

**REGULATION OF RETAIL PRICES
FOR FRANCHISE CUSTOMERS**

IPART SECRETARIAT

**INDEPENDENT PRICING AND REGULATORY TRIBUNAL
OF NEW SOUTH WALES**

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Submissions

Public involvement is an important element of the Tribunal's processes. The Tribunal therefore invites submissions from interested parties to all of its investigations.

Submissions should have regard to the specific issues that have been raised. There is no standard format for preparation of submissions, but reference should be made to relevant issues papers and interim reports. Submissions should be made in writing and if they exceed 15 pages in length, should also be provided in computer disk in word processor, PDF or spreadsheet format.

The closing date for submissions is 17 March 1999.

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Such a claim for confidentiality should be clearly noted in a prominent position on the front page of the submission.

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Public information about the Tribunal's activities

Information about the role and current activities of the Tribunal, including copies of latest reports and submissions can be found on the Tribunal's website at www.ipart.nsw.gov.au

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1 INTRODUCTION

Since the disaggregation of the NSW electricity industry into generation, transmission, distribution and retail supply, IPART has regulated the non-contestable parts of the electricity retail market. IPART's current determination in relation to the retail supply of electricity to franchise customers will expire on 30 June 1999.

IPART is currently conducting an inquiry into the NSW electricity supply industry according to terms of reference provided to IPART by the Premier under s12A of the *Independent Pricing and Regulatory Tribunal Act 1992* ("the IPART Act"). The appropriate pricing of retail supply of electricity by NSW distribution businesses (DBs) to franchise customers is included in those terms of reference. IPART is to report to the Premier by 30 April 1999.

The retail supply of electricity is currently contestable for all customers consuming more than 160MWh of electricity per annum. According to the current contestability timetable:

- customers consuming more than 100MWh of electricity per annum will be permitted to aggregate so as to qualify for the competitive electricity market from 1 July 1999; and
- all customers consuming less than 160MWh per annum will become contestable according to a transitional timetable commencing on 1 January 2001.

As part of IPART's current s12A inquiry, this paper examines, and seeks comment on, the options available to IPART in regulating the retail supply of electricity to franchise customers after 30 June 1999. These issues were also discussed in the issues paper "Pricing for Electricity Networks and Retail Supply", which was issued in September 1998.

2 CURRENT REGULATORY ARRANGEMENTS

2.1 The IPART Act

IPART may make binding determinations in relation to the pricing of "government monopoly services" under ss11 and 12 of the IPART Act. For the purposes of the IPART Act, a "government monopoly service" is defined in s4 to be a service supplied by a government agency and declared by the regulations or the Premier to be a government monopoly service. The current declaration under s4 of the IPART Act in relation to the electricity industry includes the retail supply of electricity to franchise (non-contestable) customers.

A binding determination may be made under s11 of the IPART Act in relation to entities listed in Schedule 1 of the IPART Act. The National Electricity Law:

- removes the six NSW distribution businesses (DBs) from Schedule 1 of the IPART Act;
- provides that the Tribunal may, until 31 December 2000, continue to exercise its functions under the IPART in relation to distribution network services provided by the DBs as if the DBs were listed in Schedule 1.

As is explained below in section 3.2.1, one of the effects of these provisions of the National Electricity Law is that IPART will only be able to regulate retail prices for franchise customers after 31 December 2000 if Schedule 1 of the IPART Act is amended to include the NSW DBs or IPART receives a reference from the Premier under s12 of the IPART Act.

IPART's current determination in relation to retail prices for franchise customers (Determination No. 2.2 of March 1996, as amended by Determination No. 5.3 of July 1997) was made under s11 of the IPART Act.

A binding determination may also be made under s12 of the IPART Act in relation to a matter referred to IPART by the Premier. A reference made under s12 may extend to an annual or other periodic determination and could, potentially, include the retail supply of electricity to franchise customers within NSW by the NSW DBs.

2.2 March 1996 Determination

2.2.1 Gross retail margin

In Determination No. 2.2 of 1996, IPART set a cap for the gross margin of the retail business of each DB. The regulated gross margin only applied to franchise customers and was adjusted as retail competition was gradually introduced to reflect the changing number of customers to which it applied. The regulated gross margin can be defined as electricity revenue minus electricity purchases, network charges and market operations and ancillary fees. A formula containing a number of forward looking drivers regulated the gross margin after the first year of the regulatory period:

$$\text{RGM} = [(a + (b_1N_1 + b_2N_2 + b_3N_3) + cM) - Y] * (1 + (\text{CPI} - X))$$

where:

RGM = regulated gross margin

N = customer number by customer size

N_1 = small	=	0 to 20,000 kWh
N_2 = medium	=	20,000 to 200,000 kWh
N_3 = large	=	above 200,000 kWh

M = MWh sales

a = is a residual fixed term capturing other costs

b = dollar margin per customer for each customer size

c = dollars margin per MW

Y = an adjustment factor to remove the gross margin attributable to contestable customers in the largest tranche

The coefficients 'b₁', 'b₂', 'b₃' and 'c' act as forward looking marginal cost drivers which reflect the changes in overall revenue requirements of the retailer arising from changes in customer numbers and energy throughput respectively.

The gross margin cap was indexed by CPI-X, with X set at the same level for each retailer as for that DB's network business.

2.2.2 Pass-through elements

As is noted above, the gross margin was defined as electricity revenue minus electricity purchase costs, where electricity purchase costs included the cost of electricity, DUOS charges, TUOS charges, market operations fees and ancillary services fees.

Vesting contracts

The cost of purchasing electricity is one of a retailers' principal costs. Retailers are currently required to purchase 85% of the electricity that they supply to franchise customers through vesting contracts. The role of vesting contracts is outlined in the ACCC's draft determination in relation to the NSW vesting contracts:

Vesting contracts are contracts arranged by State jurisdictions between their local generators and retailers. They cover that portion of the electricity load still governed by regulated, rather than competitive tariffs. They aim to provide a range of outcomes, including progressive exposure to competition, hedging protection for retailers against volatile spot prices and revenue stability for generators and retailers.¹

The ACCC also noted in its draft determination that an issue arose from the difference between the revenues NSW retailers collect from their franchise tariffs and the cost of spot market purchases and that:

Under the regulatory arrangements established in March 1996 for the period to July 1999, compliance with the cap on the overall gross margin in the franchise market was calculated on the following purchase cost assumptions:

- 85% of franchise load is purchased under vesting contracts and passed through at an average price of \$44.50 MWh; and
- 15% of franchise load is purchased in the open market and passed through at an average of \$38MWh.

In determining the pass-through arrangements, IPART had regard to:

- the agreement, through an exchange of published letters with the NSW Premier, that prices should fall on average by 20% in the five years to 2000 and the overall level of dividends from the industry, in total, should be maintained at previous levels. This agreement was reached as part of the reform agenda that saw the restructuring of the industry in NSW and the introduction of competition.
- the estimates of the new entrant price of the order of \$40MWh which were current at the time.²

Market operations fees and ancillary services fees

Retailers supplying electricity to franchise customers are also able to pass through market operations fees and ancillary services fees after the commencement of the National Electricity Market.

2.2.3 Side constraints

A number of side constraints were established in the March 1996 determination:

- no single domestic bill (or domestic component of a rural tariff) is to increase by more than the greater of: the CPI increase; or \$5 per quarter for customers not on off-peak tariffs or \$7 per quarter for customers on off-peak tariffs.
- average residential tariffs are not to increase by more than 4.2% which is less than the current annual rate of inflation of 5.2%.

¹ ACCC draft determination in relation to the application for authorisation of NSW vesting contracts, p1.

² ACCC draft determination in relation to the application for authorisation of NSW vesting contracts, p44.

- no commercial or industrial customers' bill is to increase by more than the greater of 5% in real terms or \$50 per annum.³

The March 1996 determination allowed DBs to restructure tariffs as long as these side constraints are not exceeded.

The side constraints were amended in IPART's July 1997 Determination (although they remain largely unchanged):

1. The CPI to apply is the percentage increase in the March year-on-year all groups Sydney CPI calculated for the Tribunal's purposes. This will be denoted by $CPI_{ipartYY}$. As an example, for the year to March 1997, the $CPI_{ipart96/97}$ is 2.3 percent.
2. Residential Tariffs. Any increase in the bill of any individual residential customer may not exceed the greater of:
 - $CPI_{ipartYY}$, or
 - For customers on non off-peak tariffs, \$5.00 per quarter, or
 - For customers on off-peak tariffs, \$7.00 per quarter.

Any increase in the average residential tariff for the total residential group may not exceed 80 percent of the applicable $CPI_{ipartYY}$.

3. Rural tariffs. Any increase in the domestic component of a rural tariff is also subject to the same preceding constraints applicable to the bill of a residential customer.
4. Commercial or Industry Customers. The bill of any commercial or industrial customer may not increase by more than the greater of:
 - 5 percent in real terms, or
 - \$50 per annum.⁴

3 REGULATION OF FRANCHISE CUSTOMERS POST 1 JULY 1999

3.1 IPART's Current Review of the NSW Electricity Industry

IPART is currently conducting a review of the NSW electricity supply industry according to terms of reference provided to IPART by the Premier under s12A of the IPART Act. The terms of reference require IPART to prepare a report in two parts. The first part of the report is to deal with the pricing of electricity transmission network services, while the second part of the report is to deal with the pricing of electricity distribution network services and the retail supply of electricity to franchise customers.

In particular, the terms of reference require IPART to:

- report on the appropriate pricing of government monopoly electricity services provided to franchise customers, by energy distributors, for the period from July 1999.
- base its recommendations on the application of the National Electricity Law and the National Electricity Code with the objectives of protecting the long term commercial value of the affected businesses for the benefit of the State's taxpayers and the long terms interests of the customers of these businesses.

³ Determination No. 2.2, 'Electricity Prices March 1996', pp5-6.

⁴ Determination No. 5.3, 'Electricity Prices July 1997', p11.

3.2 Legislative basis for regulation by IPART after 1 July 1999

Chapter 6 of the National Electricity Code provides IPART with powers to regulate distribution network pricing from 1 July 1999. However, the Code does not provide IPART with any powers in relation to the retail market. The preamble to Chapter 6 states that “retail trading is not regulated by the Code – that is left to the jurisdictions”.

If IPART is to regulate the retail supply of electricity to franchise customers after 1 July 1999, it will have to rely upon the IPART Act.

3.2.1 Limitations of the IPART Act after 31 December 2000

IPART's powers to regulate retail prices for franchise customers

As is noted above, IPART can only make binding determinations under ss11 and 12 of the IPART Act. Electricity retail trading for franchise customers falls within the terms of the current s4 declaration and, therefore, the Tribunal will be able to issue a binding determination in relation to retail prices for franchise customers:

- under s11, until 31 December 2000, when the six NSW DBs are no longer deemed to be listed in Schedule 1 of the IPART Act; or
- under s12, but only if IPART receives a reference from the Premier.

It must be stressed that IPART will only be able to regulate retail prices for franchise customers after 31 December 2000 if:

- **Schedule 1 of the IPART Act is amended to include the NSW DBs; or**
- **IPART receives a reference from the Premier under s12 of the IPART Act.**

3.3 Options for regulating the supply of electricity to franchise customers after 1 July 1999

This section sets out three possible mechanisms that could be adopted for the regulation of the retail market post 1 July 1999, should the appropriate powers be ensured. The Tribunal will consider any other options that are submitted.

3.3.1 OPTION 1 - Cap on price movements from current tariffs

The regulatory mechanism could take the form of a cap on the movement of prices from current levels. This option would not allow the retailer to pass through any of its costs. If such a cap were to take the CPI-X form, the only regulatory decision would be to set the ‘X’ for the term of the regulatory control period.

A cap on price movements could take a number of forms, including:

- a maximum increase for any one customer or tariff class;
- a maximum increase in an index of tariffs; or
- a maximum increase in a retailer’s average price (or revenue yield).

While a cap on price movements would have the advantage of simplicity, it may also suffer from a number of deficiencies, which are outlined below.

Inappropriate allocation of risk

A cap on price movements, without any cost pass through, would not necessarily reflect changes in a retailer's costs. All of the risk associated with changes in what are currently pass-through costs (ie electricity purchase costs, DUOS charges, TUOS charges and market system and ancillary costs) would reside with the retailer. Allocating the risk associated with changing costs to the retailer may be inappropriate where those costs are outside the control of the retailer.

DUOS charges, TUOS charges and market system and ancillary services costs are outside the control of retailers and, therefore, forcing retailers to bear all of the risk associated with changes in these costs may result in substantial windfall gains or losses. It may be costly for the retailer to bear these risks. The purchase price of electricity is also outside the control of retailers to the extent that retailers are required to purchase electricity via vesting contracts when supplying franchise customers.

The fact that costs are outside the control of retailers does not necessarily mean that retailers should not be required to accept risks in relation to those costs. It is not clear that customers are any better able to absorb these risks than the retail business. Some control over the final price for customers may be necessary to ensure the continuing acceptability of electricity reform.

It is important to note that retailers will have increasing control of the cost of electricity that they purchase from the wholesale market. Currently, retailers are permitted to purchase 15% of the electricity that they supply to franchise customers from the wholesale market.

Abuse of market power

A further problem could arise under this option if the cap on movements permits price movements large enough to allow structural reform in that such a cap could permit the abuse of market power and accrual of monopoly rents. In order to address this possibility, it may be necessary to impose a number of separate caps on different groups of customers.

Accommodating further tranches of contestable customers

It will be necessary for there to be an adjustment mechanism to allow for further tranches of customers becoming contestable whichever form of regulation is used. The nature of the adjustment mechanism will depend upon the type of cap imposed.

As is noted above, the cap outlined in option 1 could take a number of forms including a cap on average prices or a cap on the prices for a particular tariff class. A cap on the movement of average prices will need to be adjusted for each tranche of contestable customers so as to reflect the changing profile of the remaining franchise customers. A cap on the movement of the prices for a particular tariff may also need to be adjusted if some, but not all, customers on that tariff become contestable.

This problem will not arise if all remaining customers become contestable in a single tranche.

3.3.2 OPTION 2 - maximum retail price with pass-through costs

A regulatory mechanism that set either a maximum retail price or a maximum retail margin (discussed below) could be structured to allow retailers to pass through costs outside their control. This would significantly reduce the risks associated with retailers' profits compared to the cap on price movements outlined above, where retailers would not be able to pass through any costs. As is noted above, while reducing retailers' risks is worthwhile it is unclear that customers are any better able to deal with the risks associated with these costs than retailers.

A maximum retail price could take the following form:

Maximum retail price =

$$(\text{Energy Costs} + \text{TUOS} + \text{DUOS} + \text{market operations fees} + \text{profit margin}) * (1 + \text{CPI} - X)$$

A maximum retail price could take a number of forms, including a maximum price for all franchise customers or a series of maximum prices to apply to different segments of the franchise market (eg residential, small business etc). It could be specified as an absolute maximum not to be exceeded by any tariff or as a maximum for the average across a range of tariffs or customer classes.

Retailers' profits restricted from exceeding a reasonable level

One of the principal advantages of setting a maximum retail price would be that retailers' profits on franchise sales would be limited to a reasonable level. Where costs were not passed on, there would be the potential for retailers to make substantial windfall gains (and losses), and thereby earn monopoly rents. Further, because retailers would be allowed to pass on costs outside their control, retailers would face less risk than if they were subject to a cap on price movements of the type discussed above.

On the face of it, establishing a regulatory mechanism which sets maximum prices for franchise customers while allowing retailers to pass on many of their costs may be inconsistent with the principles of incentive regulation. One of the fundamental principles of incentive regulation is that revenue or prices, rather than profits, should be regulated. Allowing a retailer to pass on some of its costs may create inappropriate incentives. However, under this option such, incentives may not be a problem given that the principal controllable cost (the 15% of electricity purchased through the spot market) could be set at an arm's length value.

When considering which costs a retailer should be allowed to pass on, the following considerations will be important:

- whether the costs are outside the retailer's control; and
- whether the retailer is not the most appropriate party to bear the risks associated with those costs.

Difficulty of measuring the cost of electricity purchases

As retailers purchase electricity both through vesting contracts and the wholesale market, the cost of electricity for retailers will depend upon both the vesting contract price and the price that retailers are able to negotiate in the wholesale market. The price that retailers

negotiate in the wholesale market will not be known by the regulator and, therefore, the costs of the retailer will need to be calculated in terms of a 'deemed' market price. Arrangements for the calculation of the deemed market price and the manner of adjustment, if any, during the period of the cap would be critical to the success of these arrangements.

Accommodating further tranches of contestable customers

As new tranches of customers become contestable, the allowed profit margin per customer may need to be adjusted to reflect the changing profile of customers.

3.3.3 OPTION 3 - Maximum gross retail margin with pass-through costs

The current regulatory arrangements take this form. As with option 2, retailers are permitted to pass through a number of costs outside their control.

Setting a maximum retail margin has similar advantages and disadvantages to setting a maximum retail price. By allowing retailers to pass through costs that are beyond their control, retailers' profits are kept to a reasonable level. However, as with setting a maximum retail price, problems associated with deeming a 'market' price for electricity purchases and adjusting for further tranches of contestable customers will arise.

3.3.4 OPTION 4 – A mix of regulatory mechanisms

It is also possible to implement a combination of the regulatory mechanisms outlined above. For example, a maximum retail margin could be combined with side constraints, as in the current determination.

The Secretariat seeks comments on the appropriate form of regulation for retail prices for franchise customers to apply after 30 June 1999. In particular, the Secretariat seeks comments on:

- ***which form of cap should be applied to the retail supply of electricity to franchise customers after 30 June 1999***
- ***whether the cap (whichever form the cap takes) should include forward looking cost drivers, as it did in the March 1996 determination and, if so, what those drivers should be***
- ***whether a CPI-X adjustment should be incorporated in the retail cap and, if so, how 'X' should be determined***
- ***what costs retailers should be permitted to pass-through.***