes;
- limit on increase to the retail component and
- limit on the variation of the fixed component.

This approach is not consistent with light-handed regulation and as under previous decisions will result in the same issues and risk the achievement of cost reflective tariffs in the next regulatory period. AGL ES&M urges the Tribunal to review its decision to continue with a similar approach in the next regulatory period.

A single price constraint such as that adopted by the Victorian government to constrain the deviation of bills from the average price change to no more than 5% for any customer tariff category could help avoid similar issues occurring in the future. AGL ES&M is strongly of the view that in the context of our comments on the approach to regulation and tariff restructuring, the Tribunal should remove the constraints on tariffs that it considers are above target levels.

Further, we believe that the constraints on distribution tariffs and retail prices will make it difficult to realise the objectives of distribution tariff reform (including installation of interval meters for small customers) to provide price signals for demand management. The retail price constraints are likely to make demand management tariffs ineffective.

AGL ES&M is concerned that the industry will be required to spend \$100M's of dollars on the rollout of interval meters as proposed by the distributors. We believe that a rollout is not consistent with the Department of Energy, Utilities and Sustainability (DEUS's) stated position with respect to a requirement for a cost benefit analysis or with the recommendations of the joint jurisdictional review of metrology procedures. The risk is that the industry will be required to undertake a significant investment without any real benefits with respect to the objectives of the rollout.

AGL ES&M urges the Tribunal to review its decision on interval meters ("tariff reforms") to ensure that the industry is not required to incur additional and unnecessary costs at this stage.

6. EFFECTIVENESS OF COMPETITION

The Tribunal view at this stage is that while retail competition is developing, it is not yet effective. This is based on a report to the Tribunal by Price Waterhouse Coopers. The Tribunal notes that as competition becomes more effective, regulation of prices could become more light-handed.

The Tribunal cites the example from the United Kingdom (UK) where the UK regulator withdrew from regulation of retail prices when 40% of the market had changed their supplier. The Tribunal however, does not acknowledge that this level of customer switching was achieved because falling wholesale electricity costs¹⁰ resulted in a significant increase in retail margins from the 1.5% initially established by the regulator.

AGL ES&M considers that the two prime characteristics of a competitive market — being a customer's right of choice and the availability (or potential availability) of alternative offers of service which may be from the incumbent retailers. The Tribunal's definition of an effectively competitive market places an emphasis on the incumbent retailers losing market

¹⁰ Section 3.2, Electricity Supply Competition, An Ofgem Occasional Paper (18/02), 16 December 2002

share. We do not believe that it is necessary that incumbent retailers lose market share to demonstrate effective competition. Customers exercising their choice of accepting or not accepting a market offer should be sufficient.

AGL ES&M also believes that the rationale for treating electricity and gas markets as two separate markets on the basis of limits on fuel substitution is not sound. Retail competition in the energy market is not reliant on fuel substitution (Network competition is), but rather on the availability of sustainable returns from one or both fuels. Since the majority of the retailers in the NSW energy market are dual fuel suppliers, it would make sense to treat the electricity and gas markets as one energy market.

7. COMMENTS ON OTHER MATTERS

Inclining Block Tariffs

The Tribunal's statement that there does not appear to be a cost reflective basis for an inclining block structure in the R component (that is, that retail costs do not appear to become greater for each customer as their consumption increases) is not correct.

Energy costs vary with demand both daily and seasonally, thus there is merit at looking at price structures that will improve cost reflectivity in the retail component.

The Tribunal notes that retailers have advocated inclining block tariffs to manage demand for electricity. The Tribunal considers that the likely impact (of inclined block tariffs) on demand is uncertain and suggests that quarterly billing might blunt price signals.

AGL ES&M has recognised this uncertainty with the effectiveness customer response to demand side signals. We have strongly argued that studies or trials need to be undertaken before decisions on initiatives such as inclined block tariffs or interval meter rollout are taken. Given these concerns, we believe that the Tribunal should reject the distributors' proposals to rollout interval meters ("tariff reforms") as part of their capital programs until a full cost benefit analysis of all options is undertaken.

Regulation of Non- Tariff Charges

AGL ES&M notes the restrictions under the Electricity Supply Act on allowing additional non-tariff charges. However, our previous submissions with respect to ensuring that services are provided on a cost reflective basis remain relevant.

It will be appropriate that the distributors are not allowed to pass on costs to retail businesses as non-tariff charges that cannot be recovered from the customers.

AGL ES&M notes the Tribunal's decision not to allow an increase in the late payment fee to cost reflective levels as proposed by EnergyAustralia. We are not convinced by the argument that these charges have the effect of increasing hardship for low income and disadvantaged customers.

The late payment fees are intended to provide an incentive to customers who are able to pay their bills but do not pay on time. Customers in hardship are assisted by retailers separately through payment plans, retailer hardship management programs, referral to financial counsellors and support agencies, and energy advice. A customer in hardship who approaches a retailer for assistance prior to a bill becoming overdue will not be charged a late payment fee.

Schedule 2 of the Tribunal's 2002 Determination on the review of regulated retail prices for electricity ensures that this is the case.