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ELECTRICITY MID TERM RETAIL REVIEW

Public Submission to the Independent Pricing and Regulatory Tribunal

March 2002

CONTENTS PAGE

1 OVERVIEW

Country Energy is pleased to provide a response to IPART's mid term review of Regulated Retail Prices for Electricity to 2004. Country Energy believes that this review provides an ideal opportunity to assess the effectiveness of the current determination, particularly in relation to transitioning transitional tariffs to the target levels. The assessment of any material movements in the cost of supply is also welcomed, particularly in light of the proposed changes to the NSW Greenhouse Gas Licence Regime.

Country Energy currently has 313 individual prices, with 211 of those prices under the target retail tariff. As demonstrated throughout this submission, a large proportion of those tariffs may not reach the target retail tariff by 2004. This situation will be further exacerbated if anticipated increases of greater than CPI are experienced in components of the target retail tariff.

Based on our analysis we believe that if side constraints are relaxed the objectives of ensuring prices reach cost reflective levels can be achieved without price shocks to customers. The purpose of a side constraint should be to minimise price shocks to consumers, Country Energy believes this could still be achieved without a strict and standard approach to side constraints.

Flexibility in the side-constraint and allowable movements in tariffs is needed to ensure the ability to rationalise and restructure tariffs is available. More importantly, this flexibility is essential in ensuring that regulated retail tariffs transition to the target retail tariff on or before the termination date, so as not to undermine the effective operation of the competitive market.

The side constraint may be best handled through negotiation at time of price change and may be different for retailers depending on their current tariff position. If this was negotiated by retailers and the Tribunal at time of price change it would be flexible enough, if required, to adapt increases to customer classes or at the tariff level.

This would ensure that the right price signals are developed, which ultimately will lead to efficient pricing where the user pays. At the moment regulated retail tariffs below the target retail tariff will remain there resulting in other customers having to subsidise these price levels.

The target retail tariff are designed to reflect the costs of supply. Regulated retail tariffs below the target retail tariffs are effectively not contributing to the full cost of supply. Choices for a customer are reduced, as it may be unlikely that a competitive offer will propose an incentive to move to the competitive market, if the customer's current regulated retail tariff is below the cost of supply. However, transitioning the regulated retail tariff to the target level is inhibited by the side constraint, which ultimately undermines the effective competition in the deregulated market.

2 TERMS OF REFERENCE

The Independent Pricing and Regulatory Tribunal of NSW is investigating the current determination, *Regulated Retail Prices for Electricity to 2004, December 2000.* The Terms of Reference requests information on the robustness of regulated retail prices following the introduction of Full Retail Competition and the appropriateness of the target tariffs in relation to the cost of supply.

Information is sought on any factors, which may have contributed, to a material change in the following cost components in the setting of cost reflective 'target' tariffs:

- an allowance for electricity purchases based on the assessment of the long-run marginal cost of electricity generation;
- an allowance for purchases of green energy;
- energy losses;
- network charges;
- NEMMCO fees;
- retail gross margin; and
- an allowance for indexation.

The Tribunal is also to take account of the following matters:

- Do tariffs under the target level materially undermine the effective operation of the competitive electricity market,
- The effect of side constraints in facilitating the rationalisation of tariffs and the transition to the target retail tariffs;
- Clarification of circumstances which standard retail suppliers may introduce regulated retail tariffs;
- Clarification of off-peak versus controlled loads and the possibility of introducing a shoulder target retail tariff; and
- FRC cost recovery.

A copy of the terms of reference is at Attachment A.

3 GENERAL MATTERS FOR CONSIDERATION

3.1 COST REFLECTIVE TARGET TARIFFS

The Terms of Reference seek assistance in investigating:

For the purpose of section 43EB (2)(a) of the Electricity Supply Act, the tribunal is to consider whether there are any factors that would lead the Tribunal to from the view that there has been a material change in the following cost components in the setting of cost-reflective 'target' tariffs since the determination was issued and if so whether this justifies a change in the level of the target tariffs to apply from 1 July 2002 to 30 June 2004.

- ***an allowance for electricity purchase costs based on an assessment of the long-run marginal cost of electricity generation;***
- ***an allowance for purchases of 'green energy' consistent with retailer licence obligations;***
- ***energy losses as published by NEMMCO;***
- ***network charges as determined by the Independent Pricing and Regulatory Tribunal and the Australian Competition and Consumer Commission;***
- ***fees (including charges for ancillary services) as imposed by NEMMCO under the National Electricity Code;***
- ***an appropriate Retail Gross Margin;***
- ***the allowance for annual indexation based on the Consumer Price Index and expected movements in regulated components and NEMMCO Fees;***

Country Energy has reviewed each of the cost components of the target tariff, and suggests that the following cost components must be reviewed carefully in light of proposed changes and determinations. Foreseeable changes to cost components can be summarised as follows:

- proposed changes to NSW greenhouse-related licence conditions for electricity retailers;
- FRC Cost Recovery for both networks and retail;
- CPI plus increases for network charges;
- NEMMCO participant fee dispute;
- NEMMCO FRC cost recovery; and
- Market fees determination.

Below, Country Energy has addressed each of the cost components in relation to determining if there has been a material change in the cost component, and also offers comments in relation the current translation of costs into the target tariff.

3.1.1 Electricity Purchase Costs

The regulated energy cost is based on the Long Run Marginal Cost and is annually indexed by CPI. Country Energy is not in a position to determine if there has been a material change in the long run marginal cost, however we must have the ability to pass on increases in electricity purchases to customers. As discussed throughout the paper, increases in revenue are consistently below the increases seen in costs to the retail business.

3.1.2 Green Energy

Standard Retail Suppliers are required to comply with various environmental obligations. Two such obligations, which directly affect regulated retail customers, are the Commonwealth *Mandatory Renewable Energy Target* (MRET) and the NSW licence condition relating to greenhouse gas emissions reduction.

Country Energy makes every endeavour to comply with licence conditions in relation to environmental issues. These conditions pose a significant financial and administrative burden on the organisation and our efforts are constrained by the availability and cost of alternative energy sources.

The national MRET liability increases to 1,110 GWh in 2002 and 1,800 GWh in 2003. From January 2002 retailers are also required to surrender RECs to SEDA for "new" purchases to satisfy their green power accreditation. A combination of the MRET liability and 80% green power sales is a significant increase on the 2001 demand based on modelling completed by Country Energy.

Additionally, the uncertainty of the NSW greenhouse gas related licence conditions with proposed changes to the scheme, if implemented will inevitably increase costs,

Consideration must be given to the recent NSW Government position paper – *Greenhouse-related licence conditions for electricity retailers,* which proposes changes to the existing benchmark scheme for NSW Licence Compliance. The proposed change would effectively introduce a penalty imposed on Retailers, who fail to meet the target, where as before no such penalty existed. If implemented, Country Energy would be required to either meet the target or pay the penalty for the shortfall, which essentially represents an additional significant cost over and above the costs of compliance presently.

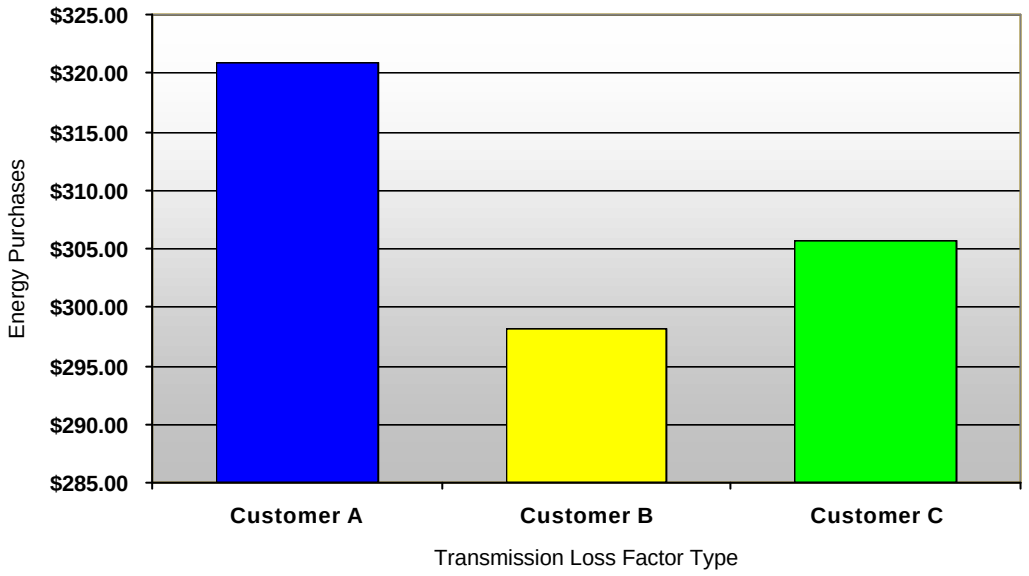
The Government anticipates the average cost of electricity delivered to customers will increase by $1-2/MWh if the scheme applies just to NSW liable entities. The actual cost would vary across retailers and Country Energy is still in the process of modelling the impacts of the proposed changes. Country Energy needs the ability to pass this cost through to its customer base in the regulated tariff structure.

3.1.3 Losses

The retail component of the target tariff effectively smears all costs for an entire supply district. Country Energy has a unique supply district, which is predominantly rural. Although, a proportion of Country Energy's cost components do not vary significantly throughout the supply district, the cost of transmission losses can vary quite dramatically.

The variance between the minimum and maximum transmission loss factor is approximately 9%, and is especially prevalent in the former NorthPower network area. Figure 1 below is an example, which demonstrates the variability in transmission loss factors, as they would translate to a customer.

Figure 1 Smearing transmission loss factors



Customer A, B and C each consume an equivalent amount of electricity each year. Customer A is located in an area where the transmission loss factor is 1.0914. Customer B is located in another area, which has a transmission loss factor of 1.0143. Customer C has an average transmission loss factor applied of 1.04. These losses translated to purchases based on the same purchase price demonstrate the extreme variability transmission loss factors can generate.

Effectively the target tariff would treat both Customer A and Customer B, equal to Customer C who has an average TLF applied. Customer A would not contribute to the costs of supply, whilst Customer B would contribute more than the underlying cost of supply. The outcome of applying an average TLF, is that Customer B will have an incentive to enter the market, where as Customer A may be inhibited from doing so.

The current structure of the target retail tariff effectively smears this significant variance in transmission loss factors. If tariff rationalisation is the main objective of the determination, then this may be achieved if the regulated retail tariff transition to the target tariff. However, the tariff may not represent the true costs of supply which ultimately represents an impediment for some customers to enter the market whilst others may have an incentive to do so.

This variability is not as prevalent in other distribution areas within NSW. It may be appropriate to introduce target retail components, which are reflective of, the variability in transmission losses for Country Energy.

3.1.4 Network Charges

The current network pricing determination ensures that the average network rate does not increase by CPI, however increases for domestic customers are subject to a side constraint of $30 or CPI+2. Given that not all network price increases flow through to the regulated retail tariff, there is a disconnect between retail and network regulation. This disconnect means that retail cannot always pass through network price changes.

The effect of the inability to pass through network charges, which at times are CPI plus increases, negatively impacts the gross margin. If this trend continues, coupled with the current side constraints, the retail component will be eroded due to the inability to pass through this uncontrollable cost.

Although the target tariff effectively allows direct pass through of these costs, any increase above CPI in the network component rarely translates to an equivalent increase in the regulated retail tariff. Ultimately, this has an impact on customer choice, as the incentive for a customer to enter the competitive market, gradually diminishes as the retail margin is squeezed.

Country Energy strongly recommends that uncontrollable costs such as network charges should not be subject to the retail side constraint, and thus directly passed through in the regulated retail tariff.

3.1.5 NEMMCO Fees

Country Energy does not believe there has been a material change in NEMMCO fees, however there is a level of uncertainty for future market charges, which would justify a change in the target retail tariff. This uncertainty is due to:

- NEMMCO participant fee dispute;
- NEMMCO FRC cost recovery; and
- Market fees determination.

As a result of the level of uncertainty surrounding NEMMCO fees, Country Energy also recommends that this uncontrollable cost should not be subject to the retail side constraint, and thus directly passed through.

3.1.6 Appropriate Retail Gross Margin

Country Energy believes that a fixed retail gross margin across all retailers is inappropriate, primarily because of the relatively different operating environments. Country Energy, in particular has a significant rural customer base, and with that there is a degree of responsibility and social obligation to fulfil the needs of customers. This may involve operating a customer centre in a rural area that services a significantly reduced customer base compared to a city counterpart.

There are significant differences in the size of NSW retailers in terms of customer numbers, retail revenue, and franchise area. Given the significant investment in information systems required to operate in the retail market a large proportion of operating costs are fixed. These costs may be disproportionately larger per customer across retail business.

The UK Office of Gas and Electricity Markets (OFGEM) have commented on this and recognised this in a past review. OFGEM stated "A major determinant of public electricity suppliers (PES's) supply business costs is the number of customers that a PES serves. There may also be an element of costs that do not vary with customer numbers. OFGEM's approach in taking a view on the appropriate level of supply business costs in determining the level of price restraint for 2000/01 has therefore been to consider an appropriate per customer allowance, together with an appropriate allowance for costs that do not vary with size."

Under the current determination, increases in revenue are generally less than the increases seen in costs. Regulated retail tariffs below the target retail tariff can increase, however the tariffs that are above the target level are held, therefore an overall CPI increase is generally not possible for retail.

As a result, an appropriate gross margin that is predetermined may never be recovered due to circumstances completely out of the control of retailers. Country Energy advocates that:

- a relaxation of the side constraints is required to ensure a retailer can recover the appropriate retail gross margin; and
- revenue must increase by at least as much as underlying costs to ensure tariffs adequately recover efficient costs of supplying electricity.

A diminishing regulated retail gross margin, ultimately impacts the customer as the incentive to move to the competitive market is also diminished.

3.1.7 Annual Indexation

Country Energy believes that it is appropriate for the target retail tariff to be indexed in line with general inflation by CPI. However, ability to pass through costs over which retailers have no control, such as network costs must be allowed. Country Energy proposes that whenever the regulated retail tariff is below the cost-reflective target retail tariff, CPI plus increases should be allowed. This could be achieved through a relaxation of the side constraint.

The CPI is designed to measure movements in the cost of living for a representative group of consumers. It does not include investment goods and to that extent is not particularly appropriate for reflecting the cost increases which should go into the indexation arrangements for the cost of producing electricity. Further, the CPI includes an element for household electricity costs, and to that extent has a degree of circularity when used for indexation purposes. It would be possible to identify a price deflator from the national accounts, which might more closely match the costs to be indexed by IPART. That said, a number of problems would remain, including the frequent revision of the national accounts. For this reason, Country Energy continues to support use of the CPI for indexation purposes.

3.2 REGULATED TARIFFS AND THE COMPETITIVE ELECTRICITY MARKET

The Terms of Reference seek assistance in investigating:

Consistent with the requirement of section 43EB (2)(b) of the Supply Act, the Tribunal should review the system of tariffs to determine whether the tariffs that are currently below the relevant target level are likely to materially undermine the effective operation of the competitive electricity retail market. If the market is adversely affected by these below target tariffs the Tribunal should determine the changes necessary to the system of regulated tariffs to ensure the market operates effectively.

Country Energy believes that regulated retail tariffs below the target retail tariff materially undermine the effective operation of the competitive retail market. The target retail tariff, if set correctly, effectively represents the cost of supply, so regulated retail tariffs below this target may remove much of the incentive for small retail customers to move to the competitive market.

A number of regulated retail tariffs are significantly below the target retail tariff and may not reach the target on or before the termination date. Consequently, this represents an impediment for customers to enter the competitive market and does not facilitate customer choice.

The main reason for regulated retail tariffs remaining under the target retail tariff, is essentially the inability to transition these tariffs due to side constraints. The current determination does not allow in some cases, an increase in the regulated retail tariff equivalent to the increases seen in the underlying costs of supply.

This is especially true for domestic tariffs, where greater than CPI increases in the underlying network component, erode the retail allowable increase which is generally CPI or less. The effect of the side constraints is explained in more detail in section ***4.1 Side Constraints***.

The best way to foster competition in the electricity market is to minimise artificial restraints on demand, supply and prices, restrain monopolistic pressures and foster complete knowledge of the market. While "perfect competition" can seldom be achieved in practice the allocation of resources will be improved if restraints on the market system result in minimal distortions to the free market.

The aim should thus be to establish a regime of default tariffs that encourages customers to enter the market and discourages retailers from misallocating resources. The current determination, in theory, would meet these objectives and thus promote competition. However, the side constraints limit the effective transitioning of the regulated retail tariff to the target retail tariff resulting in the objectives not being met.

Based on our analysis we believe that if side constraints are relaxed the objectives of ensuring prices reach cost reflective levels can be achieved without price shocks to customers.

In summary

- Target retail tariffs should reflect the cost of supply;
- Regulated retail tariffs below the target retail tariffs are effectively not contributing to the full cost of supply;

- Transitioning the regulated retail tariff to the target level is inhibited by the side constraint;
- Choices for a customer are reduced, as it may be unlikely that a competitive offer will propose an incentive to move to the competitive market, if the customers current regulated retail tariff is below the cost of supply;
- These factors ultimately undermine effective competition in the deregulated market.

4 SPECIFIC MATTERS FOR CONSIDERATION

4.1 SIDE CONSTRAINTS

The Terms of Reference seek assistance in investigating:

The effect of side constraints in facilitating the rationalisation of existing regulated tariffs and the transition to the target retail tariffs by 30 June 2004.

The current retail determination inhibits the rationalising of existing tariffs and does not allow effective transitioning to the target retail tariffs by 2004. This is primarily due to the side constraints imposed on price changes of regulated retail tariffs.

4.1.1 Tariff rationalisation

Generally the side constraints limit the price change of a regulated retail tariff under the target level, so as to ensure small retail customers being supplied electricity as a:

- **residential customer**, total bills do not increase by more than $25 or CPI
- **business customer**, total bills do not increase by more than $50 or CPI+5%

for the corresponding period of the immediately preceding year, for the same usage.

Given the interaction between side constraints and the current retail determination, Country Energy believes that any side constraints should be assessed carefully to ensure broad consistency with overall movements in regulated tariffs. Having both mechanisms working together adds a degree of complexity but this could be minimised if side constraints were determined appropriately.

Complexity arises in instances where customers are being supplied electricity for more than one tariff, but are still subject to the same side constraint as a customer being supplied on a single tariff. The effect is that the $25 or $50 side constraint that is a fixed dollar amount, in some instances will not yield increases as high as the side constraint that is a percentage amount.

Clause 6 - *Target Levels of Regulated Retail Tariffs* of the retail determination states that tariffs below the target must equal the target level on or before the termination date. A standard retail supplier will not be in breach of the determination if it has increased tariffs under the target by the maximum level, and despite this the tariff does not equal the target level on or before the termination date. Conversely, tariffs equal to or above the target cannot depart from the target level on or before the termination date.

Effectively, if a retailer does not increase a tariff under the target level by the maximum allowable amount, the retailer will be in breach of the determination, which translates to a breach in its NSW standard retail supplier's licence.

The increase achievable is dependent on a retailers tariff mix, annual consumption and the number of tariffs in this mix that are below the target retail tariff. If most tariffs are under the target, the maximum increase in most case, will result from applying the percentage side constraint. The regulated customer base is predominantly residential with a side constraint of $25 or CPI, which ultimately translates to an increase of revenue that is CPI or less. The implications of a CPI or less increase in revenue is erosion of the allowable retail gross margin. Additionally, many regulated retail tariffs will never reach the target level, primarily

due to the side constraints and increases being less than or equal to the annual indexation of the target. This situation is exacerbated if the network component increases by more than CPI and is explained in more detail below in section ***4.1.2 Transitioning tariffs to the target level***.

Alternatively, if less tariffs are under the target retail tariff, then the $25 or $50 side constraint that is a fixed dollar amount, may yield the maximum increase. This maximum increase for that tariff may be greater than CPI, allowing the regulated tariff to transition to the target retail tariff.

Tariff rationalisation generally involves transitioning like tariffs to a single tariff. This may be achieved by increasing, decreasing and restructuring tariffs. Thus full tariff rationalisation may take a significant number of years to achieve due to side constraints in place. However, decreasing regulated retail tariffs under the current determination is not permitted, and to ensure the determination is not breached, regulated retail tariffs under the target retail tariff must increase by the maximum allowable.

Country Energy has 313 different regulated retail prices and is committed to tariff rationalisation to ensure equitable and efficient pricing is achieved for all its customers. The side constraints together with the requirements of price changes for tariffs above and below the target also limit restructuring of tariffs. Currently Country Energy's tariffs are structured as follows:

- A fixed charge plus a variable charge for units consumed (as per determination)
- A minimum charge for energy plus a variable charge block structure for units consumed
- Combinations of the above

These structures can vary significantly, and applying the current determination, reduces the scope for tariff rationalisation. Additionally, unwinding current tariff structures to a fixed and variable component, in most cases is difficult without:

- foregoing revenue and consequently breaching the determination; or
- conversely, breaching side constraints.

In summary a retailer's discretion in rationalising tariffs is severely limited due to the following:

- A standard retail supplier must not breach side constraints;
- A standard retail supplier must increase tariffs under the target by the maximum allowable amount;
- Tariffs at the target level must not depart from the target level;
- Target levels generally increase by more than CPI per annum, which is greater than the allowable percentage change for residential customers.

4.1.2 Transitioning tariffs to the target level

The effect the side constraint has on transitioning regulated retail tariffs to the target retail tariff was touched on briefly above. A retailer with regulated retail tariffs under the target by more than the percentage increase allowable under the side constraint will be at a disadvantage when attempting to transition these tariffs to the target level. Given the annual indexation of the target, most regulated retail tariffs under the target level will not reach the target on or before the termination date, even though compliance with the determination is adhered to.

Contributing factors to the inability to transition regulated retail tariffs to the target retail tariff are as follows:

- The network component of the target tariff generally increases by more than CPI each year. This was clearly demonstrated last price change where the network component for Country Energy increased by 3.3%, where as the CPI was at 2.92%. The network determination allows CPI+2% increases for residential customers which further exacerbates the situation if an increase of this type were to be applied;

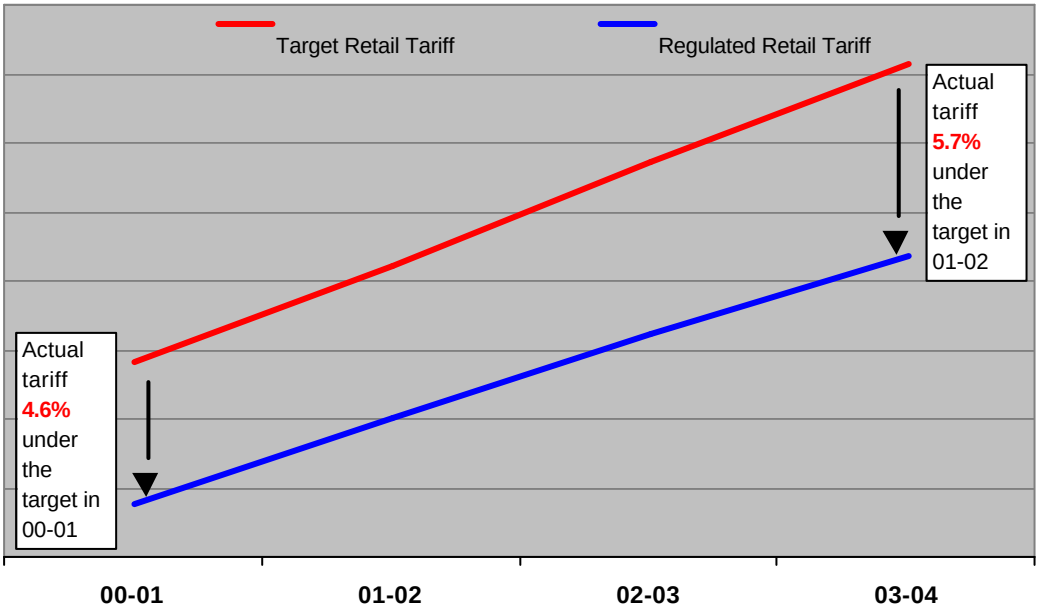
- The retail component of the target tariff is indexed by CPI at each price change date; and

- Due to the issues described above, greater than CPI increases for most tariffs is unlikely.

The result is a widening gap between the target retail tariff and a regulated retail tariff.

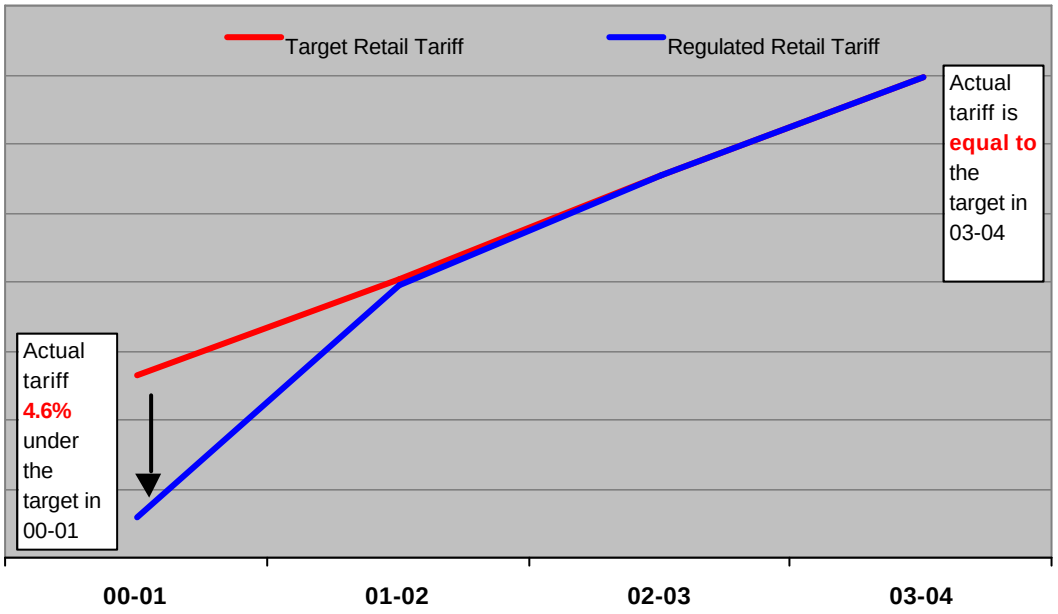
Figure 2 below demonstrates this trend. The example is based on a network price increase for 2002 of CPI + 1% and a retail price increase subject to the side constraint of CPI. Even though the retailer may have applied the maximum increase each year the regulated retail tariff is actually further under the target in 2004 then it was in 2001.

Figure 2 Transitioning to the target tariff assuming CPI increases



The side constraint does allow a CPI+5% or $50 increase for small retail customers being supplied as a business customer. However, due to historical cross subsidisation, most business tariffs are above or will reach the target level on or before the determination date, as the allowable increase is greater than the movement in the target each year. Figure 3 demonstrates this trend.

Figure 3 Transitioning to the target tariff assuming CPI+5 increases



This suggests that a relaxation of the side constraints is required to ensure that regulated retail tariffs transition to the target retail tariff. Country Energy strongly recommends that the Tribunal consider, relaxing side constraints for the following reasons:

- Tariffs below the target level are effectively below the cost of supply;
- The incentive for a customer to move to the competitive market may not exist due to regulated retail tariffs that are under the target level;
- Contributes to impediment of customer choice in a deregulated environment.

Flexibility in the side-constraint and allowable movements in tariffs is needed to ensure the ability to rationalise and restructure tariffs is available. More importantly, this flexibility is essential in ensuring that regulated retail tariffs transition to the target retail tariff on or before the termination date, so as not to undermine the effective operation of the competitive market.

The purpose of a side constraint should be to minimise price shocks to consumers. This could still be achieved without a strict and standard approach to side constraints.

The side constraint may be best handled through negotiation at time of price change and may be different for retailers depending on their current tariff position. If this was negotiated by retailers and the Tribunal at time of price change it would be flexible enough, if required, to adapt increases to customer classes or at the tariff level.

This would ensure that the right price signals are developed, which ultimately will lead to efficient pricing where the user pays. At the moment regulated retail tariffs below the target retail tariff will remain there resulting in other customer having to subsidise these price levels.

Country Energy strongly recommends, that a relaxation of the side constraint be implemented, so as to allow regulated retail tariffs to transition to the target retail tariff on or before the termination date.

It would be Country Energy's preference to see no pre-determined side constraint, but believes that a guideline of price change limits be negotiated between the retail and the tribunal at time of price change. This would be an approach that ensures customers are protected from price shocks and retailers are given the opportunity to transition regulated retail tariffs to the target retail tariff.

It is important to note that regulated retail tariffs only apply to those small retail customers who are supplied electricity by a standard retail supplier under a standard form customer supply contract. Therefore it is important to remember the purpose of the target retail tariff, and that is a tariff that represents the efficient cost of supply to be used for customers who choose not to or cannot enter the competitive market, whilst not inhibiting competition.

4.2 INTRODUCING REGULATED RETAIL TARIFFS

The Terms of Reference seek assistance in investigating:

Clarification of the circumstances in which standard retail suppliers may introduce regulated retail tariffs in addition to the transitional and target retail tariffs, in particular arrangements for introducing 'green' tariffs.

4.2.1 Non 'green' tariffs

Country Energy's view is that the determination should allow the introduction of new regulated retail tariffs. Standard Retail suppliers should be allowed sufficient scope to introduce new tariffs, provided that the tariff complies with the determination

An option, which could be considered, is to allow implementation of the target tariffs in place of the current regulated retail tariffs. Increases to customers could be controlled via a billing system functionality, which ensures that any increase in a customer's bill is subject to an appropriate side constraint. The billing system functionality would effectively ensure that each customer would not receive an increase greater than the side constraint by refunding to the customer any increase, which is outside of the maximum allowable increase. This means the side constraint is applied at customer level, rather than at a tariff level.

Implementing the target retail tariff price list coupled with a refunding functionality has several advantages, in that:

- The tariff implemented will essentially be the target tariff;
- All tariffs will have transitioned to a Fixed + Variable structure, removing the previous structures which may be varied and inconsistent;
- The side constraint applied through the use of the refunding function of the billing system will ensure that the tariff moves at greater rate to the target level, which eventually diminishes the need for a refund functionality;
- Given that the tariff will better reflect the cost of supply, customers will have choice, as an incentive to move to the competitive market will exist.

Country Energy recommends that the Tribunal consider allowing standard retail suppliers to transition regulated retail tariffs to the target tariff immediately, whilst limiting the impact on customers to a side constraint.

4.2.2 'Green' tariffs

Currently, small retail customers already have an option to purchase green energy, which generally involves a premium being charged to the account depending the percentage of 'green' energy the customer requires. The product is completely optional, and is not a mandatory requirement.

However, all customers are required to contribute to the cost of purchasing renewable energy, regardless of whether they elect to purchase a green product. This contribution is required, as a result of a standard retailer suppliers requirement to comply with the Mandatory Renewable Energy Target and the NSW Licence condition aimed at greenhouse

gas emission reduction. The cost of compliance will inevitably increase, if the proposed changes to the NSW greenhouse gas licence compliance regime are implemented.

Country Energy believes that 'green' energy tariffs are best left to the competitive market, otherwise differentiation between the competitive market and the regulated market will be diminished. 'Green' energy tariffs are essentially a product decision and thus Country Energy does not foresee any merits in introducing a 'green' energy tariff to the regulated market.

It is Country Energy's preference that green compliance costs form part of the regulated tariff and that all customers contribute to this cost. If a customer is seeking a 'green' tariff this is a product available in the competitive market.

4.3 OFF PEAK VERSUS CONTROLLED LOADS

The Terms of Reference seek assistance in investigating:

Clarification of off-peak versus controlled loads including the merits of introducing a 'shoulder' target retail tariff.

The current retail component is split into a fixed and variable component, *Variable R.* The variable R has been determined for each retailer, in four categories as shown below:

- Urban Standard;
- Urban Controlled Load;
- Rural Standard; and
- Rural Controlled Load.

Country Energy requests that these categories be clarified in relation to application of the target levels, for the following reasons:

- The controlled load variable R is open to interpretation. Taken literally, controlled load is defined as load in which the network's equipment controls the availability of electricity to certain times. Generally, electricity is available for Off Peak 1 in Off Peak periods, however electricity can also be available at other times depending on the network. With Country Energy, Off Peak 2 tariffs are quite varied, where electricity can be available for up to 20 hours per day and is not restricted to Off Peak periods. Applying the controlled load target levels to controlled load tariffs, is not representative of the costs of supply given that the *Regulated Energy Cost* charged for purchases under the *Electricity Tariff Equalisation Fund* is a two rate structure of Peak and Off Peak.

- Tariffs with an Off Peak component such as a Time of Use two rate tariff or a Time of Use three rate tariff are not limited to the network controlling the availability of electricity. The electricity supplied is not restricted in any way, with consumption measured by a Time of Use meter to determine consumption occurring in each of the defined periods. As such, the Off Peak component of a Time of Use tariff is similar to an Off Peak 1 tariff controlled by the network, but significantly different to an Off Peak 2 tariff. The definitions taken literally would assume that the standard variable R would be applied to the three rate tariff as it is not a controlled load as such.

- Incorrect application of the target levels will result in the regulated tariff not being representative of the underlying costs of supply, which ultimately is an impediment to competition, particularly if a regulated tariff is significantly below the costs of supply but is also at the target level. Customers may not have an incentive to move to the competitive market due to the tariff being below cost reflective levels.

The Terms of Reference also seek assistance in investigating the merits in introducing a 'shoulder' target retail tariff. Country Energy believes that there is no value in introducing such a target for the following reasons:

- Depending on the intended application of a 'shoulder' target retail tariff, measuring the exact consumption consumed in shoulder periods is not possible without a Time of Use meter. Energy consumed in shoulder periods can be estimated using a profiling methodology, however this is a cumbersome and time consuming process.

- Introducing a 'shoulder' target retail tariff will not be representative of the costs of supply given that the *Regulated Energy Cost* charged for purchases under the *Electricity Tariff Equalisation Fund* is a two rate structure of Peak and Off Peak. Thus, the energy consumed in these periods is purchased at the same cost as in peak periods.

- The underlying network tariff of a Time of Use retail tariff will be the differential in terms of price. Given that the network component of the target tariff is completely separate to the retail component, necessity for a shoulder target retail tariff does not exist as a shoulder period does not effectively exist in the *Electricity Tariff Equalisation Fund.*

If a shoulder tariff were to be introduced as a target retail tariff, the current peak and off peak structure of the *Regulated Energy Cost* used to determine purchase costs in the *Electricity Tariff Equalisation Fund,* would also need to be adjusted accordingly so that the purchase price also reflects a 'shoulder' period.

It is important to understand that retail tariffs do not match the wholesale market, and thus it is extremely difficult to determine the level of consumption in various periods. This is a result of the metering arrangements in place, which are mostly aggregation meters that have no time of use capability. Given this, it is important that the target retail component reflects this, so that targets can be applied directly to the tariff, rather than estimating percentages of loads to apply to certain targets.

Country Energy suggests that the current controlled load retail component be renamed as controlled load 1 (Off Peak 1) and apply to tariffs where consumption is primarily in off peak periods as governed by the *Electricity Tariff Equalisation Fund*. Such tariffs would include Off Peak 1 and the off peak component of time of use tariffs.

The current standard retail component would remain largely unaffected, as this target would apply to all tariffs where consumption is in the peak, shoulder and off peak periods as governed by the *Electricity Tariff Equalisation Fund.* However, the introduction of a controlled load 2 target (Off Peak 2) would be required as Off Peak 2 consumption is predominantly within the shoulder and off peak periods. Applying the current controlled target would result in the Off Peak 2 tariffs being below cost reflective levels. Conversely, applying the standard target tariff would result in tariffs being above cost reflective levels. Thus it is appropriate, that a new target be devised that accurately reflects the costs of supply.

In summary, Country Energy recommends that the current retail components remain in place with the addition of a further target tariff, that being a controlled load 2 target (Off Peak 2). However, the current retail components require clarification to ensure that:

- The target retail targets are not open to interpretation;

- Incorrect price signals are not sent out to the customer; and

- Customer choice is facilitated in a deregulated market.

This approach will also minimise change to the current retail determination as it would essentially only involve the introduction of a new target retail component, that being a Off Peak 2 component.

Country Energy has prepared the following table, in an effort to summarise the recommendations discussed above. The table below is effectively, definitions and applicability of the variable R targets proposed by Country Energy.

Figure 4 Variable R retail components

Variable 'R' Component	Applicability	Rationale
Urban Standard	➢ Urban Continuous supply; ➢ Urban Peak and Shoulder periods of Time of Use Tariffs.	Energy consumed on these tariffs is generally in peak, shoulder and off peak periods and thus a weighted peak and off peak component of the regulated energy cost best represents the cost of supply.
Rural Standard	➢ Rural Continuous supply; ➢ Rural Peak and Shoulder periods of Time of Use Tariffs.	
Urban Off Peak 1	➢ Urban Off Peak 1; ➢ Urban Off Peak periods of time of use tariffs.	Energy consumed on these tariffs is generally in the off peak period and thus the off peak component of the regulated energy cost best represents the cost of supply.
Rural Off Peak 1	➢ Rural Off Peak 1; ➢ Rural Off Peak periods of time of use tariffs.	
Urban Off Peak 2	➢ Urban Off Peak	Energy consumed on these tariffs, depending on the network, can be in all periods however should be weighted predominantly more to the off Peak period than the peak period of the regulated energy cost according to an average profile.
Rural Off Peak 2	➢ Rural Off Peak 2	

4.4 FRC COST RECOVERY

The Terms of Reference seek assistance in investigating:

Arrangements for the recovery of all reasonable full retail competition costs.

The Tribunal is currently conducting a review in conjunction with PB Associates to determine the prudent Full Retail Competition Expenditure of NSW Retailer and Distributors.

As a general comment, Country Energy supports in principle the approach adopted by the Tribunal that systems and procedures employed by the energy businesses, to ensure capacity to introduce competition for small business and household customers, be prudent and incremental in nature. We also support the view that it would be inappropriate to pass through into regulated prices, marketing costs associated with retail businesses to retain or expand market share, and that the NSW energy businesses should be individually assessed given the variations in operational requirements between the businesses in terms of systems and processes required to undertake FRC related activities, both now and into the future.

The current costs incurred by Country Energy and the estimated future cost requirements in introducing FRC have been derived on the following basis:

- A conservative FRC strategy based on expected customer churn;
- The employment of resources to ensure compliance with government policy, with a strong focus on ensuring a smooth and efficient transition to support FRC, ensuring compliance readiness with market systems and procedural requirements, and the capturing of all FRC requirements into internal business systems and processes;
- Adopting a pragmatic and minimalist approach to all FRC IT system design and development in the key areas of interfaces to market systems (MSATS), back office systems and processes and business to business transactions, through the selection and integration of the best features of all internal IT systems from the predecessor organisations and building and updating these features and making the necessary changes wherever possible in an incremental manner; and
- Prudently investing in new IT customer facing systems only where internal IT systems were not available or cost effective to modify.

Country Energy believes that based on this conservative approach to system design and development and the resources employed, that all FRC related costs as reported by Country Energy to PB Associates are prudent and incremental, can be specifically attributed to the introduction of FRC.

Country Energy believes that a 5 year period for recovery of capital is reasonable. However due to market uncertainties, the potential high rate of change of the market and the fact that many of the market rules are still being refined, which could create redundant IT assets, we strongly urge the Tribunal to give consideration to allowing FRC related operating costs to be recovered over a shorter period to the end of the regulatory period. This would minimise the risk to the retailer of not recovering investments in enabling services to allow the implementation of FRC.

Country Energy does not support PB Associates recommendation that FRC related operating costs should be recovered over a five year period. Operating costs represent approximately 30% of total allowed costs for Country Energy. From an equity perspective and in

accordance with good regulatory practice, current (efficient) operating costs should be fully recovered in the time period in which they were incurred (ie in the current regulatory period and not smoothed into future periods) as current consumers are taking advantage of benefits provided by current operating activities.

Country Energy should not be financially disadvantaged because of the costs of implementing FRC and should be provided with sufficient capacity in terms of returns on capital invested to fund future IT investments required under FRC. We believe that an approach to full cost recovery smoothed over the remainder of the current regulatory period, represented by a small legitimate real price increase, would not create a price shock to customers.

In the current target retail tariff a fixed amount per customer has been allocated for FRC costs. Based on the draft report, this amount is an appropriate level and should continue. However, Country Energy would maintain that this revenue has not been recovered from all customers in the current environment. If all regulated retail tariffs were at the target level, then FRC cost would have been collected, however this is not the case.

On average Country Energy regulated retail tariffs are below the target level, therefore a percentage of FRC costs remain uncollected, and will remain uncollected. The result is that returns to the retail business are eroded, and as customers transition to the competitive market these costs will become more difficult to recover.

The situation will be exacerbated, if the network component of the target retail tariff increases to recover prudent FRC costs. The retail business may end up funding these network recoveries, if the current side constraints are not relaxed. As outlined in the previous section this is a significant and unacceptable risk for the retail business. Relaxation of the side constraints is discussed in more detail under section ***4.1 Side Constraints***.

5 ATTACHMENT A

Terms of reference for an investigation and report by the Independent Pricing and Regulatory Tribunal on regulated retail tariffs to apply between 1 July 2002 and 30 June 2004 under Division 5 of Part 4 of the *Electricity Supply Act 1995.*

BACKGROUND

The *Electricity Supply Act I995* sets out arrangements for determining regulated retail tariffs for small retail customers (less than 160 MWh per annum). The Tribunal's report of December 2000, *Regulated Retail Prices for Electricity to 2004,* was taken to be a determination[1] under Section 43EB of the *Supply Act 1995* for the period 1 January 2001 to 30 June 2004.

Small retail customers in NSW can seek supply from the competitive market or they can remain with their standard retail supplier on a regulated 'safety net' tariff. Customers can also switch backwards and forwards between these alternatives. These arrangements are designed to encourage customers to test the market by providing a safety net if a customer's market experience is unsatisfactory. Customers will seek competitive retail supply if the market price is less than the regulated safety net tariff and/or if competitive retail suppliers offer superior service to the standard form contract associated with the regulated safety net arrangements.

The Tribunal's current determination of regulated retail tariffs aimed, in part, to rationalise the number of tariffs through time through the setting of a 'target' level for each regulated retail tariff and a transitional process for moving regulated retail tariffs towards that level over time.

Standard retail suppliers are able to increase regulated retail tariffs that are currently below their target level in line with IPART determined side constraints.

Target levels are 'end-points' for existing regulated retail tariffs. The duration of the transition to the target tariff for an individual customer will depend on how cost reflective the small retail customer's regulated retail tariffs was when the transition commenced. Standard retail suppliers are not able to increase regulated retail tariffs that are currently above the relevant target level, so that these tariffs will decrease in real terms. However, it seems likely that a number of customer tariffs will remain below the target level for some time and this indicates that customers are being charged less than it costs to supply them. The presence of these under-recovering tariffs may undermine the proper functioning of the competitive retail market.

[1] See clause 37, Schedule 6, *Electricity Supply Act 1995.*

Matters for consideration

For the purpose of section 43EB (2)(a) of the *Electricity Supply Act 1995,* the Tribunal is to consider whether there are any factors that would lead the Tribunal to form the view that there has been a material change in the following cost components in the setting of cost-reflective 'target' tariffs since the determination was issued and if so whether this justifies a change in the level of the target tariffs to apply from 1 July 2002 to 30 June 2004:

- an allowance for electricity purchase costs based on an assessment of the long-run marginal cost of electricity generation;
- an allowance for purchases of 'green energy' consistent with retailer licence obligations;
- energy losses as published by NEMMCO;
- network charges as determined by the Independent Pricing and Regulatory Tribunal and the Australian Competition and Consumer Commission;
- fees (including charges for ancillary services) as imposed by NEMMCO under the National Electricity Code;
- an appropriate Retail Gross Margin;
- the allowance for annual indexation based on the Consumer Price Index and expected movements in regulated components and NEMMCO fees.

Consistent with the requirement of section 43EB (2)(b) of the *Supply Act***,** the Tribunal should review the system of tariffs to determine whether the tariffs that are currently below the relevant target level are likely to materially undermine the effective operation of the competitive electricity retail 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 operates effectively.

More specifically, the Tribunal is to take account of the following matters in undertaking its mid term review:

- the effect of side constraints in facilitating the rationalisation of existing regulated tariffs and the transition to the target retail tariffs by 30 June 2004;
- clarification of the circumstances in which standard retail suppliers may introduce regulated retail tariffs in addition to the transitional and target retail tariffs, in particular arrangements for introducing 'green tariffs';
- clarification of off-peak versus controlled loads including the merits of introducing a 'shoulder' target retail tariff; and
- arrangements for the recovery of all reasonable full retail competition costs.

The Tribunal may consult with stakeholders as appropriate, within the timetable for the investigation and report. The Tribunal's report is to be made publicly available.

Timing

The Tribunal is to investigate and provide a report of its determination of regulated retail tariffs by 1 June 2002.

Definitions

'Regulated retail tariff' means a tariff for or in relation to the supply of electricity required to be charged to a small retail customer under a standard form customer supply contract, being a tariff specified in a determination in force under Division *5* of Part 4 of the *Electricity Supply Act 1995.*

'Small retail customer' means a customer that consumes electricity at less than 160 MWh per year as prescribed in clause 7 of the *Electricity Supply (General) Regulation 2001.* A small retail customer is eligible for supply under a standard form customer supply contract.

'Standard retail supplier' means a retail supplier to whose retail supplier's licence is attached a standard retail supplier's endorsement. A standard retail supplier must impose tariffs and charges for or in relation to supplying electricity under a standard form customer supply contract in accordance with any relevant determination of the Tribunal under Division *5* of the *Electricity Supply Act 1995.*[2]

'Standard form customer supply contract' means a contract entered into under Division 3 of Part 4 of the *Electricity Supply Act 1995.*

[2] The standard retail supplier for each supply district is the existing local retailer for that district, based on the existing local network supply areas – Australian Inland Energy and Water, Country Energy, Energy Australia and Integral Energy