



Promoting retail competition and investment in the NSW electricity industry

Regulated electricity retail tariffs and charges for small customers 2007 to 2010

Electricity - Draft Report and Draft Determination
April 2007



Independent Pricing and Regulatory Tribunal

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**The Tribunal members for this review are: Dr Michael Keating AC, Chairman,
Mr James Cox, Full Time Member and Ms Sibylle Krieger, Part Time Member**

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Draft Report No 1, 2007

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**Independent Pricing and Regulatory Tribunal
of New South Wales**

Reference No: 05/499

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1 INTRODUCTION AND OVERVIEW

The Independent Pricing and Regulatory Tribunal of NSW (the Tribunal) is responsible for setting the regulated retail electricity tariffs charged by the Standard Retailers in NSW – Country Energy, EnergyAustralia and Integral Energy – to small retail customers on standard form customer contracts.¹

Since 1 January 2002, all electricity customers in NSW have had the option to choose their retail electricity supplier and negotiate a retail supply contract, or to remain with their Standard Retailer on a regulated tariff.² Although customers are increasingly exercising choice and negotiating retail supply contracts, around 70 per cent of customers are still on regulated tariffs.

At the COAG meeting of 10 February 2006, Australian governments agreed to the Ministerial Council on Energy's (MCE's) reform agenda. Part of this agenda is the phasing out of energy retail price regulation where effective competition can be demonstrated, with reviews to commence on 1 January 2007.³ In this context, it has asked the Tribunal to set regulated retail tariffs and charges for small retail customers from 1 July 2007 to 30 June 2010, but to do so in a way that reduces customers' reliance on regulated prices, and facilitates retail competition.

The Tribunal considers that higher retail electricity prices in NSW are justified, and indeed necessary, to ensure that the people in this state continue to have access to a safe and reliable supply of electricity. Over the next three years, the Electricity Tariff Equalisation Fund (ETEF) will be phased out and, as a consequence, NSW electricity arrangements will more closely resemble those in Victoria and South Australia. Wholesale energy prices need to be sufficient to attract efficient and economic investment in generation to NSW, and to enable retailers to meet their obligations regarding greenhouse gas emissions and purchases of renewable energy. In addition, retail prices need to be sufficient to recover the costs incurred in selling electricity in a competitive market, and to compensate retailers for the risks that they face. Retail prices also need to be sufficient to recover investments in the distribution network associated with increased reliability standards and higher peak demand.

In undertaking its review and making its draft determination, the Tribunal has been guided by the terms of reference provided by the Minister for Energy (see Appendix 1). The terms of reference require the Tribunal to do the following:

- The Tribunal is required to assess the costs of a hypothetical retailer, including the retail operating costs and margin of a mass market new entrant, and the energy purchase costs, in the absence of the ETEF, for the regulated load in each Standard Retailer's supply district.
- The Tribunal is required to recognise retailers' hedging, risk management and transaction costs. This is because in the past, the Standard Retailers have had minimal trading risk: initially, they purchased energy through vesting contracts, and later

¹ Customers consuming less than 160 MWh per annum of electricity can be supplied under a standard form customer contract and, therefore, be subject to a regulated tariff or can enter into a negotiated contract.

² Over the five years since full retail competition was introduced the Tribunal has continued to regulate electricity retail tariffs for small customers that have not entered into the competitive market.

³ Council of Australian Governments' Meeting, *Communiqué*, 10 February 2006, Appendix A to Attachment B, p 8.

through the Electricity Tariff Equalisation Fund (ETEF). However, the ETEF arrangement is to be phased out over the 2007-10 determination period, exposing Standard Retailers to trading risk for their regulated load.

- The Tribunal is required to consider retailer operating costs and margin based on those of a mass market new entrant. A mass market new entrant's costs include customer acquisition costs, which are not incurred by a Standard Retailer in servicing *regulated* customers.
- The terms of reference do not direct the Tribunal to have regard to the impact of its determination on customers. Instead, the focus on ensuring that tariffs are cost reflective (from the perspective of the hypothetical retail business) by the end of the regulatory period is stronger than in previous terms of reference.

Under the Tribunal's draft determination, total average prices for EnergyAustralia, Integral Energy and Country Energy will increase by 4.5, 5.0 and 4.0 per cent respectively in real terms each year. These total average price increases arise from:

- increased energy purchase costs (except for Country Energy)
- increased retail operating costs (principally, the inclusion of customer acquisition costs)
- increased retail margin
- increased network charges.

As noted above, the terms of reference require the Tribunal to construct the costs of a hypothetical retailer -- a retailer that is neither a mass market new entrant nor a Standard Retailer -- including the retail operating costs and margin of a mass market new entrant, and the energy purchase costs, in the absence of the ETEF, for the regulated load in each Standard Retailer's supply district. The aggregated cost allowances for this hypothetical retailer are likely to be higher than the efficient costs of the Standard Retailers supplying regulated customers, because:

- They include customer acquisition costs which, as noted above, are not incurred in relation to regulated customers.
- Standard Retailers will still have access to the ETEF for a significant proportion of their regulated load until the end of the determination period, and therefore will face less market risk than the Tribunal has allowed for.
- The Tribunal has set the retail margin allowance on the basis of a mass market new entrant, and this could be higher than the margin required by the Standard Retailers under current circumstances. However, it will become more appropriate for these retailers towards the end of the determination period, as the Tribunal expects the competitiveness of the NSW market to increase over this period.

The hypothetical retailer costs could also be higher than those of an efficient mass market new entrant, which may engage in a different trading strategy to the one the Tribunal assumed in constructing these cost allowances, where it adopts a lower cost but higher risk portfolio. In addition, the terms of reference required the Tribunal to assess the energy cost allowance on the basis of the regulated load only, which ignores potential portfolio benefits that could be achieved by (Standard or mass market new entrant) retailers in a broader market.

The Tribunal considers that its draft determination, through both the form of regulation and the level of tariffs, will reduce customers' reliance on regulated prices and facilitate retail competition, including the potential for new mass market retailers. It should also encourage investment in new generation, where it is efficient and economic. Regulation should be removed in 2010 if, as expected, there is sufficient competition in the market.

In addition, the Tribunal notes that the increased competition should place pressure on all retailers, including the Standard Retailers, to pursue efficiency gains to increase their competitiveness. This is in the long-term interest of customers.

1.1 Overview of the draft determination

To assist it in undertaking its review and guide its decision making, the Tribunal established a set of assessment criteria based on the terms of reference, the requirements of the *Electricity Supply Act 1995* (the Act), and regulatory best practice. These criteria are set out in Chapter 2. However, the two overriding criteria, and Tribunal's primary objectives for this review, were:

1. to ensure that Standard Retailers charge prices that are at cost reflective levels by 2010 in order to provide regulatory protection to small retail customers
2. to facilitate the development of effective retail competition for small retail customers.

As part of its review and decision making, the Tribunal formed a view on the appropriate form of regulation, and on the value of the regulated retail price controls that will apply to regulated tariffs. An overview of its considerations and conclusions on each of these matters is provided below.

1.1.1 Form of regulation

In general, as a market becomes more competitive, less regulation is required. The Tribunal reviewed the competitiveness of the NSW retail electricity market to inform its decision making on the form of regulation. It found that, for the purposes of this review, there are currently two distinct markets within NSW – the metropolitan market, which includes EnergyAustralia's and Integral Energy's supply areas, and the non-metropolitan market, which includes Country Energy's supply area. These markets have different levels of competition. On balance, the Tribunal considers that:

- In the metropolitan market there is sufficient competition to restrain increases in each individual tariff.
- In the non-metropolitan market, competition is developing but it is unclear whether there is currently sufficient competition to restrain increases in each individual tariff. There is the potential for the level of competition to increase over the 2007 to 2010 regulatory period. However, there may also be persistent factors that will prevent the level of competition in this market from developing to the same extent as the metropolitan market over the medium term.

The Tribunal expects that the competitiveness of the market will increase over the next three years, partly as a result of its determination.

Given this view on the current level of and potential for competition, the Tribunal considers that moving towards more light-handed form of regulation in this draft determination is justified.⁴ In particular, the Tribunal has made draft decisions to:

- Adopt a form of weighted average price cap as the form of regulation for regulated tariffs, which will allow the Standard Retailers to set their own prices subject to meeting an overall regulatory constraint. This overall constraint is expected to allow full cost reflectivity by 2010.
- Increase the discretion of the Standard Retailers to set their own prices by removing specific regulations relating to price setting from the determination.
- Remove limits on price movements (except for a threshold limit on individual price increases for Country Energy).
- Maintain a prohibition on introducing new regulated tariffs (except with the agreement of the Tribunal).
- Allow the abolition of regulated tariffs (with some additional constraints for Country Energy).

This form of regulation is consistent with the Tribunal's assessment criteria. Specifically, the Tribunal considers that it will allow the Standard Retailers to use pricing discretion to set tariffs at cost reflective levels by 2010, and will facilitate the development of competition in the market for small retail customers. The Tribunal considers that the Standard Retailers are best placed to determine individual cost reflective tariffs throughout the determination period, although the Tribunal would be concerned by very large movements in any particular individual tariff.

1.1.2 Level of regulated price controls

The Tribunal has determined the values of the regulated retail price controls (R values), which are to be included in the weighted average price cap, together with actual network charges (N values). These values are higher than those provided in the 2004-2007 determination.

For 2010, the Tribunal has set R values (in \$2006/07) that reflect:

- market-based energy purchase costs, based on the Frontier Economics' conservative point estimate for each business
- an allowance for volatility in these costs based on a cost of associated working capital approach of \$0.7/MWh for Country Energy, \$0.9/MWh for EnergyAustralia and \$1.1/MWh for Integral Energy
- costs associated with greenhouse reduction and renewable energy requirements of \$5/MWh to \$6/MWh
- retail operating costs of \$75 per customer plus customer acquisition costs of \$34 per residential customer and \$42 per business customer per annum (with 75 per cent of retail operating costs and 100 per cent of customer acquisition costs being fixed costs per customer)
- retail margin of 5 per cent (on an EBITDA basis)

⁴ For example, this draft determination gives greater pricing discretion to the Standard Retailers compared to previous determinations and removes limits on individual prices.

- NEM fees of \$0.7 per MWh
- energy losses of 6.4 per cent for EnergyAustralia, 9.0 per cent for Integral Energy and 12.6 per cent for Country Energy.

The Tribunal decided to set the R values for 2007/08 and 2008/09 to reflect a transition to the calculated hypothetical retailer costs in 2009/10. It considers that these R values are appropriate given the gradual increase in risks and costs as the ETEF unwinds and competition increases. Further, the Tribunal considers that the hypothetical retailer costs more than recover the costs of a Standard Retailer for regulated customers while the ETEF remains and competition increases.

The total retail price of electricity includes network (distribution and transmission) charges, which are applicable irrespective of whether a customer remains on a regulated tariff or has entered into a negotiated tariff. Network prices are regulated by the Tribunal and the Australian Energy Regulator, and these prices will increase in real terms, on average, by around 3 to 4 per cent each year of the determination period.

Table 1.1 shows the cumulative real price increase in total retail tariffs over the period from 2007 to 2010 and the drivers of these increases.

Table 1.1 Cumulative real increases in total retail tariffs and drivers of these increases (2006/07 – 2009/10)

	EnergyAustralia	Integral Energy	Country Energy
Electricity costs	3.8%	5.7%	-1.6%
Retail costs	3.6%	3.3%	2.9%
Retail margin	3.3%	3.3%	3.4%
Network (including margin on network)	4.3%	4.5%	6.1%
Under/over recovery	-0.3%	0.0%	3.2%
Other	-0.7%	-1.1%	-1.5%
Cumulative average price increase	14.0%	15.7%	12.4%

Notes:

1. Under/over recovery refers to the difference between the costs established in the 2004 to 2007 determination and the costs recovered through tariffs.
2. Other includes losses, NEM fees and the effect of changes in the consumption of different types of tariffs since the 2004 determination.
3. Totals may not sum due to rounding.

As Table 1.1 shows, the main sources of price increases are:

- an increase in the energy cost allowance, due to the fact that:
 - the ETEF will cease to operate, exposing the Standard Retailers to riskier energy trading, and
 - the Standard Retailers have different regulated load shapes, which were not individually recognised in the 2004-2007 determination
- an increase in retail operating costs (principally, the inclusion of customer acquisition costs)

- an increase in the retail margin
- an increase in network charges.

The Tribunal also considered regulated retail charges (or non tariff charges) and has decided to continue the arrangements set out in the 2004 to 2007 determination, with minor amendments. However, it has made a draft decision to increase the late payment fee from \$5 to \$7.

This draft report explains the Tribunal's draft decisions and accompanies the Tribunal's draft determination on this matter. The Tribunal is now seeking comment from interested parties before making its final determination.

1.2 Review process

In July 2006, the Tribunal released an issues paper and sought submissions from the three Standard Retailers and other stakeholders. The Tribunal also engaged Frontier Economics to provide expert advice on energy costs and mass market new entrant retail costs and margins for the review.

On 8 September 2006, the Tribunal held a public information session, where the Standard Retailers presented their proposals to inform other stakeholders and to assist them to prepare their submissions.

On 27 October 2006, the Tribunal released a paper drafted by Frontier Economics setting out its proposed methodologies for assessing energy costs and retail costs and margin. On 2 November, it held a workshop for interested parties to comment on the proposed approaches.

Frontier Economics' draft reports were released on 20 December 2006 and the Tribunal invited interested parties to attend a public meeting on 25 January 2007 to provide feedback on these reports. The Tribunal also sought submissions on these reports by 2 February 2007, which Frontier Economics took into account in making its final recommendations to the Tribunal at the end of February.

The Tribunal carefully considered the views expressed in all the submissions it received and at the public meetings, and undertook its own analysis. It also considered the final recommendations made by Frontier Economics. The Tribunal is releasing Frontier Economics' final public report with this draft report and determination.

The Tribunal now seeks comments on this draft report and determination. Submissions are due on 2 May 2007. Following consideration of these submissions, the Tribunal will release a final report and determination by 14 June, which will apply from 1 July 2007.

Stakeholders should note that the Tribunal anticipates that the cost allowances in the final determination may differ from the draft determination. The AEMC is currently considering proposed changes to the NEM regional boundary structure, which may impact the appropriate energy purchase cost allowance. Other factors that also have the potential to influence the Tribunal's decisions are its intention to investigate the scope for efficiencies in retail operating costs driven by increased competition and to further consider some of the analysis underlying the retail margin allowance.

The members of the Tribunal for this review are: Dr Michael Keating AC, Chairman, Mr James Cox, Full Time Member and Ms Sibylle Krieger, Part Time Member.

1.3 Structure of the report

This report explains the draft determination in detail, including the analysis that supports the Tribunal's draft decisions, and addresses the Minister's terms of reference.

- Chapter 2 sets out the Tribunal's approach to the review, including its objectives and assessment criteria
- Chapter 3 sets out the policy for context for the review, including a number of recent Government decisions that the Tribunal has taken into account in making its draft determination
- Chapter 4 explains the Tribunal's findings and analysis on the current level of competition in the NSW retail electricity market
- Chapter 5 outlines the approach to tariff setting in the draft determination, including which tariffs are regulated, the form of regulation adopted and how this form will be applied, the requirement for Country Energy to obtain approval to increase tariffs by more than a specified level, and the inclusion of a pass through mechanism for certain costs
- Chapter 6 provides the Tribunal's draft findings in relation to the allowance for energy purchase costs
- Chapter 7 provides the Tribunal's draft findings in relation to the allowances for retail operating costs and retail margin
- Chapter 8 summarises how the Tribunal has calculated the hypothetical retailer costs from the allowances for energy costs (Chapter 6) and retail operating costs and margins (Chapter 7). It also explains how the Tribunal used these costs to inform its draft decision on the value of the regulated retail price controls ('R values'), and why its decision is based on the 2009/10 cost allowances
- Chapter 9 illustrates the expected impact of the draft determination on customers
- Chapter 10 sets out the Tribunal's draft decisions on non tariff charges (including late payment fees, dishonoured bank cheque fees, and security deposits).

2 THE TRIBUNAL'S APPROACH TO THE REVIEW

Because this review is different to previous regulated retail electricity price reviews, the Tribunal needed to develop a new approach for its analysis and decision-making.

One important difference between this and previous reviews is that the terms of reference for this review direct the Tribunal to have regard to the costs of a 'hypothetical retailer', not those of the regulated businesses (the Standard Retailers). Another important difference is that the Tribunal is setting regulated retail tariffs and non tariff charges in the context of an increasingly competitive market.

The sections below explain the approach the Tribunal used to undertake its analysis and support its draft decisions, and discuss the Tribunal's objectives and the detailed assessment criteria it applied within this approach.

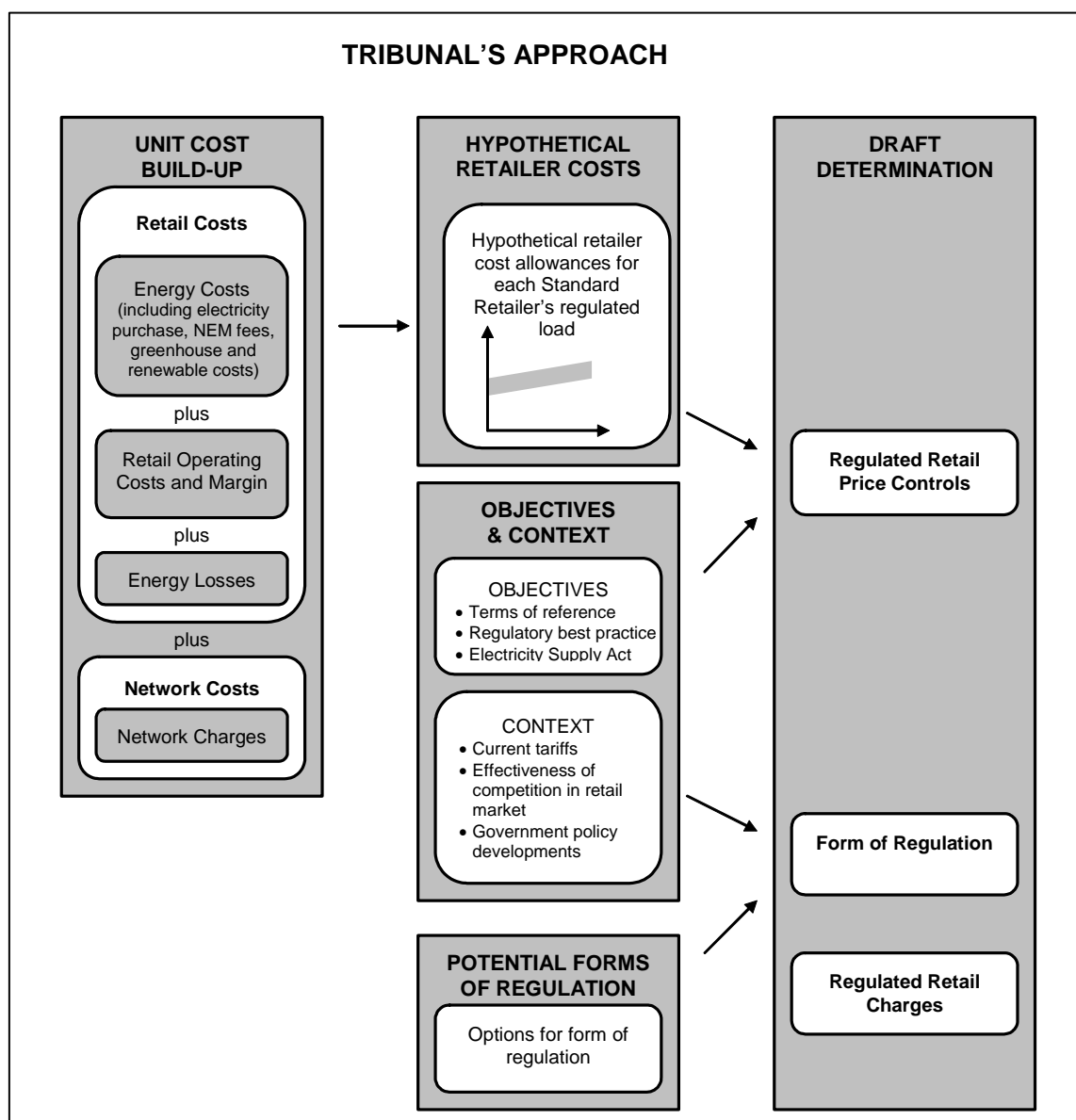
2.1 Overall approach

The Tribunal's approach to the review involved a number of explicit steps, which were designed to align with the terms of reference and to recognise the interim 'decision points' in the analysis process.

This approach, which is illustrated in Figure 2.1 below, involved the following steps:

- **Establishing objectives and assessment criteria.** At the outset of the review, the Tribunal established detailed objectives and assessment criteria to guide its analysis and support its decision-making.
- **Considering context.** The context for the review differs from previous reviews due to significant policy changes, such as the decision to phase out the Electricity Tariff Equalisation Fund (ETEF) arrangement over the course of the determination period, and also developments in retail competition. The Tribunal assessed these developments to inform its decisions.
- **Analysis of options for regulating retail tariffs.** The terms of reference asked the Tribunal to set regulated retail tariffs and charges, but did not prescribe the form of regulation it was to apply. Therefore, the Tribunal identified and analysed the options for regulating retail tariffs in the determination period, to inform its decision on the form of regulation.
- **Analysis of costs.** The terms of reference required the Tribunal to consider cost allowances for a hypothetical retailer and to recognise a number of risks. As a first step, the Tribunal assessed each cost component specified in the terms of reference. Second, the Tribunal aggregated these costs to obtain a cost allowance for a hypothetical retailer in each standard supply area. Third, it broke down these aggregated costs per unit (\$ per customer and \$ per MWh) for each year of the determination period. The output of this work informed the Tribunal's decisions, particularly those in setting the regulated retail price controls.
- **Deciding on the form of regulation and on the value of the regulated retail price controls.** As a last step, the Tribunal drew together the various streams of analysis, and made its draft decisions on the form of regulation to apply over the period, and on the value of the regulated retail price controls within this form of regulation.

Figure 2.1 Tribunal's approach to the review



2.2 Tribunal's objectives and assessment criteria

At the outset of the review, the Tribunal set objectives and assessment criteria to guide its decision making. These objectives were largely determined by the *Electricity Supply Act 1995* and the terms of reference for this review. They were also influenced by the Tribunal's experience in other reviews and best practice regulation.

The *Electricity Supply Act 1995* requires the Tribunal to have regard to the matters specified in the terms of reference and to the effect of its determination on competition in the retail electricity market.

The terms of reference provide detailed guidance on the matters to be considered by the Tribunal. However, there are inherent tensions between some of the objectives implied by the terms of reference and, as a result, there are trade-offs in how well any determination can meet these various objectives. For example, it is difficult to develop a form of regulation that

would both allow for the further rationalisation of regulated retail tariffs and ensure that network charges are fully recovered, due to the large number of network tariffs.

There are also inconsistencies within the terms of reference. For example, the terms of reference require the Tribunal to consider costs of a mass market new entrant retailer while also requiring it to consider issues specific to the Standard Retailers (for example, recognising that the ETEF will cease operation within the determination period and the different load profiles of each Standard Retailer).

The Tribunal established the following criteria and objectives for this review:

1. To ensure that Standard Retailers charge prices that are at cost reflective levels by 2010 in order to provide regulatory protection to small retail customers.
2. To facilitate the development of effective retail competition for small retail customers.
3. To explicitly address each of the costs and factors listed in the terms of reference as "matters for consideration" under section 43EB (2)(a).
4. To take account of the "Government's policy aim to reduce customer's reliance on regulated prices".
5. To allow for the further rationalisation of regulated retail tariffs.
6. To enable, where possible, decisions to be made by the parties who are in the best position to make those decisions (avoid regulatory micro-management).
7. To ensure the determination is practical, pragmatic and feasible.
8. To ensure the determination is simple and understandable.
9. To ensure the determination is targeted – so that there is a clear match between the choice of mechanisms and the regulatory objectives.
10. To ensure that any 'solutions' within the determination are proportionate with the problem.

The first two objectives are the primary objectives of this review and were the Tribunal's main focus. These objectives are derived from the terms of reference and the Act. The third, fourth and fifth objectives are derived from the terms of reference, while the remaining objectives/criteria reflect regulatory best practice.

The Tribunal applied these objectives and assessment criteria during each of the steps in this review.

3 POLICY CONTEXT FOR THE REVIEW

Since the Tribunal made its last electricity retail price determination in 2004, there have been a number of developments in government policy that affect the regulation of retail prices.

In particular, the Tribunal had to take into account five key policy issues in making its draft determination. These were:

- the endorsement by the Council of Australian Governments (COAG) of the Ministerial Council on Energy's reform agenda, particularly the agreement to phase out retail price regulation where effective competition is demonstrated
- COAG's agreement to the progressive national roll out of 'smart' electricity meters from 2007 to allow the introduction of time-of-day pricing
- the NSW Government's decision to phase out the Electricity Tariff Equalisation Fund arrangement (ETEF) between September 2008 and June 2010
- new policies relating to renewable energy, including the requirement in the NSW Greenhouse Plan for retailers to offer a 10 per cent Green Power component to all new or moving residential customers, and the proposed NSW Renewable Energy Target
- significant existing customer assistance measures.

This chapter provides a summary of the Tribunal's considerations on each of these issues and a short overview of how they have influenced the draft determination.

3.1 COAG endorsement to phase out retail price regulation

At the COAG meeting of 10 February 2006, Australian governments agreed to the Ministerial Council on Energy's (MCE's) reform agenda. Part of this agenda is the phasing out of energy retail price regulation where effective competition can be demonstrated, with reviews to commence on 1 January 2007.⁵ The Amended Australian Energy Market Agreement specifies that the Australian Energy Market Commission (AEMC) will undertake regular assessments of the effectiveness of competition in retail energy markets and conduct a review every two years until all retail energy price controls are phased out. States and Territories retain the right to maintain reserve price regulation powers, obligation to supply arrangements and price monitoring to protect consumer interests, provided these do not materially impede competition.⁶ The AEMC is currently consulting on the timing and process for its reviews.

Given the above, the Tribunal recognises that retail price regulation is a transitional measure. For this reason, it has selected a more light-handed approach to regulation, which it considers will facilitate the development of effective competition for small retail customers. Chapter 5 contains further discussion of the Tribunal's analysis in relation to this issue.

⁵ Council of Australian Governments' Meeting, *Communiqué*, 10 February 2006, Appendix A to Attachment B, p 8.

⁶ Ministerial Council of Energy, *Energy Market Reform Bulletin No. 64*, 7 June 2006.

3.2 COAG agreement to roll out of time of use meters

In February 2006, COAG agreed to improve price signals for energy consumers and investors. COAG committed to:

... the progressive national roll out of 'smart' electricity meters from 2007 to allow the introduction of time of day pricing and to allow users to better manage their demand for peak power only where benefits outweigh costs for residential users and in accordance with an implementation plan that has regard to costs and benefits and takes account of different market circumstances in each State and Territory.⁷

Electricity network service providers in NSW have already begun introducing time-of-use meters for small retail customers. For example, EnergyAustralia is currently rolling out 'smart' meters that are able to record consumption in half-hour periods. It intends to implement time-of-use metering and pricing progressively over the next decade, as part of a long-term plan to help reduce the increasing peaks in electricity demand by spreading electricity consumption more evenly across the day.⁸

Under the current determination, retailers have experienced some practical difficulties in restructuring tariffs, including establishing time-of-use tariffs. The Tribunal considers that its draft determination will provide the Standard Retailers with the flexibility to incorporate demand management initiatives, including time-of-use pricing. Chapter 5 contains further discussion of this issue.

3.3 Decision to phase out the ETEF arrangement

The Electricity Tariff Equalisation Fund (ETEF) arrangement was put in place to allow the NSW Government to regulate retail prices without undermining competition or exposing retailers or the Government to unacceptable financial risk.⁹ Retailers contribute to and/or withdraw from the fund based on differences between the actual price they pay for electricity and the cost of electricity assumed in setting regulated retail tariffs. Government-owned generators are also required to contribute to the fund when it falls below a certain level.

The Government has announced that the ETEF arrangement will be phased out gradually between September 2008 and June 2010.¹⁰ The timetable for phasing out the ETEF is shown in Table 3.1.

⁷ Council of Australian Governments' Meeting, *Communiqué*, 10 February 2006, p 5.

⁸ EnergyAustralia website <<http://www.energy.com.au/energy/ea.nsf/Content/NSW+TOU+Res+Home>>

⁹ Office of Financial Management, *Electricity Tariff Equalisation Fund – Information Paper*, December 2000, p 1.

¹⁰ Office of Financial Management, *Payment rules for the Electricity Tariff Equalisation Fund*, April 2006, p 3.

Table 3.1 Timetable for phasing out the ETEF

Date	Percentage of NSW regulated retail load supported by the ETEF
Until 27 September 2008	100
28 September 2008 to 28 March 2009	80
29 March 2009 to 26 September 2009	60
27 September 2009 to 27 March 2010	40
28 March 2010 to 26 June 2010	20
27 June 2010 onwards	0

Source: Office of Financial Management, Payment rules for the Electricity Tariff Equalisation Fund, April 2006, p 3.

The terms of reference for the review require the Tribunal to recognise that the ETEF arrangement will cease operation within the determination period and to consider the additional costs and risks that the Standard Retailers will face in its absence.

The Tribunal accepts that the Standard Retailers will increasingly face costs and risks associated with hedging and risk management as the proportion of regulated load supported by the ETEF reduces. The Tribunal has considered these costs and risks in making its draft determination. Chapters 6 and 8 contain further discussion of the Tribunal's analysis in relation to this issue.

3.4 New policies relating to renewable energy

Under the NSW Greenhouse Plan,¹¹ the NSW Government requires energy retailers to offer a minimum of 10 per cent Green Power to all new and moving customers. Since 15 January 2007, all retailers that offer electricity to new residential customers or residential customers that change address must offer a minimum of 10 per cent of electricity from accredited renewable energy sources. Customers have the option of taking electricity supply with or without 10 per cent Green Power.

Prior to this requirement being introduced, electricity retailers were able to offer customers the option of paying a premium to ensure that an agreed proportion of their electricity is sourced from renewable energy or 'green' sources. The 10 per cent Green Power requirement does not prevent a retailer from continuing to offer other green products.

In the past, the Tribunal has chosen not to regulate the price customers elect to pay to ensure that a certain percentage of their electricity is generated from renewable sources (the 'green premium'). The 2004 determination allows customers being supplied on a regulated retail tariff to elect to pay a green premium without the need to move to a standard form supply contract. The Tribunal considers that it is appropriate to continue not to regulate the premium. This includes the premium offered in relation to the 10 per cent Green Power program. This issue is discussed further in Chapter 5.

¹¹ NSW Greenhouse Office, The Cabinet Office of the Government of NSW, *NSW Greenhouse Plan*, 2005.

In addition, the Government proposes to introduce a NSW Renewable Emissions Target (NRET). The scheme will impose a target on electricity retailers and will include renewable energy certificate trading and an enforceable penalty for non-compliance where retailers fail to meet their targets.¹² Retailers will be required to meet their obligations under this scheme by surrendering renewable energy certificates. The Tribunal has included the likely prudent costs of securing adequate supply of renewable energy certificates to meet these statutory obligations in the green cost allowance. This is discussed further in Chapter 6.

3.5 Customer assistance measures

There are a number of NSW Government assistance measures to address the needs of customers in financial hardship, including:

- pensioner rebates (\$112 pa for pensioners with a Centrelink Pensioner Concession card, a Department of Veterans Affairs Pensioner Concession Card and pensioners in receipt of a Department of Veterans Affairs war widows/widowers or disability pension at the 'totally and permanently incapacitated' rate or 'extreme disablement adjustment rate' or 'Gold' Repatriation Health Card)
- life support rebates
- Energy Accounts Payment Assistance Vouchers, EAPA (\$30 vouchers to assist pay energy bills, issued by participating community welfare organisations).

Customer hardship measures also form part of the obligations placed on holders of retail supplier licences. These include requirements for:

- disconnection and reconnection procedures
- Standard Retail Suppliers to operate payment plans with certain criteria
- all retailers to comply with directions of the Minister relating to implementation of any aspect of the Government's social programs for energy, which include Pensioner Energy Rebates, Life Support Rebates and EAPA programs administered by the NSW Department of Energy Utilities and Sustainability (DEUS).

The Tribunal also notes that if the draft regulations¹³ circulated for comment in February 2007 are passed, it would be a licence condition for all retailers supplying residential small retail customers to:

- operate a payment plan that allows customers to make payments by instalments and for the instalments to be calculated having regard to the customers' consumption needs and capacity to pay
- before disconnecting a customer for failure to pay, ensure that they have advised the customer that s/he can apply for assistance under the payment plan and that the customer has either failed to apply for assistance or has been assessed as ineligible for assistance under the payment plan.

¹² Department of Energy, Utilities and Sustainability *NSW Renewable Energy Target Explanatory Paper*, November 2006, p 2.

¹³ Public Consultation Draft, *Electricity Supply (General) Amendment Regulation 2007*, circulated 5 February 2007.

The Tribunal is aware that in addition to these requirements, retailers currently have or are developing assistance programs such as:

- payment plans tailored to the customer's circumstances
- referrals to assistance agencies and financial counselling services
- the provision of free energy audits for eligible customers
- guarantees of no disconnection for customers in assistance programs
- the use of internal indicators for early identification of customers in financial hardship so advice and assistance can be provided early
- incentive matching payments for eligible customers on instalment plans satisfying payment requirements.

In making its draft determination, the Tribunal has considered these current and proposed customer assistance measures. From the retailers' point of view, many of the costs of administering these measures are unavoidable costs of doing business. In addition to meeting customer assistance obligations, efficient businesses will voluntarily incur costs associated with hardship programs as a business strategy to reduce costs associated with non-payment/bad debts. On this basis, the Tribunal has taken account of the costs associated with the measures currently in place as part of its consideration of efficient mass market new entrant retail costs, which is set out in Chapter 7.

4 CURRENT LEVEL OF RETAIL COMPETITION

One of the main factors the Tribunal considered in making its draft decision on the most appropriate form of regulation for the period 2007 to 2010 is the effectiveness of competition in the NSW retail electricity market. If competition is effective, it will impede retailers' ability to keep tariffs significantly above cost reflective levels. This means that regulation can be more light-handed, as competition will provide customer choices and limit prices to efficient levels.

The Tribunal examined the level of competition for small retail customers in the metropolitan market (which includes the EnergyAustralia and Integral Energy standard supply districts) and the non-metropolitan market (the Country Energy standard supply district). It also considered the likely effect of its draft determination on the level of competition in both these markets. This involved identifying the competitive constraints that currently exist, and the extent to which these competitive constraints will be addressed by the draft determination.

The Tribunal's draft findings and the analysis that underpins these findings are set out in the sections below.

4.1 Overview of draft findings

In relation to the metropolitan market, the Tribunal finds that the balance of evidence suggests there is competition for small retail electricity customers in the metropolitan area. In the Tribunal's view, there is sufficient competition in this market to restrain increases in each individual tariff. Although there is still a high degree of market concentration, the fact that new entrants have acquired a significant number of small customers implies that there are no material barriers to entry in this market. On the information available to it, the Tribunal considers that there is rivalry between competitors in the form of increasing product diversity and/or price savings to entice customers to move off the regulated tariff.

In relation to the non-metropolitan market, the Tribunal finds that, on balance, the available evidence suggests that competition is developing; however, it is unclear whether there is currently sufficient competition to restrain increases in each individual tariff. The Tribunal notes that new entrants to this market have not acquired a significant number of small retail customers, and a high number of customers remain on the regulated tariff. The Tribunal considers that this implies that there are material barriers to entry in this market. However, the Tribunal also considers that there is potential for the level of competition to increase over the 2007 to 2010 determination period.

The Tribunal's draft determination addresses some of the key impediments to retail competition in the non-metropolitan market by:

- accounting for the removal of the ETEF arrangement in the energy purchase cost allowances
- allowing regulated retail tariffs to increase to cost reflective levels
- allowing Country Energy sufficient pricing discretion to rationalise tariffs (including reducing the number of obsolete tariffs).

Nevertheless, the Tribunal recognises that there may be persistent factors that will prevent the level of competition in this market from developing to the same extent as in the metropolitan market over the medium term.

4.2 Tribunal's analysis

In undertaking the analysis that underpins the above findings, the Tribunal had regard to the structural features of the NSW retail electricity market, the conduct of electricity retailers operating in this market, and the outcomes for customers. Specifically, it considered the following matters:

- the definition of effective competition
- the definition of the market
- market structure, including the number of retailers contesting the market, market concentration, and barriers to entry
- market conduct, including customer awareness, retailer marketing activity, and retailer offers
- customer outcomes, including exercise of customers' choice and customer switching behaviour.

An overview of its considerations in relation to each of these matters is set out below.

The Tribunal notes that the MCE has recently outlined a number of criteria to be used by the AEMC in determining whether competition is effective in retail energy markets.¹⁴ The matters the Tribunal considered are broadly consistent with these criteria, and with the approaches taken by other regulators in Australia.

4.2.1 Definition of effective competition

The Tribunal considers that in an effectively competitive market, the ability of participants to exercise market power (eg, by raising prices above the efficient cost level, restricting services, or reducing service quality to increase profits) is restricted by the actions of competitors in the market, or the actions of potential competitors yet to enter the market. That is, competition from existing firms or the threat of entry from potential competitors has a disciplinary effect on the behaviour of the incumbents.

This view recognises that a definition of effective competition must consider both:

- actual competition (where new entrants have entered the market and actively compete with the incumbent suppliers, taking market share from them), as well as
- potential competition (whereby the threat of entry effectively disciplines the incumbents against abusing their market power but no entry actually occurs).

¹⁴ Ministerial Council on Energy, *Phase Out of Retail Price Regulation for Electricity and Natural Gas - Final Effective Competition Criteria*, p 1.

4.2.2 Definition of the market

The Tribunal considers that there are two relevant markets for the retail supply of electricity. These are to customers consuming less than 160 MWh per annum in:

- the combined standard supply areas of Integral Energy and EnergyAustralia (the metropolitan market)
- Country Energy's standard supply area (the non-metropolitan market).

In reaching this view, the Tribunal noted that the relevant market needs to be defined with reference to the most important sources of competition for a retailer or set of retailers. Defining the market too broadly and including products or sellers that do not constrain the ability of retailers to exercise market power may overstate the competitiveness of the market. Defining the market too narrowly may understate the extent of competition, as some effective competition may be excluded from the analysis. The Tribunal also took into account the functional, product, geographic and time dimensions of the relevant market, and considered whether there are separate sub-markets defined along consumption or residential/business lines within NSW.

Functional dimension

The Tribunal considers that the functional market relevant to this review is the retail market. While there may be some efficiencies associated with a retailer holding generation or distribution assets, the electricity retail function is both economically separable and economically distinct.

Product dimension

The Tribunal considers that the product market relevant to this review is electricity only. It examined whether the product market should include the broader energy market, which includes the retail supply of gas. However, it concluded that gas and electricity are not reasonable substitutes for each other over the period of its draft determination. The sunk costs associated with switching from electricity to gas prevent them from being sufficiently interchangeable to be considered reasonable substitutes over the next three years. Further, customers may be able to use gas for a limited selection of activities such as cooking or heating, but they could not switch to gas for all their power needs. Therefore, the Tribunal does not consider the retail supply of gas to form part of the relevant market.

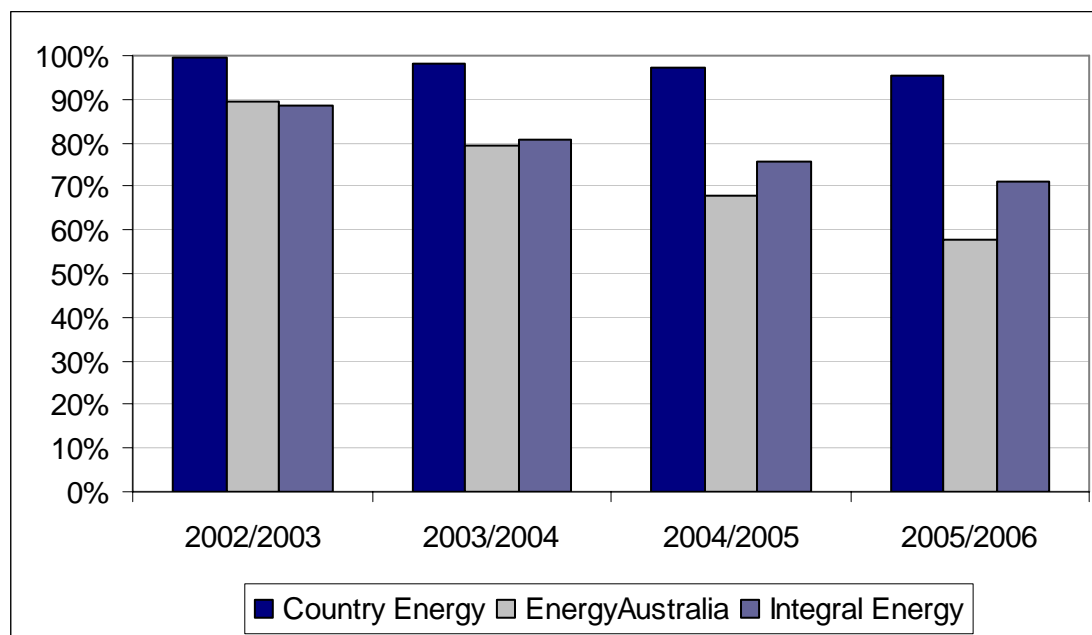
Geographic dimension

The Tribunal considered the geographic areas in which retailers currently operate, or could operate and to which customers can practically turn for the retail supply of electricity. It is of the view that defining the market as the National Electricity Market (NEM) would be too broad and would include products and sellers that do not constrain the ability of retailers licensed in NSW to exercise market power.

As outlined above, the Tribunal considers that there are two relevant markets for the retail supply of electricity in NSW – the metropolitan market and the non-metropolitan market. In forming this view, the Tribunal noted the differing trends in market concentration in these markets. In addition, a significant proportion of small retail customers in the metropolitan market have exercised choice in the competitive market by moving off the regulated tariff and signing a negotiated contract either with a second tier retailer or with the incumbent. However, very few customers in the non-metropolitan market have done so.

As Figure 4.1 shows, in 2005/06, 58 per cent and 71 per cent of customers in the EnergyAustralia and Integral Energy standard supply areas respectively remained on regulated tariffs, compared to around 95 per cent of customers in Country Energy's standard supply area. This implies there is a significant difference in competitive activity between the metropolitan and non-metropolitan areas, and that the geographic dimension of the market definition should be narrower than NSW.

Figure 4.1 Percentage of small retail customers on regulated tariffs in each standard supply area 2002/03 – 2005/06



Time dimension

The Tribunal considers that the time period relevant to this review is the period of the determination (the three years from 2006/07 to 2009/10).

Sub-markets

The Tribunal considered whether there should be separate markets defined along consumption or residential/business lines for small retail customers. The Tribunal notes a number of licensed retailers in the NSW market do not supply small residential customers. The Tribunal also notes the Federal Court definition of the retail markets in Victoria being a market for supply to industrial and commercial users and a market for residential and small business users.¹⁵

¹⁵ Australian Gas Light v Australian Competition and Consumer Commission (No.3) [2003] FCA 1525, paragraph 380.

The Tribunal recognises that there may be small classes of customers that do not have access to the competitive market.¹⁶ However, based on its examination of the available information, including information on the consumption characteristics of small residential and business customers on negotiated contracts with the Standard Retailers, it considers that there are not separate retail markets defined along consumption or residential/business lines for small retail customers.

For example, Table 4.1 shows that the number of low and medium consumption residential customers (less than 10 MWh per annum) on negotiated contracts with the Standard Retailers has increased significantly between 2003/04 – 2005/06.

Table 4.1 Consumption characteristics of small retail customers on negotiated contracts with standard retailers 2003/04 – 2005/06

	2003/04	2004/05	2005/06
Residential			
Up to 5 MWhs per annum	38,002	68,866	107,596
5.1 to 10 MWhs per annum	118,612	204,759	253,979
10.1 to 15 MWhs per annum	87,302	121,989	120,170
15.1 to 20 MWhs per annum	33,803	40,389	37,184
20.1 to 160 MWhs per annum	17,587	20,846	19,246
Total small residential customers	295,307	456,849	538,175
Business			
Up to 20 MWhs per annum	27,474	28,800	22,666
20.1 to 40 MWhs per annum	15,254	15,074	10,737
40.1 to 60 MWhs per annum	7,309	6,797	5,123
60.1 to 100 MWhs per annum	6,389	6,139	4,668
100.1 to 160 MWhs per annum	3,439	3,701	2,921
Total small business customers	59,866	60,511	46,115
Total small customers	355,172	517,360	584,290

Source: Information provided by Standard Retailers on a confidential basis.

While a proportion of these customers may be dual fuel customers who are attractive to retailers because they are large overall energy consumers, these data indicate that low and medium volume electricity customers are able to negotiate contracts in the competitive market. The Tribunal also notes preliminary results from its 2006 household survey, which indicate that customers across a range of demographics are being offered negotiated contracts by their current supplier and/or other retailers and are taking up these offers.¹⁷

¹⁶ PIAC submission, February 2007, p 2. PIAC notes that certain customers such as residents of residential parks and villages (such as caravan parks) across NSW cannot negotiate a retail supply contract as the price paid by tenants of residential parks is directly benchmarked to the regulated tariff in accordance with the *Residential Parks Regulation 2006*.

¹⁷ To gain a better understanding of the characteristics of energy customers, the Tribunal has undertaken a survey of households in the Sydney, Blue Mountains and Illawarra regions. The Tribunal expects to release the results from the survey later this year.

4.2.3 Market structure

The structure of a market will affect the scope for effective competition within it. In making an assessment of the implications of market structure for the effectiveness of retail competition, the Tribunal had regard to the number of electricity retailers operating in the two relevant markets in NSW, the concentration of these markets, and barriers to entering these markets.

The number of firms

There are currently 24 electricity retail licence holders in NSW. However, only 13 of these currently supply or are intending to supply the small retail market. While the number of electricity retail licence holders has not significantly increased since 2004, the number of retailers supplying small retail customers, particularly small residential customers, has increased.

The retail licence holders participate in the NSW market to differing degrees. These suppliers can be categorised as:

- incumbent retailers (the Standard Retailers)
- mass market 2nd tier retailers
- niche 2nd tier retailers.

The incumbent or Standard Retailers are the three retailers that have inherited the standard supply areas that mirror the distribution network areas: EnergyAustralia, Integral Energy and Country Energy. In addition to being Standard Retail Suppliers, these firms also have the distribution function in their supply area. The mass market 2nd tier retailers are the non-incumbent retailers who aim over time to establish a customer base of sufficient size to achieve economies of scale. The niche retailers are those that focus on specific customer classes or offer specific products and are likely to remain on a smaller scale.

Concentration of the market

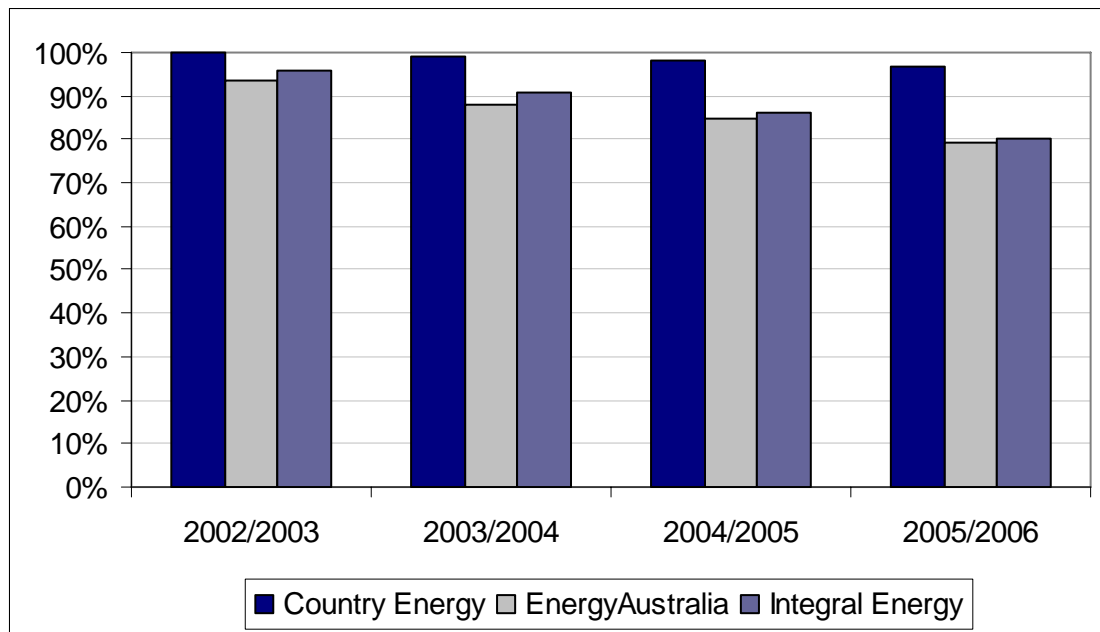
The more concentrated a market, the greater the potential for firms to exercise market power. Therefore, a market with a considerable number of firms may still not exhibit effective competition if the market is concentrated in the hands of a small number of firms.¹⁸

The Tribunal notes that there are significant differences in market concentration in the two relevant markets in NSW. Since the introduction of full retail contestability in 2002, a considerable number of customers in the metropolitan market have entered into negotiated contracts, and new entrants have steadily reduced the market share of the incumbents (Figure 4.2). As at 1 July 2006, EnergyAustralia and Integral Energy had around 80 per cent of the small retail electricity customers in their standard supply areas, while other retailers including new entrants had around 20 per cent.

Although the metropolitan market would typically be considered highly concentrated, the Tribunal considers that this reflects the fact that the market is still in transition from the previous franchise monopoly market towards a competitive energy retail market.

¹⁸ Firms with considerable market share may be able to exercise market power.

**Figure 4.2 Market shares of incumbents in each standard supply area
2002/03 – 2005/06**



In the non-metropolitan market, a significantly higher proportion of small customers have remained with the incumbent retailer, Country Energy. As at 1 July 2006, Country Energy had around 97 per cent of the small retail electricity customers in this market, while other retailers including new entrants had around 3 per cent. As noted earlier, significant proportion of customers also remain on the regulated tariff.

The level of market concentration and the low uptake of negotiated contracts in Country Energy's standard supply area most likely indicate that there are barriers to entry to this market.

Barriers to entry

Barriers to entry are the key determinant of how easy it is for firms to enter or exit a market. Generally, a competitive market does not have significant barriers to entry, ensuring that the behaviour of market participants is disciplined by entry of new firms or by the threat of new entry. If barriers to entry exist in a market, there may be an opportunity for firms in the market to exercise market power, reducing the extent to which competitive pricing and product differentiation occurs. Barriers to entry do not include obstacles that are part of the normal process of entering any market.

The Tribunal has considered whether any of the following barriers to entry limit the potential for competition in the NSW retail electricity markets:

- sunk costs¹⁹
- legal or regulatory barriers
- advantages for incumbent firms
- under-recovering tariffs
- customer inertia.

The Tribunal considers that sunk costs or legal/regulatory differences are unlikely to act as barriers to entry to the retail market. However, there are advantages for the incumbent firms such as having access to information on consumption levels and load profiles of customers that is not initially available to new entrants. There are also benefits to incumbents from customer inertia or possible customer loyalty. The Tribunal notes that the Standard Retailers' access to the ETEF, to the extent that the ETEF price is below market-based prices, could also provide a barrier to entry by other retailers.

However, the Tribunal considers that the fact that new entrants have acquired a significant number of small customers in the metropolitan market, and that a considerable number of customers have moved off the regulated tariff implies that there are no material barriers to entry for the metropolitan market.

In the non-metropolitan market, the fact that there has been little reduction in concentration since the introduction of full retail contestability and that the majority of customers remain on regulated tariffs would seem to indicate that there are barriers to entry.

The Tribunal considers that the large number of tariffs, particularly the significantly under-recovering obsolete tariffs, represents a barrier to entry in this market. Around 47 per cent of Country Energy's regulated tariffs are more than 5 per cent below the cost reflective targets for 2006/07 set by the Tribunal in 2004.²⁰ The majority of significantly under-recovering tariffs are obsolete tariffs, in that customers are unable to move onto these tariffs. Around 24 per cent of Country Energy's tariffs are more than 20 per cent below the target for 2006/07.

There are more than 100 network tariffs in Country Energy's area, including obsolete network tariffs, creating more than 300 regulated retail tariffs. To attract customers to move off the regulated tariff, a second tier retailer would need to identify the relevant network tariff to apply to the customers and the relevant regulated retail tariff (being a measure of the price to beat). The Tribunal notes AGL's comments that new entrants find it difficult to compete in areas where there are numerous regulated tariffs.²¹

The remoteness of some customers and the relatively low population density in some parts of Country Energy's supply area are also likely to limit the extent of competition.

¹⁹ Sunk costs are costs which cannot be recovered by firms when exiting a market. Sunk costs arise because some activities require specialised or firm-specific assets that cannot easily be diverted to other uses. As these assets cannot easily be sold, the existence of sunk costs creates risk for firms entering the market.

²⁰ This refers to the percentage of Country Energy tariffs below cost, not the percentage of customers on under-recovering tariffs.

²¹ AGL submission, October 2006, p 9.

4.2.4 Market conduct

Even markets that exhibit high levels of concentration may achieve competitive market outcomes, provided there is ongoing competition between competing firms or potential competition from the threat of entry. In an effectively competitive market, retailers are motivated to compete for customers by making innovative price/service offers and providing supporting information about their offers to customers. In examining market conduct in the metropolitan and non-metropolitan markets in NSW, the Tribunal considered the level of customer awareness and the extent of competitive rivalry between firms in terms of retailer marketing activity and the price/service packages being offered to customers.

Customer awareness

To exercise choice, customers must be aware that a competitive market for electricity exists. Customer awareness of full retail contestability is influenced by the extent of retailer marketing and government awareness programs.

The Tribunal's 2003 household survey of the greater Sydney region (which includes Sydney and the Blue Mountains and Illawarra areas) found that 74 per cent of respondents were aware they could change their electricity supplier.²² The Tribunal notes that preliminary results from the 2006 household survey indicate customer awareness of full retail contestability is now widespread in this region, with 91 per cent of respondents answering they were aware they could choose their electricity supplier. Further, the level of customer awareness of full retail contestability does not differ significantly across different customer income groups.

The Tribunal notes that the level of customer awareness in the greater Sydney region is in line with other jurisdictions that have competitive energy markets. In Victoria (one of the most active retail markets), the Essential Service Commission's 2004 survey noted that 90 per cent of customers were aware that they were able to choose their electricity supplier.²³ In the United Kingdom (the most active retail market), Ofgem's 2004 review noted that surveys conducted between 2001 – 03 found that 92 – 94 per cent of people were aware they could buy electricity from suppliers other than their local electricity supplier.²⁴

As the Tribunal's household surveys are limited to the greater Sydney region, it has not been able to form a view on the extent of customer awareness of full retail contestability in the non-metropolitan market.

Retailer marketing activity

To have effective competition, customers not only have to be aware of their ability to choose their retailer, they also need to be provided with sufficient information to allow them to make an informed choice.

²² IPART, *Residential energy use in Sydney, the Blue Mountains and Illawarra: Results from the 2003 household survey*, December 2004, p 35.

²³ Essential Services Commission, *Review of Effectiveness of Retail Competition in Gas and Electricity: Draft Report*, 30 March 2004, p 55.

²⁴ OFGEM, *Domestic Competitive Market Review 2004: A review document* April 2004, p 22.

The Tribunal considers there is market information available to customers in NSW to allow them to exercise choice. The Tribunal supports the comments by the Energy and Water Ombudsman of NSW that there would be value in having a comparative information service available (as there is in Victoria and South Australia) which presents market offerings in a simple and easily understood manner.²⁵ The Tribunal also notes that the Department of Energy, Utilities and Sustainability (DEUS) provides some information to customers on full retail contestability.²⁶

Retailer offers

The Tribunal's analysis indicates that discounts of up to 10 per cent are available in the metropolitan market.²⁷ On the whole, smaller discounts are on offer in the non-metropolitan market. The Tribunal notes that these results differ from the 2004 review of regulated retail electricity tariffs, which found that relatively small discounts of 2 – 5 per cent off the regulated tariff were being offered.²⁸

In a competitive retail market, suppliers would also be expected to offer innovative price/service packages to entice customers onto their market contracts. Although stakeholders have offered contrasting views on the extent of product diversification in the NSW market, the Tribunal considers that there is increasing innovation in the price/service packages being offered to customers.

As part of its 2004 review of regulated retail electricity tariffs, the Tribunal found that although incumbent retailers were offering dual fuel products, there appeared to be limited product innovation in negotiated offers.²⁹ The Tribunal noted that in most cases, the regulated price formed the benchmark in negotiated offers and that most offers involved a fixed term contract of 2 – 3 years with fees for early termination.

Although the regulated price still often forms the benchmark in negotiated offers, with discounts offered as a percentage reduction on this price, there are an increasing number of price/service options being offered to customers. These include:

- time-of-use tariffs targeted to specific customer groups
- alternative methods of bill payment (including payment plans and discounts for direct debit)
- opportunity for bundling of services, such as electricity, gas and telecommunications services
- opportunity for varying levels and sources of green energy supply
- differing levels of termination fees (including no termination fees)
- differing contract lengths (including no fixed contract).

²⁵ Energy and Water Ombudsman of NSW (EWON) submission, October 2006, p 12.

²⁶ See the DEUS website: <http://deus.nsw.gov.au/>

²⁷ Discounts are relative to the regulated tariff.

²⁸ IPART, *NSW Electricity Regulated Retail Tariffs 2004/05 to 2006/07 - Final Report and Determination*, June 2004, p 35.

²⁹ IPART, *NSW Electricity Regulated Retail Tariffs 2004/05 to 2006/07 - Final Report and Determination*, June 2004, p 30.

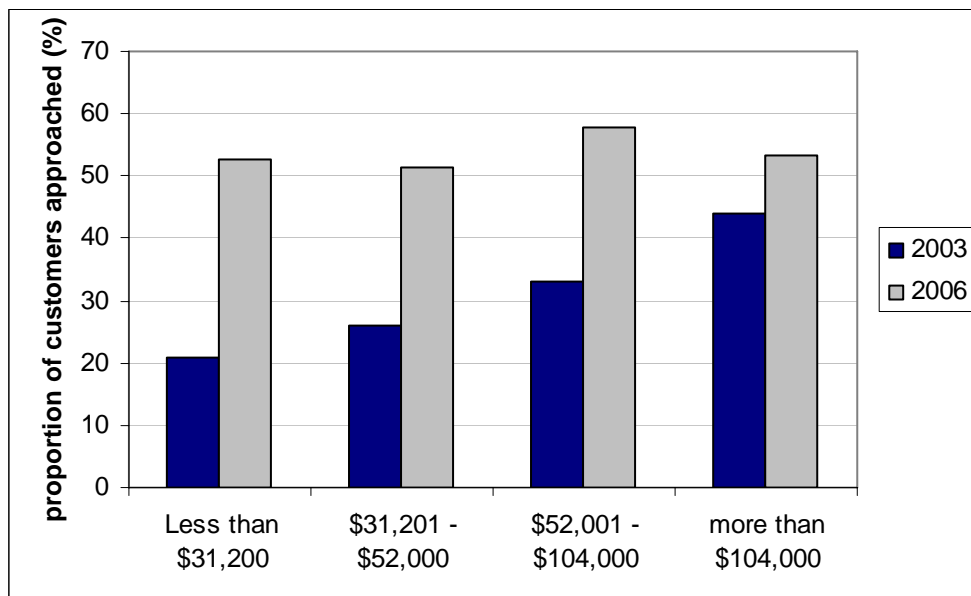
Retailers are also offering a range of other rewards/savings to customers such as:

- petrol discounts
- shopping vouchers
- frequent flyer points
- magazine subscriptions
- free electricity for one month.

The Tribunal also considers that an increasing number of customers from a range of demographics are being offered negotiated contracts. For example, several stakeholders expressed the view that retailers are targeting wide sections of the community for negotiated contracts.³⁰ Information provided by Integral Energy on a confidential basis indicates that customers in this Standard Retailer's standard supply area who have traditionally been considered vulnerable and unlikely to be offered competitive contracts (such as low income customers or customers with poor credit ratings) are now being offered and are accepting negotiated contracts from other suppliers.

The preliminary results from the 2006 household survey also indicate that all income groups across the greater Sydney region have been offered negotiated contracts by other suppliers to broadly the same degree (Figure 4.3).³¹ This represents a change from the 2003 household survey, which found that higher income households were more likely to be targeted than those in lower brackets.

Figure 4.3 Relationship between competitive offers from other suppliers and income



³⁰ Energy and Water Ombudsman of NSW (EWON) submission, October 2006, p 9, Integral Energy submission, September 2006, p 12.

³¹ 'Approach' must be a phone call, household visit, a specific letter addressed to occupants or a 'flyer' in the letterbox. A general notice attached to a bill is *not* defined as an approach.

The 2006 household survey also indicates that homeowners and tenants (renters) are being approached by other suppliers to the same extent. Again this is a change from the 2003 household survey, which found that customers who were homeowners were more likely to be offered contracts from other suppliers than renters.

4.2.5 Customer outcomes

The Tribunal considered the extent to which customers are benefiting from the competitive rivalry between firms. In particular, it looked at the extent to which customers are exercising their option to choose their retailer and move off the regulated tariff, and customer switching behaviour.

Exercise of customer choice

Preliminary results from the 2006 household survey indicate that the majority of customers who entered into a negotiated contract with their existing retailer or switched their electricity retailer did so because they felt the prices offered were lower.

An increasing number of customers in NSW are moving onto negotiated contracts with either their existing retailer or with another retailer. As at 30 June 2006, around 922,000 customers, or 29 per cent of the small customer base in NSW, were on negotiated contracts.

However there is a significant difference in competitive activity across the two relevant markets in NSW. Table 4.2 below shows that as at 30 June 2006, 42 per cent and 29 per cent of customers in the EnergyAustralia and Integral Energy standard supply areas respectively were on a negotiated contract for electricity (including with their existing supplier) compared with fewer than 5 per cent in the Country Energy standard supply area.

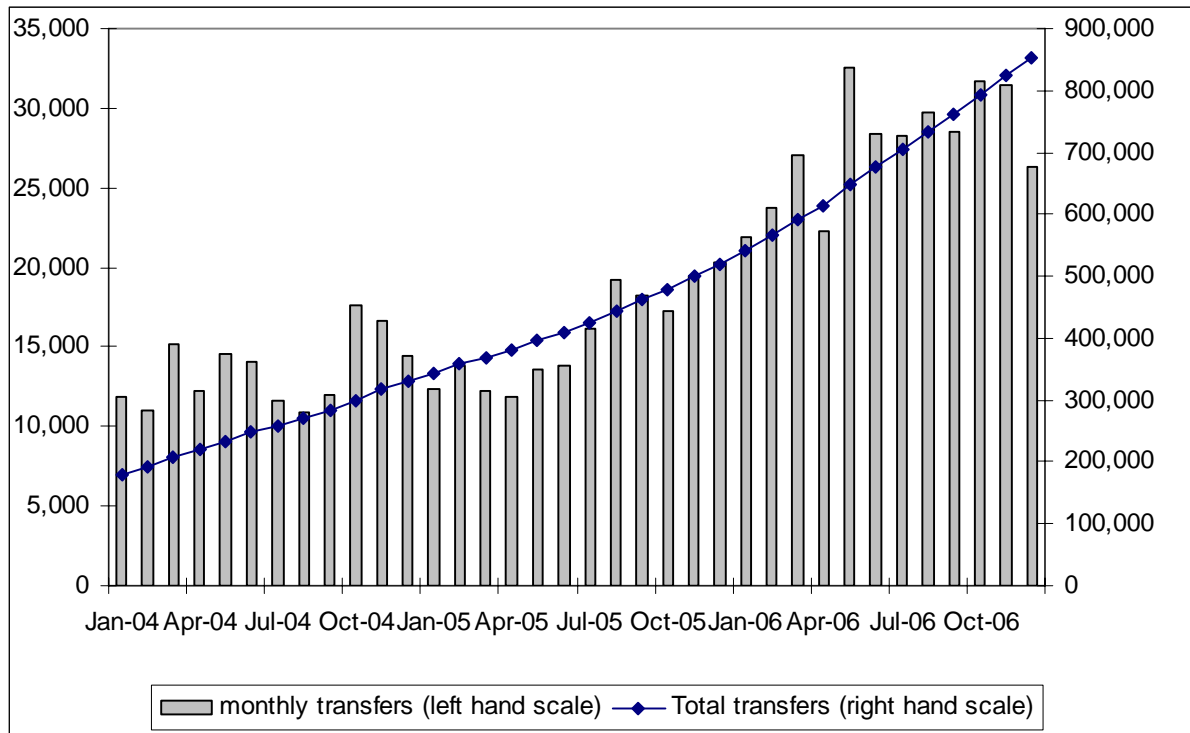
Table 4.2 Total small customers on negotiated contracts in NSW by standard supply area, 2003/04 – 2005/06

	2003/04	2004/05	2005/06
Country Energy standard supply area			
Total small customers on negotiated contracts tariffs	12,359	20,041	34,464
Total small customers	741,894	753,720	757,179
% of total customers	1.7	2.7	4.6
EnergyAustralia standard supply area			
Total small customers on negotiated contracts tariffs	311,039	489,365	648,310
Total small customers	1,499,653	1,526,143	1,544,271
% of total customers	20.7	32.1	42.0
Integral Energy standard supply area			
Total small customers on negotiated contracts tariffs	157,564	199,887	239,081
Total small customers	809,514	816,752	829,196
% of total customers	19.5	24.5	28.8

Customer switching behaviour

The Tribunal's analysis indicates that customers are also increasingly switching retailers as well as taking up competitive offers with their current retailer. NEMMCO switching data (shown in Figure 4.4) indicates that the cumulative number of small customer transfers in NSW at the end of December 2006 was 851,277, up from around 180,000 in January 2004.³² Since June 2006, switching between electricity retailers has increased to levels in excess of 25,000 per month.

Figure 4.4 Completed small retail customers transfers (gross switching) in NSW



Source: NEMMCO, MSATS transfer data.³³

During 2006, there were 331,706 small customer transfers in NSW, which represents an annualised switching rate of almost 11 per cent.³⁴ Based on this level of switching, NSW is more active than the ACT market but less active than the Victorian and South Australia markets.

³² http://www.nemmco.com.au/data/ret_transfer_data.htm. NEMMCO transfer data records gross customer switching between suppliers. It does not record customers moving from the regulated tariff to a negotiated contract with the same supplier. NEMMCO completed small customer transfers at 31 December 2006.

³³ http://www.nemmco.com.au/data/ret_transfer_data.htm.

³⁴ This represents the total number of transfers between suppliers in 2006, not the total number of customers switching suppliers. It may include customers that have switched supplier multiple times.

The Tribunal recognises that, unlike the information on customers taking up negotiated contracts, the switching information is not broken down between the metropolitan and non-metropolitan markets. Therefore, the above information is of more limited use in examining the effectiveness of competition in the two relevant markets. However, given the barriers to entry in the non-metropolitan market and the market share of the incumbent the Tribunal is of the view that customer switching is likely to be less in the non-metropolitan market.

5 HOW TARIFFS WILL BE REGULATED

As part of its review, the Tribunal considered which retail electricity tariffs should be regulated, what form this regulation should take, and whether any additional regulatory mechanisms are required. The section below provides an overview of the Tribunal's draft decisions on each of these issues. The subsequent sections discuss the decisions and the Tribunal's considerations in relation to them in more detail.

5.1 Overview of draft decisions on how tariffs will be regulated

In line with the Government's request, the Tribunal will continue regulating retail tariffs and retail charges for small customers who have not chosen to enter a negotiated electricity supply contract, or who have returned from a negotiated contract to a regulated retail tariff.³⁵ However, retailers will be able to rationalise their existing regulated retail tariffs and remove those that are obsolete. In addition, retailers will only be able to introduce new regulated tariffs in exceptional circumstances, with the approval of the Tribunal. This will avoid a proliferation of regulated tariffs, which could prolong customers' reliance on regulated tariffs, and have an adverse impact on the development of retail competition.

In relation to the form of regulation, the Tribunal has made a draft decision to introduce a weighted average price cap (WAPC), which constrains the change in the average level of regulated tariffs (weighted by customer numbers and consumption). This form of regulation gives retailers the flexibility to restructure and simplify their tariffs, while ensuring that average prices do not exceed the average cost allowance determined by the Tribunal. It represents a stepping stone from the 2004 determination, which regulated individual tariffs, towards the potential removal of price regulation in the future. The Tribunal's analysis of competition in Chapter 4 was a key consideration in its decision to adopt this form of regulation.

The Tribunal has also made draft decisions to introduce two additional regulatory mechanisms to complement the WAPC approach. These are:

1. A 'threshold price increase test' for Country Energy, which requires Country Energy to seek Tribunal approval if it proposes to increase an individual tariff above a threshold level. This test aims to ensure any significant increases to Country Energy's individual regulated tariffs reflect the underlying costs.
2. A cost pass-through mechanism, which allows retailers to pass through to customers material increases or decreases in costs associated with regulatory or taxation change events, which were unanticipated at the time of the determination. Approved cost pass-through amounts are included in the formula for the WAPC.

In addition, the Tribunal's draft decision is that no additional price constraints will apply on either the retail component of prices, or on individual customer bills. This reflects the focus in the terms of reference on ensuring that regulated tariffs are cost reflective by 2010, and on reducing customers' reliance on regulated prices.

³⁵ A small customer is defined as one who uses less than 160MWh of electricity per year, which is equivalent to an annual bill of around \$20,000.

5.2 Which tariffs will be regulated

The Tribunal considered whether it will regulate the 'green premium' component of regulated tariffs, whether retailers can introduce new regulated tariffs during the determination period, and whether they can remove regulated tariffs during this period.

5.2.1 Tribunal's draft decisions

The Tribunal's draft decisions are that:

- it will not regulate the green premium paid by customers who choose to have an agreed proportion of their electricity sourced from renewable energy or 'green' sources
- a Standard Retailer will not be able to establish new regulated retail tariffs unless there are exceptional circumstances and it obtains Tribunal approval
- Standard Retailers will have the flexibility to rationalise their regulated retail tariffs, and to remove obsolete tariffs, as long as they continue to offer a regulated tariff to small retail customers
- Country Energy will be subject to an additional condition such that if it seeks to remove regulated tariffs and transfer customers from that tariff to another tariff, it must seek Tribunal approval if the price applying to the two tariffs (including level and structure) is not the same.

5.2.2 Tribunal's considerations

Green premiums

The Tribunal's draft decision is not to regulate the premium customers voluntarily pay to ensure that a certain percentage of the electricity they use is generated from renewable sources. This continues the approach taken in the 2004 determination to allow an unregulated green premium incurred voluntarily by the customer to sit on top of a regulated base tariff. The Tribunal considers this approach will promote retail competition and cost reflectivity of green premiums.

Introducing new regulated retail tariffs

The Tribunal's draft decision limits the circumstances under which retailers can introduce new regulated retail tariffs to exceptional circumstances, and only with the approval of the Tribunal. This is consistent with the terms of reference for the review, which direct the Tribunal to consider the Government's aim of reducing customers' reliance on regulated prices. The Standard Retailers are free to make business decisions about new tariffs, and to consider tariff innovations in the competitive market.

In addition, the Tribunal is concerned to ensure that competition is not inhibited by the proliferation of regulated tariffs, and that retailers are not able to use new regulated tariffs as a means of segmenting customers (for example, by offering more competitive tariffs to some regulated customers, while raising prices above cost reflective levels to customers they perceive they are less likely to lose to the competitive market). Requiring retailers to provide justification and obtain Tribunal approval for new regulated tariffs provides the scope for new regulated tariffs where these are desirable, while facilitating the development of competition.

During the course of the review, Country Energy wrote to the Tribunal proposing to create special regulated 'hardship' tariffs that would mirror a customer's regulated tariff but remove the fixed charge. Country Energy noted that it would have eligibility criteria for customers seeking access to the proposed tariffs, and that these tariffs would only be available to the customer for a limited period of time.

The Tribunal's draft decision is that it will not approve the proposed hardship tariffs as new regulated tariffs. This does not prohibit Country Energy from introducing such tariffs in the competitive market, or from offering rebates on regulated tariffs to customers in financial hardship. However, the Tribunal does not consider that specific regulated hardship tariffs should be introduced, for the following reasons:

- Allowing the introduction of regulated hardship tariffs would not be consistent with the terms of reference, which require regulated tariffs to reach cost reflective levels by 2010, and which require the Tribunal to consider the Government's aim of reducing customers' reliance on regulated tariffs.
- The Tribunal notes that those with low incomes are provided with assistance through various Federal and State schemes. The Tribunal is also aware that Country Energy has a range of schemes in place to assist customers who may be having difficulty paying their electricity bills.
- Given the form of regulation proposed (the weighted average price cap – discussed in section 5.3 below), the costs associated with a new regulated hardship tariff could be recovered through increases in other regulated tariffs. While Country Energy may make a commercial business decision to provide rebates to customers in financial hardship, the Tribunal does not believe it is appropriate to recover these costs from the rest of the regulated customer base.

Removing regulated retail tariffs

The terms of reference for the review require the Tribunal to consider "the potential to simplify regulated tariff structures including the potential to remove obsolete tariffs". This requirement is reflected in the Tribunal's fifth objective for this review, which is to "allow for the further rationalisation of regulated retail tariffs" (see Chapter 2).

The Tribunal's draft determination facilitates the rationalisation of tariffs in several ways:

- It allows retailers to abolish obsolete tariffs.
- The form of regulation – the weighted average price cap (discussed in section 5.3 below) – provides the Standard Retailers with significant flexibility to restructure their tariffs, in terms of both the level of tariffs and their structure. This will increase the opportunity for retailers to consolidate their regulated tariffs.

- The removal of the constraint on the change in individual customers' bills (discussed in section 5.4.4 below) gives retailers greater latitude to restructure and rationalise their tariffs.

The Tribunal's analysis indicates that one of the reasons retail competition has not developed to the same extent in the Country Energy standard supply area as it has elsewhere in the state is that the proliferation of retail tariffs in that area makes it more difficult for competing retailers to know the 'price to beat' for individual customers. By increasing retailers' flexibility to rationalise tariffs and delete obsolete tariffs (albeit constrained by the number of network tariffs in Country Energy's area), the Tribunal's draft decision will enhance the potential for competition.

The Tribunal has also decided to impose an additional requirement on Country Energy to seek the Tribunal's approval if it proposes to abolish a tariff, and transfer customers from that tariff to another tariff that has a different price structure and/or level. This requirement should ensure the threshold test (discussed in section 5.4.2 below) cannot be circumvented by transferring customers from one tariff onto another tariff that is significantly higher.

5.3 The form of regulation

5.3.1 Tribunal's draft decision

The Tribunal's draft decision is that regulated retail tariffs will be regulated using a weighted average price cap (WAPC) approach. The WAPC will ensure that prices do not recover more revenue than the total of network charges and the regulated retail price control set by the Tribunal. The WAPC will be calculated on the following basis:

1. the N values, which relate to network costs, will be based on actual network charges imposed by the distribution network service providers
2. the R values, which relate to retail costs, are determined by the Tribunal in this draft determination (see Chapter 8)
3. the quantities used to weight prices will be:
 - for fixed components, actual customer numbers as at 31 December in the previous year, and
 - for variable components, estimated consumption (in MWh) for the previous 12 months.

5.3.2 Tribunal's considerations

Under the WAPC approach, the Tribunal will regulate the *average* change in regulated tariffs (weighted by the relevant quantity), rather than the change in *individual* tariffs. This is a significant change from the 2004 determination, under which the Tribunal regulated individual tariffs by setting target tariffs and establishing a process for retailers to move towards those targets. The main difference between the two approaches is that, under a WAPC, retailers have more discretion over the setting of individual tariffs. The WAPC gives retailers flexibility to determine the level and structure of individual tariffs, as long as they meet the constraint on the change in weighted average prices.

The Tribunal's Issues Paper for this review³⁶ outlined four broad options for regulating retail electricity tariffs:

1. setting target or maximum tariffs based on a build up of the network and retail (N + R) cost components (the approach used in the current determination)
2. applying a WAPC
3. establishing a new 'safety net' or 'opt-in' tariff that customers will need to choose to be on
4. monitoring prices for some types of tariffs or classes of customer.

In their submissions to the review, the Standard Retailers all supported a move away from individual tariff control towards the regulation of average prices (such as through a WAPC), as did several second tier retailers (though they did not always use the same terminology). In contrast, several submissions from consumer and environment groups³⁷ supported a continuation of the current N+R target tariff approach.

In considering how tariffs should be regulated, the Tribunal took account of its analysis of the level of competition (or potential competition) in the retail electricity market, discussed in Chapter 4. The need for price regulation stems from a concern that competitive forces are not sufficiently developed to ensure that customers are offered services with the mix of characteristics they demand (including quality and price), at prices that reflect efficient costs.

Regulation also imposes costs, both in terms of the direct costs of the regulator and the regulated business, as well as the risk of 'regulatory error' – costs resulting from the regulator making imperfect decisions. More intrusive forms of regulation may be justified where there is little competition (that is, where the potential costs resulting from market power are likely to be high), while a more light-handed approach can be adopted where there is greater competition.

³⁶ IPART, *Review of Regulated Retail Tariffs and Charges for Electricity 2007 to 2010, Issues Paper*, July 2006, p 9.

³⁷ Public Interest Advocacy Centre submission, October 2006, p 5, Total Environment Centre submission, October 2006, p 2, Council of Social Service of NSW (NCOSS) submission, October 2006, p 3.

Given the role the competitive market can play in restraining prices, and the development of retail competition since the 2004 review, the Tribunal sees merit in moving towards a more light-handed form of regulation than the current target tariff approach. By giving retailers discretion over individual prices, the WAPC approach is less intrusive, while still ensuring that average prices reflect the average costs allowed by the Tribunal. The WAPC acts as a stepping stone from the current regulatory framework towards the possible removal of retail price regulation in the future.

The current 'target tariff' approach was designed to ensure that retailers moved their tariffs towards cost reflective levels. However, the price constraints on changes in individual customer bills constrained retailers' ability to restructure tariffs and reach cost reflective levels.

Even without these price constraints (discussed further in section 5.4.4), individual tariff setting has shortcomings. The costs used to set target tariffs are estimates made by the Tribunal, and involve averaging. Therefore, they can diverge from the actual cost of serving different customers, and may diverge from costs during the regulatory period as circumstances change. Without the flexibility to adjust tariffs to reflect actual costs, this imposes costs on retailers (who may be unable to charge the full cost of supply for some tariffs) as well as efficiency costs, because customers may not face prices that reflect actual (rather than estimated) costs.

For example, the target tariff approach used in the 2004 determination created difficulties when network businesses began introducing time-of-use metering. Retailers argued that the structure of target tariffs was not conducive to time-of-use billing, and that they were restricted in their ability to restructure tariffs to reflect the changes in their underlying cost base. The WAPC will facilitate the introduction of time-of-use metering by giving retailers flexibility to restructure their tariffs. This is consistent with the COAG agreement to introduce 'smart' meters to facilitate time-of-use metering (discussed in Chapter 3), as well as the terms of reference requirement to consider the impact of the determination on demand management.

The WAPC allows retailers to minimise any regulatory error involved in the Tribunal's cost estimation, and to respond to changes in their cost base by restructuring individual tariffs to reflect the underlying costs. Nevertheless, while a WAPC ensures that, on average, prices reflect the costs assessed by the Tribunal, it does not ensure that all individual tariffs are cost reflective.

The potential for individual prices to exceed costs will depend on the level of competition. In their submissions to the Tribunal, a number of retailers (both standard and second tier) stated that any over-pricing by Standard Retailers under a WAPC would be corrected by competition.³⁸ In contrast, the Total Environment Centre submitted that a WAPC "allows too much room for retailers to manipulate tariffs and charges".³⁹

³⁸ EnergyAustralia submission, September 2006, p 27, Origin Energy submission, October 2006, p 11, Integral Energy submission, September 2006, p 21, TRUenergy submission, October 2006, p 3.

³⁹ Total Environment Centre submission, October 2006, p 2.

As discussed in Chapter 4, the Tribunal's assessment is that there is sufficient competition in the metropolitan market to restrain increases in each individual tariff. For this reason, the Tribunal considers that a WAPC, together with the competitive pressures already present in the market, will ensure that cost reflectivity will be achieved.

However, the Tribunal is concerned that the current level of competition in the non-metropolitan market may not be sufficient to restrain increases in each individual tariff. As a result, the Tribunal considers that a WAPC, by itself, may not ensure cost reflectivity for each of Country Energy's regulated tariffs.

For this reason the Tribunal considers it necessary to implement a supplementary mechanism for Country Energy, which will provide further reassurance to the Tribunal that significant increases in regulated tariffs reflect underlying costs. This mechanism, the 'threshold price increase test', is discussed in section 5.4.2.

5.3.3 The weighted average price cap

Under the WAPC, the maximum average regulated tariff charged by the retailer (weighted by customer numbers and consumption) must be less than the average price calculated by the Tribunal on the basis of the N and R values. This is equivalent to saying that the tariff *revenue* earned by the retailer must be less than the revenue allowed by the Tribunal (given assumed customer numbers and electricity consumption). The formula for the WAPC proposed by the Tribunal is as follows:

$$\sum_{i=1}^n \sum_{j=1}^m P_{ij}^t \cdot q_{ij}^{t-1} \leq \sum_{i=1}^n \sum_{j=1}^m C_{ij}^t \cdot q_{ij}^{t-1} + PT^t$$

where:

$i=1, 2, \dots, n$ and $j=1, 2, \dots, m$

that is, the retailer has n regulated tariffs which have up to m components (such as a fixed component and variable components).

P_{ij}^t is the price proposed by the retailer for each component of tariff i

q_{ij}^{t-1} is the relevant quantity (eg, customer numbers or consumption in MWh)

$C_{ij}^t = N_{ij}^t + R_{ij}^t$, that is, the regulated price control set by the Tribunal

PT^t is the cost pass-through amount allowed or required by the Tribunal

And

More detailed definitions are provided in the draft determination in clause 7. A worked example of the WAPC is provided in Box 5.1.

Each year of the determination, the WAPC will be calculated using:

1. The relevant R values determined by the Tribunal as part of this determination.
2. The N values, which are equivalent to the actual network charges incurred by the retailer.
3. The relevant quantities, including consumption figures and customer numbers for each tariff.

The R values

The R values for each year of the determination period have been set by the Tribunal as part of this determination, and are discussed in Chapter 8.

The N values

The 2004 determination allowed retailers to pass through network charges in the N component of target tariffs. Experience with the current approach shows it has been relatively simple to implement and ensure compliance, and has gained wide acceptance both by industry and customer groups. Stakeholders did not raise any reasons for changing this approach. Furthermore, the terms of reference require the Tribunal to ensure that network charges are fully recovered. Therefore, the Tribunal's draft decision is that actual network charges will be used to calculate the WAPC.

The N values will be determined on the basis of the network charges approved by the regulator. These charges are proposed each year by the distribution network service providers (DNSPs), and must meet the constraints set out in the Tribunal's electricity network determination.⁴⁰ Since these charges are determined on an annual basis, the WAPC for retail prices must also be determined on an annual basis.

While the Tribunal's draft decision is to allow retailers to recover the actual costs of network charges, the WAPC approach gives retailers flexibility regarding *how* these charges are recovered. The WAPC limits the tariff revenue that retailers can recover (for a given demand), but leaves retailers to determine the level and structure of individual tariffs.

The quantities

The quantities required to calculate the WAPC include consumption figures (in MWh) and customer numbers for each regulated tariff. Potentially, these quantities may either be forecast for the entire determination period, or set on a year-by-year basis. For the retail sector, there is considerable uncertainty about the level of demand over the determination period, given that customers can choose to enter the competitive market (or to return to regulated tariffs). Furthermore, network charges are set on an annual basis. For these reasons, the Tribunal considers that quantities should be estimated on an annual basis during the determination period.

There is a further choice – whether to *forecast* quantities for the coming year (as suggested in Integral Energy's submission⁴¹) or whether to *estimate* them based on the current year's data (which is used for compliance purposes under the current determination). Given the potential for forecasting errors, the Tribunal's draft decision is to calculate the WAPC using

⁴⁰ The Tribunal's determination applies until 30 June 2009. The Australian Energy Regulator is expected to make a new price determination commencing 1 July 2009.

⁴¹ Integral Energy submission, September 2006, p 22.

estimates of the current year's consumption to weight the variable components, and using actual customer numbers on December 31 of the previous year to weight the fixed components.

5.4 Additional regulatory mechanisms

5.4.1 Tribunal's draft decisions

The Tribunal's draft decision is to introduce two supplementary regulatory mechanisms:

1. A 'threshold price increase test' for Country Energy, which imposes additional conditions on Country Energy if it proposes to increase individual tariffs above a threshold level. This threshold is set as the annual change in the costs allowed by the Tribunal, plus an additional 5 per cent.
2. A cost pass-through mechanism which allows retailers to pass through to customers material increases or decreases in costs associated with regulatory or taxation change events, which were unanticipated at the time of the determination.

The Tribunal has also made a draft decision not to impose any additional price limits.

Each of these decisions is discussed below.

5.4.2 Threshold price increase test for Country Energy

As discussed in Chapter 4, the Tribunal is not convinced that there is sufficient competition to restrain increases in each individual tariff in the non-metropolitan market – that is, Country Energy's standard supply area. As a result the Tribunal is concerned that the WAPC alone may not ensure that Country Energy's regulated tariffs will be cost reflective. The Tribunal considers that an additional constraint on Country Energy has merit, whereby Country Energy will be required to seek Tribunal approval if it proposes to increase any individual tariff by more than a 'threshold' level.

The formula for the threshold price increase test is as follows, for each individual tariff:

$$\frac{\sum_{j=1}^m P_{ij}^t \cdot q_{ij}^{t-1}}{\sum_{j=1}^m P_{ij}^{t-1} \cdot q_{ij}^{t-1}} \leq \frac{\sum_{i=1}^n \sum_{j=1}^m C_{ij}^t \cdot q_{ij}^{t-1} + PT^t}{\sum_{i=1}^n \sum_{j=1}^m C_{ij}^{t-1} \cdot q_{ij}^{t-1} + PT^{t-1}} + 0.05$$

The definitions for these variables are provided in section 5.3.3 above. A worked example is provided in Box 5.1.

The threshold price increase test compares the proposed increase in each individual tariff (weighted by the different components of the tariff) with the average increase in costs allowed by the Tribunal (the WAPC), plus an additional 5 per cent. This means that, for example, if the WAPC allows Country Energy to increase average prices by 4 per cent in one year, Country Energy will need to seek Tribunal approval if it proposes to increase an individual tariff by 9 per cent or more in that year.

The Tribunal's focus is on encouraging Country Energy to rationalise its tariffs and restructure them to better reflect underlying costs. Where Country Energy is able to demonstrate that a significant increase in an individual tariff reflects the underlying costs of that tariff, the Tribunal will approve the tariff change. The threshold price increase test is designed to deter a significant, unjustified increase in an individual tariff, while ensuring that increases based on underlying costs are allowed.

5.4.3 Cost pass-through mechanism

As noted in section 5.1 the Tribunal's draft decision is to introduce a pass-through mechanism that will allow retailers to pass through to customers the costs associated with certain regulatory or taxation change events, with the amount to be passed through to be determined by the Tribunal. The pass-through mechanism will allow retailers to pass through costs associated with:

- regulatory events, including:
 - meeting additional obligations related to green energy schemes (existing and future)
 - a retailer of last resort (ROLR) event
 - meeting additional obligations related to Government-imposed energy hardship policies
 - one-off NEMMCO charges (such as reserve trader or direction events)
- certain new taxation events.

The WAPC formula incorporates the pass-through amount (identified as PT). The pass-through amount is incremental to the original revenue allowed under the determination.

Given that it is difficult to assess the probability of a regulatory or taxation change event occurring, and that these events are both beyond the control of retailers and may impose material costs on the retailers, the Tribunal considers that it is appropriate for retailers to share some of the risk associated with these events occurring with customers. The principal benefit of the cost pass-through mechanism is that it will reduce the financial risk associated with unforeseen changes in the retailers' regulatory and taxation obligations, by allowing them to pass through to customers the efficient incremental costs associated with these changes. The Tribunal considers that such a mechanism helps to ensure that regulated prices are set at cost reflective levels, given that some of the costs that should be recovered are uncertain. The Tribunal also considers that such a mechanism is preferable to including an allowance for the risk that retailers will incur such costs in the retail margin.

Establishing a materiality threshold

The Tribunal's draft decision is to establish a materiality threshold per event to limit the pass through of costs to those that have a material impact on the retailers' financial position. The Tribunal considers that small cost changes should be viewed as part of the ordinary operation of business.

The Tribunal's draft decision is to allow each Standard Retailer to pass through the costs associated with a pass-through event if the average annual cost impact as a result of that event is equivalent to or greater than 0.25 per cent of its previous year's allowed revenue. The threshold is not cumulative across events.

The Tribunal considers that a materiality threshold at this level avoids the risk of the regulatory framework becoming a cost-plus regime by limiting the pass through of costs to those that have a material impact on the retailers' financial position. Given the nature of an incentive based regime, the Tribunal considers the cost impacts associated with a 0.25 per cent threshold to be acceptable. The inclusion of a materiality threshold at this level would also ensure to some extent that the pass-through amount is not outweighed by the administrative costs of assessing a pass-through event.

Applying a symmetrical approach

The Tribunal's draft decision is to adopt a symmetrical pass-through mechanism. Under this mechanism, retailers are obliged to inform the Tribunal of a material cost-reducing regulatory or taxation change event. The Tribunal may also initiate the process of approving the pass through of cost savings following such an event.

The Tribunal recognises the requirement in the terms of reference to ensure that tariffs are at cost reflective levels. Ensuring that tariffs are cost reflective requires cost increases and decreases associated with regulatory and taxation change events to be passed through to customers. The Tribunal recognises that in a market with sufficient competition, customers would be able to benefit from any cost savings associated with a regulatory or taxation change event. Rivalry between competitors would encourage retailers to pass on cost savings regardless of whether the Tribunal required them to do so in regulated tariffs. However, the Tribunal does not consider there is sufficient competition in the Country Energy standard supply area to ensure that customers benefit from cost savings resulting from a regulatory or taxation change event. For simplicity, the Tribunal considers that one mechanism that passes through cost increases and decreases should apply to all regulated tariffs in NSW.

The scope of the Tribunal's approval process

Retailers seeking to pass through costs associated with a regulatory or taxation change event will need to apply for approval of these costs. The pass-through mechanism is intended to only capture costs that are incremental, efficient and a direct result of the pass-through event.

The Tribunal's approval process will:

- ensure that the event is consistent with the Tribunal's definitions of regulatory and/or taxation change event
- check that the costs incurred by the retailers are as a direct result of the event and are incremental (ensuring they are not already included in original cost build up)
- assess whether the costs represent an efficient or reasonable response to the event (including consideration of whether the retailers have failed to take any action that could have reduced the costs incurred)
- determine the total amount of costs associated with the regulatory and/or taxation event that can be passed through in each year.

In applying to pass through the costs, retailers will be required to provide evidence of the nature of the pass-through event and the actual and likely costs, and to demonstrate that the costs represent the efficient and incremental costs associated with the pass-through event. While all costs associated with regulatory or taxation events will be subject to approval by

the Tribunal, the time and complexity of the review will depend on the costs being passed through.

Retailers will be required to apply to the Tribunal no later than 4 months before the date of effect of the increase. As prices are only adjusted at 1 July each year, retailers need to submit their application by 1 March to allow the Tribunal sufficient time to review the application.

5.4.4 No additional price limits will apply

Under the 2004 retail determination, the rate at which retailers could move tariffs towards the target tariff levels was constrained by two mechanisms:

1. limits on increases to each retailer's total retail revenue, and
2. limits on increases to individual customer bills.

The 2004 determination reflected the need for the Tribunal to balance two objectives – achieving cost reflectivity, and managing the impact on customers. However, the additional price limits limited retailers' ability to move under-recovering tariffs towards cost reflective levels. This particularly affected Country Energy, which has a large number of tariffs, many of which are significantly below cost reflective levels.

The impact of the price constraints in limiting the move to cost reflective pricing and inhibiting tariff rationalisation was a consistent concern in the retailers' submissions to the Tribunal.⁴² In contrast, a number of consumer groups submitted that the price constraints have been integral to protecting customers, and should be maintained.⁴³

In considering whether price constraints on customer bills should be incorporated in the 2007 determination, the terms of reference provide clear guidance for the Tribunal. These terms state that:

The determination should ensure that:

- regulated retail tariffs and regulated retail charges are at cost reflective levels (including all the costs listed above) for all small retail customers by 30 June 2010
- the setting of any price constraint should allow the further rationalisation of regulated retail tariffs and movement to full cost recovery over the determination period

The terms of reference make it clear that if a price constraint is imposed, it should not prevent tariffs rising to cost reflective levels. Furthermore, price constraints limit tariff rationalisation by limiting the retailers' ability to raise under-recovering or obsolete tariffs to the level of current, cost reflective tariffs, making it more difficult to move customers onto the active tariff and abolish the obsolete tariff.

⁴² See, for example: EnergyAustralia submission, September 2006, p 24, Origin Energy submission, October 2006, p 11, Integral Energy submission, September 2006, p 17, Country Energy submission, September 2006, p 18.

⁴³ Council of Social Service of NSW (NCOSS) submission October 2006, p 3, Public Interest Advocacy Centre submission, October 2006, p 10, Energy and Water Ombudsman of NSW (EWON) submission, October 2006, p 18.

The development of competition is likely to be hindered if regulated tariffs are significantly below efficient cost, because competitors will have difficulty offering a competitive price to customers. Similarly, the customer will have little incentive to seek a competitive contract – in other words, they will remain reliant on regulated prices, contrary to the terms of reference, and the Tribunal’s objectives for the review.

There are additional factors that discourage the use of price constraints in the 2007 determination. There is an equity argument for removing the price constraints on obsolete tariffs. Most of the significantly under-recovering tariffs are obsolete, so no new customers have access to those tariffs. This means that two households could be on significantly different tariffs, even if their characteristics are identical apart from the fact that one household recently moved house and the other household has lived in the same house for a long time.

In addition, price constraints affect the prices of all customers, whether they are vulnerable or not. The Tribunal’s view is that concerns about the impact on specific customer groups could better be addressed through other, more targeted mechanisms.

Lastly, the Tribunal is conscious of the possibility that retail price regulation may be removed in the future, at which time customers will be on competitive contracts that are likely to be cost reflective. If regulated prices have been kept below cost reflective levels, customers could face significant price shocks at that time.

The Tribunal considers that these factors form a compelling argument for not imposing additional price constraints in this determination.

Box 5.1 Worked example of the weighted average price cap and the threshold price increase test

Consider a retailer that has two regulated tariffs. In year 1, the tariffs have the following customer numbers and total electricity consumption:

Customer Numbers	Year 1	Year 2
Tariff 1	3	
Tariff 2	5	
Electricity consumption (MWh)		
Tariff 1	5	
Tariff 2	10	

Each tariff has a fixed charge (per customer) and a variable charge (per MWh of electricity consumed).

The prices charged by the retailer in year 1, and the prices the retailer proposes in year 2, are as follows:

Price charged by the retailer	Year 1 (actual)	Year 2 (proposed)
Tariff 1		
– Fixed (\$/customer pa)	10	15
– Variable (\$/MWh)	2	4
Tariff 2		
– Fixed (\$/customer)	4	5
– Variable (\$/MWh)	2	2

Using this information, it is possible to calculate the retailer's estimated revenue, from each tariff and in total, using the customer and consumption figures for year 1. This information is an input into the checks that the Tribunal will undertake to ensure the retailer has complied with the WAPC and the threshold price increase test.

Estimated revenue using retailer's prices*	Year 1	Year 2
Tariff 1	$(10 \times 3) + (2 \times 5) = 40$	$(15 \times 3) + (4 \times 5) = 65$
Tariff 2	$(4 \times 5) + (2 \times 10) = 40$	$(5 \times 5) + (2 \times 10) = 45$
Total revenue using retailer prices	$40 + 40 = 80$	$65 + 45 = 110$

Note: * Estimated revenue = (fixed price * customer numbers) + (variable price * consumption in MWh).

The regulated price controls set by the Tribunal have two components – the R values (relating to retail costs) and the N values (relating to network charges). The Tribunal has set the R values for each year in its determination, while the N values are based on the actual network charges of the distribution business. In this example, the R values and N values for each year are as follows:

Regulated price controls set by the Tribunal	Year 1	Year 2
Tariff 1		
<i>R Value</i>		
Fixed (\$/customer pa)	7	7
Variable (\$/MWh)	1	2
<i>N Value</i>		
Fixed (\$/customer pa)	8	8
Variable (\$/MWh)	1	1
<i>Total (N+R)</i>		
Fixed (\$/customer pa)	15	15
Variable (\$/MWh)	2	3
Tariff 2		
<i>R Value</i>		
Fixed (\$/customer pa)	3	4
Variable (\$/MWh)	1	1
<i>N Value</i>		
Fixed (\$/customer pa)	2	3
Variable (\$/MWh)	1	2
<i>Total (N+R)</i>		
Fixed (\$/customer pa)	5	7
Variable (\$/MWh)	2	3

Using this information it is possible to calculate the retailer's revenue based on the N values and R values allowed by the Tribunal, using customer and consumption figures from year 1 (refer to the table at the top of the previous page) – these are also inputs into the Tribunal's compliance checking.

Estimated revenue using regulated price controls*	Year 1	Year 2
Tariff 1	$(15 \times 3) + (2 \times 5) = 55$	$(15 \times 3) + (3 \times 5) = 60$
Tariff 2	$(5 \times 5) + (2 \times 10) = 45$	$(7 \times 5) + (3 \times 10) = 65$
Total revenue using N+R allowed by Tribunal	$55 + 45 = 100$	$60 + 65 = 125$

Note: * Estimated revenue = (fixed N+R * customer numbers) + (variable N+R * consumption in MWh).

1. Compliance check: testing the WAPC in Year 2

The formula used in the determination for the WAPC is:

$$\sum_{i=1}^n \sum_{j=1}^m P_{ij}^t \cdot q_{ij}^{t-1} \leq \sum_{i=1}^n \sum_{j=1}^m C_{ij}^t \cdot q_{ij}^{t-1} + PT^t$$

That is,

$$\begin{array}{lcl} \text{total revenue (using the} & & \text{total revenue (using the regulated} \\ \text{retailer's proposed prices)} & \leq & \text{price controls plus the approved} \\ & & \text{pass-through amount} \end{array}$$

This formula tests whether the retailer's estimated total revenue from all its tariffs (using proposed prices and the previous year's demand) is less than or equal to the Tribunal's allowed revenue (using the regulated price controls, actual network charges, and the previous year's demand, plus the pass-through amount).

In the above example (and assuming $PT^t = 0$, that is, a zero pass-through amount), this test is as follows for year 2:

$$\begin{aligned} \text{Is } 65+45 &\leq 60+65? \\ \text{Ie, is } \$110 &\leq \$125? \end{aligned}$$

Yes, therefore the WAPC test is met

2. Compliance check: the threshold price increase test in Year 2

The Tribunal has decided to introduce a supplementary regulatory mechanism for Country Energy, in addition to the WAPC, known as the threshold price increase test.

The formula used in the determination for the threshold test is, for each individual tariff i :

$$\frac{\sum_{j=1}^m P_{ij}^t \cdot q_{ij}^{t-1}}{\sum_{j=1}^m P_{ij}^{t-1} \cdot q_{ij}^{t-1}} \leq \frac{\sum_{i=1}^n \sum_{j=1}^m C_{ij}^t \cdot q_{ij}^{t-1} + PT^{t-1}}{\sum_{i=1}^n \sum_{j=1}^m C_{ij}^{t-1} \cdot q_{ij}^{t-1} + PT^{t-1}} + 0.05$$

That is,

$$\begin{aligned} \text{(the change in revenue from one tariff using the retailer's proposed prices)} &\leq \text{(the change in total revenue using the regulated price controls plus the allowed pass-through amount) + 0.05} \end{aligned}$$

This formula tests whether the change in the estimated revenue from an individual tariff from one year to the next (using the retailer's prices) is less than or equal to the change in the Tribunal's estimated revenue for all tariffs (using regulated price controls plus the allowed cost pass-through), plus an additional 0.05 (5%). If this condition is not met for any individual tariff, the retailer must justify the proposed increase in the price of that tariff.

In the above example, (and assuming $PT^t = 0$, that is, a zero pass-through amount), this test is as follows:

For tariff 1:

$$\begin{aligned} \text{Is } \frac{\text{(revenue from tariff 1 in yr2 using proposed prices)}}{\text{(revenue from tariff 1 in yr1 using proposed prices)}} &\leq \frac{\text{(tot. rev using reg. price controls plus pass-through amt in yr2)}}{\text{(tot. rev using reg. price controls plus pass-through amt in yr1)}}? \\ \text{Is } \frac{65}{40} &\leq \frac{125}{100} + 0.05? \\ \text{Is } 1.625 &\leq 1.3? \end{aligned}$$

No, therefore the retailer must justify the proposed price increase in tariff 1 to the Tribunal.

For tariff 2:

$$\begin{aligned} \text{Is } \frac{\text{(revenue from tariff 2 in yr2 using proposed prices)}}{\text{(revenue from tariff 2 in yr1 using proposed prices)}} &\leq \frac{\text{(tot. rev using reg. price controls plus pass-through amt in yr2)}}{\text{(tot. rev using reg. price controls plus pass-through amt in yr1)}}? \\ \text{Is } \frac{45}{40} &\leq \frac{125}{100} + 0.05? \\ \text{Is } 1.125 &\leq 1.3? \end{aligned}$$

Yes, therefore the retailer does not need to justify the proposed price increase in tariff 1 to the Tribunal.

6 ALLOWANCE FOR ENERGY COSTS

One of the key inputs to the Tribunal's calculation of hypothetical retailer costs, which informed its decision on the value of the regulated retail price controls, was an allowance for the cost of energy over the determination period. The terms of reference required the Tribunal to take into account a range of matters in determining this allowance, including:

- an allowance for electricity purchase costs based on an assessment of the long-run marginal cost of electricity generation from a portfolio of new entrant generation to supply the load profile of customers remaining on regulated retail tariffs
- an allowance based on long-run marginal cost for retailer compliance with any Commonwealth mandatory renewable energy target (MRET) requirements and the licence requirements relating to the NSW Greenhouse Gas Benchmark Scheme, which takes in to account price and volume
- energy losses as published by the National Electricity Market Management Company (NEMMCO)
- fees (including charges for ancillary services) as imposed by NEMMCO under the National Electricity Code
- an allowance for expected movements in regulated components and NEMMCO fees
- recognition that the ETEF will cease operation within the determination period
- recognition of hedging, risk management and transaction costs faced by retailers in the absence of the ETEF
- recognition of the forecasting risks faced by retailers in the absence of the ETEF
- recognition of Net System Load Profiles (NSLPs) for each Standard Retailer, as well as projected future changes in those net system load profiles.

Because these energy costs account for 70 to 75 per cent of retailers' controllable costs (excluding network charges), and about 40 per cent of a customer's electricity bill (which includes network charges), the Tribunal's finding about the size of this allowance could have a significant impact on the regulated retail price of electricity. In addition, regulatory decisions on energy cost allowances are often controversial. This is partly because the calculations required to estimate energy costs are complicated. In addition, it is because the approach used to calculate these allowances differs between regulators, depends heavily on the terms of reference, and involves a number of assumptions and forecasts.

For these reasons, the Tribunal undertook extensive consultation, and sought independent expert advice on the energy cost allowance. As discussed in Chapter 1, it engaged Frontier Economics to develop recommendations on the allowance for energy costs to be factored into regulated retail prices, and to specifically address the associated matters in the terms of reference. It released Frontier Economics' draft methodology document and held a public workshop on that methodology. It also released Frontier Economics' draft report, held a hearing on the calculated results, and sought submissions on the draft report. Frontier Economics considered the submissions and has produced a final report, which the Tribunal has considered in making its draft determination. The Tribunal has also directly considered submissions on energy costs in this draft determination.

The Tribunal's draft findings on the allowance for energy costs which have informed its decision on regulatory retail price controls in this draft determination are set out in the section below. The subsequent sections discuss its draft findings and considerations on each of the components of this allowance, including electricity purchase costs, greenhouse and renewable energy costs, NEMMCO fees (including ancillary charges), and energy losses.

6.1 Overview of draft findings on the allowance for energy costs

The Tribunal's draft findings on the allowance for energy costs to be taken into account in setting the regulated retail tariff controls, and each of the components that make up this allowance, are shown on Table 6.1.

Table 6.1 Summary of Tribunal's draft findings on the allowance for energy costs (2006/07 \$/MWh)

Description	2007/08	2008/09	2009/10
Country Energy			
Electricity purchase costs (incl volatility allowance)	49.8	48.7	44.7
Greenhouse & renewable costs (MRET, NRET, GGAS)	4.7	5.0	5.7
Subtotal	54.5	53.8	50.4
NEM fees	0.7	0.7	0.7
Losses	6.9	6.8	6.4
Total energy costs	62.1	61.3	57.5
<i>Peak</i>	86.2	84.0	74.4
<i>Shoulder</i>	93.2	91.1	81.2
<i>Off peak</i>	38.7	38.9	39.9
EnergyAustralia			
Electricity purchase costs (incl volatility allowance)	56.5	55.3	50.7
Greenhouse & renewable costs (MRET, NRET, GGAS)	4.3	4.7	5.4
Subtotal	60.8	60.0	56.2
NEM fees	0.7	0.7	0.7
Losses	3.9	3.9	3.6
Total energy costs	65.5	64.6	60.5
<i>Peak</i>	119.9	116.9	104.3
<i>Shoulder</i>	60.3	59.8	56.1
<i>Off peak</i>	37.8	38.2	39.5
Integral Energy			
Electricity purchase costs (incl volatility allowance)	58.9	57.8	53.3
Greenhouse & renewable costs (MRET, NRET, GGAS)	4.5	4.9	5.5
Subtotal	63.4	62.8	58.9
NEM fees	0.7	0.7	0.7
Losses	5.8	5.7	5.4
Total energy costs	69.9	69.2	64.9
<i>Peak</i>	134.3	130.9	115.9
<i>Shoulder</i>	61.0	60.6	57.2
<i>Off peak</i>	41.2	41.6	42.7

6.2 Electricity purchase costs

The Tribunal's draft findings on the allowances for electricity purchase costs (excluding greenhouse and renewable costs) are shown in Table 6.2.

Table 6.2 Summary of Tribunal's draft findings on the allowance for electricity purchase costs (2006/07 \$/MWh)

Retailer	2007/08	2008/09	2009/10
Country Energy	49.8	48.7	44.7
EnergyAustralia	56.5	55.3	50.7
Integral Energy	58.9	57.8	53.3

In reaching these draft findings, the Tribunal considered Frontier Economics' assessment of the long-run marginal cost of electricity generation, and stakeholder views on this assessment. It also considered Frontier Economics' assessment of the market-based cost of electricity purchase, Frontier Economics' assessment of the additional costs and risks retailers will face in the absence of the ETEF, and stakeholder views on this assessment. It decided to base its draft findings on the market-based cost of electricity purchase, with an allowance for volatility, rather than on the long-run marginal cost or a blend of these numbers.

The following sections summarise the Tribunal's considerations in relation to the assessments of the long-run marginal cost of electricity generation for each retailer's regulated load and the market-based cost of electricity purchase, and explain why the Tribunal has adopted the market-based purchase cost, adjusted to include a volatility allowance, in the calculation of the energy cost allowance which informed its draft determination.

6.2.1 Assessment of the long-run marginal cost of electricity generation

In considering the allowance for electricity purchase costs, the terms of reference require the Tribunal to assess "the long-run marginal cost of electricity generation from a portfolio of new entrant generation to supply the load profile of customers remaining on regulated retail tariffs."

The long-run marginal cost of electricity generation has been considered by the Tribunal in the past and is also considered by analysts involved in forecasting electricity prices. However, whereas such calculations usually focus on the wider market and factor in the existing generation plant, the terms of reference for this review specifically require that the long-run marginal cost for the determination be calculated on a different basis from the one the Tribunal has used in the past.

The Tribunal engaged Frontier Economics to provide advice on the allowance for electricity purchase cost, including assessing the long-run marginal cost of electricity generation consistent with the terms of reference. Frontier Economics assessed the long-run marginal cost using its proprietary total cost optimisation model of the National Electricity Market, *WHIRLYGIG*. In doing so, Frontier Economics relied on a range of input assumptions, including:

- a pre-tax WACC of 8.6 per cent (see Appendix 4)⁴⁴
- cost estimates for generation plant set out in a report by ACIL Tasman for NEMMCO⁴⁵ adjusted for the WACC of 8.6 per cent.

In general, stakeholder submissions on the assessment of the long-run marginal cost supported Frontier Economics' approach to calculating this cost but did not concur with the findings on these costs for each of the three Standard Retailers' regulated loads in Frontier Economics' draft report, noting that they were too low. The long-run marginal cost estimates in Frontier Economics' final report are higher than those in its draft report and more closely accord with views set out in stakeholder submissions. This is mainly due to two changes Frontier Economics made to its long-run marginal cost calculations in between its draft and final reports.

First, the calculations were amended to correct an error in Frontier Economics' draft modelling resulting from the inadvertent inclusion of plant options cheaper than those reported by ACIL Tasman. This change led to an increase in the long run marginal cost.

Second, the calculations were amended to incorporate revised load data. The relativity between the estimates for each of the Standard Retailers in Frontier Economics' final report is more in line with industry views about the relative peakiness and cost of plant associated with these retailers' load profiles for regulated customers. Integral Energy has the peakiest load and has the highest long-run marginal cost. As Frontier Economics noted⁴⁶ a "less peaky load is cheaper to supply since less peaking plant is required to meet load, which means that the stock of plant is utilised more throughout the year, thereby reducing average costs."

The Tribunal had regard to Frontier Economics' final assessment of long-run marginal cost⁴⁷ (Table 6.3), and its disaggregation of these costs into peak, shoulder and off-peak periods, for the purposes of considering the allowance for electricity purchase costs in this draft determination.

Table 6.3 Frontier Economics' final assessment of long-run marginal cost of electricity generation (excluding green costs) (2006/07 \$/MWh)

Retailer	2007/08	2008/09	2009/10
Country Energy	43.0	43.0	42.9
EnergyAustralia	49.9	50.1	50.2
Integral Energy	52.0	51.9	52.0

⁴⁴ Note that Frontier Economics will reassess the long-run marginal cost prior to the Tribunal's final determination to reflect current market conditions.

⁴⁵ Report on NEM generator costs, Prepared for Inter Regional Planning Committee (IRPC) and NEMMCO, February 2005.

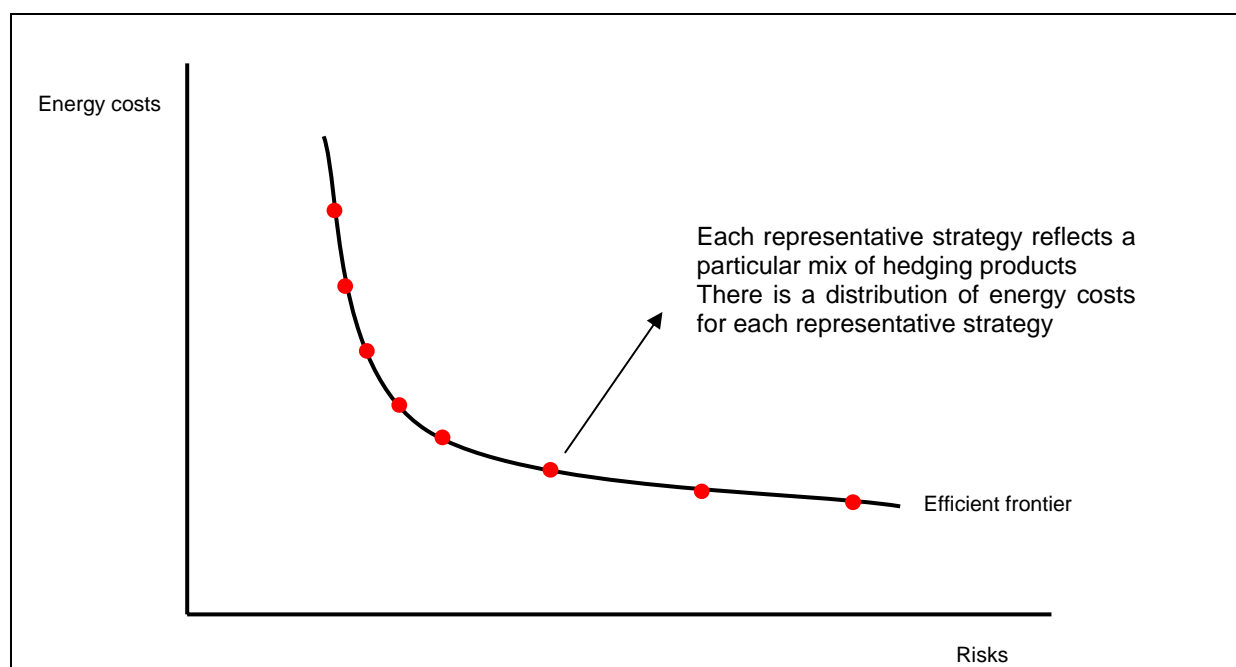
⁴⁶ Frontier Economics, *Energy costs*, Final Report, March 2007, p 14.

⁴⁷ Frontier Economics, *Energy costs*, Final Report, March 2007, p 15.

6.2.2 Assessment of market-based cost of electricity purchase

The terms of reference require the Tribunal to consider the risks faced by retailers in the absence of the ETEF, taking into account the forecasting risks, hedging risks, transaction costs and the timetable for removal of the ETEF. In its report on the draft methodology for determining the allowance for energy costs,⁴⁸ Frontier Economics proposed that these risks and costs should be considered within a consistent framework, and that the concepts of portfolio theory used in finance and investment optimisation could be applied for this purpose. Frontier Economics proposed to use its portfolio optimisation model, *STRIKE*, to determine the efficient mix of energy purchasing instruments (ie, spot and contracts of various kinds) for each level of risk. As shown in Figure 6.1, the results of this analysis can be graphically represented as an “efficient frontier” with the expected cost of the energy portfolio on the vertical axis and the associated risk on the horizontal axis.

Figure 6.1 *STRIKE* outputs – the “efficient frontier”



Frontier Economics argued that this approach would result in an assessment of the market-based cost of electricity purchase that the Tribunal could consider alongside the assessment of the long-run marginal cost of electricity generation (discussed above).

There was general support for applying Frontier Economics’ efficient frontier methodology to calculate a market-based estimate of electricity purchase costs and strong support for using a market-based approach rather than a long-run marginal cost approach to develop the energy cost allowance.

However, a number of submissions (including those from the Standard Retailers) in response to Frontier Economics’ draft report, said that the assessment of the market-based cost of electricity purchase that resulted from this methodology was too low and that it did not take

⁴⁸ Frontier Economics, *Draft Methodology for energy cost consultancy and retail costs/margin consultancy*, October 2006.

account of all the risks and costs. Some also proposed options for addressing this issue, including an additional volatility allowance and an allowance for other costs and risks.

The Tribunal considered Frontier Economics' proposed methodology, stakeholder submissions and feedback on this methodology, and its own analysis of the options for recognising the various risks highlighted in the terms of reference. The Tribunal decided that it was appropriate to consider the risks and costs associated with the phasing out of the ETEF through an assessment of the market-based cost of electricity purchase based on Frontier Economics' methodology. It also considered the arguments raised on the costs and risks that stakeholders believed were not adequately compensated for in Frontier Economics' assessment, and the need for additional allowances to address this issue.

The following sections discuss the Tribunal's considerations of:

- Frontier Economics' assessment of the market-based cost of electricity purchase
- the need for an additional volatility allowance, and an allowance for other risks and costs
- the Tribunal's draft decision on the assessment of the market-based cost of electricity purchase for each Standard Retailer to be used for the purpose of considering the allowance for energy costs.

Considerations on Frontier Economics' assessment of the market-based cost of electricity purchase

As noted above, Frontier Economics' report on energy costs sets out efficient frontiers for the three Standard Retailers calculated using its proposed methodology. The calculations were based on Frontier Economics' own spot and contract price forecasts, and on price forecasts submitted by the retailers. The calculations were also based on the relevant retailer's load forecasts.

The Tribunal first considered whether to base its draft decision on the assessment of the market-based cost of electricity purchase on the efficient frontier curve calculated using Frontier Economics' price forecasts, or on the curve calculated using the forecasts submitted by the retailers. It reviewed the analysis undertaken as input to Frontier Economics' draft and final reports, and considered the rationale for the changes in the forecasts submitted by the Standard Retailers. It considered the relative impact of the forecasts on the calculated efficient frontiers, noting that there is not a significant difference between these frontiers but that these differences increase over the period. Frontier Economics' analysis generally gives lower costs in the later years than the retailer forecasts. It also considered the benefits of basing its findings on the allowances on consistent assumptions and on independent expert advice. The Tribunal decided to base its draft decision on the efficient frontier curves calculated using Frontier Economics' own price forecasts.

Next, the Tribunal considered what point on this efficient frontier curve it should use as the starting point for its assessment of the market-based cost of electricity purchase – for example, the elbow point, the conservative point or some other point on the curve. The Tribunal has adopted the conservative point on the efficient frontier curve for each retailer (see Table 6.4).

Table 6.4 Frontier Economics' assessment of the market-based cost of electricity purchase – Conservative point (2006/07 \$/MWh)⁴⁹

Retailer	2007/08	2008/09	2009/10
Country Energy	49.1	48.0	44.0
EnergyAustralia	55.6	54.4	49.8
Integral Energy	57.8	56.7	52.2

The Tribunal's main reasons for selecting the conservative point were as follows:

- **It considers this is a realistic, prudent position.** The Tribunal wished to ensure that the position was not out of line with the approach or outcomes of an efficient business in reality. Frontier Economics advised the Tribunal that the portfolios that underlie the elbow points are not realistic,⁵⁰ but those that underlie the conservative points do represent practical hedging strategies and are in line with existing business practice.
- **It considers it preferable to err on the side of overestimating rather than underestimating the costs of electricity purchase.** While the Tribunal has devoted significant time and effort to forecasting the market-based cost of electricity purchases, it is unlikely that actual outcomes will match the forecasts exactly. This raises the issue of estimation error in the determination. The Tribunal considers that there are risks associated with both underestimating and overestimating costs.⁵¹ However, on balance and in the context of the objectives for the determination – particularly the objective of facilitating effective retail competition – the Tribunal has decided to err towards overestimation rather than underestimation. The Tribunal notes that the conservative point is at least \$2 per MWh higher than the elbow point.

Like the long-run marginal cost estimates, the Tribunal asked Frontier Economics to disaggregate the market-based costs shown on Table 6.4 by the time-of-use period. Frontier Economics determined the costs at the Peak, Shoulder and Off-peak periods by allocating the half-hourly spot load costs and contract difference payments to each respective period. It allocated cap contract premiums between the Peak, Shoulder and Off-peak periods on a pro-rata basis, according to the value of difference payments received in respect of the cap contract. The resulting costs for the Peak, Shoulder and Off-peak periods are shown in Table 6.5 below.

⁴⁹ See Frontier Economics, *Energy costs*, Final Report, March 2007.

⁵⁰ Partly this is because Frontier Economics limited the instruments used to construct the portfolios, the effect of which is pronounced at the elbow. In addition, in practice these portfolios are 'part' of larger portfolios; for example, the standard retailers also have portfolios for their contract customers.

⁵¹ Frontier Economics notes that if the energy purchase cost is underestimated then standard retailers face a potential financial loss of selling electricity more cheaply than the costs of purchasing electricity. If the cost is overestimated this will provide standard retailers with a windfall that they could use to price more competitively than retailers that do not serve regulated customers. Stakeholder submissions suggested that the impact of underestimation of energy purchase costs is greater than the impact of overestimation.

Table 6.5 Frontier Economics' assessment of the market-based cost of electricity purchase – Conservative point by time-of-use (2006/07 \$/MWh)

Description	2007/08	2008/09	2009/10
Country Energy			
Peak	70.5	68.2	59.0
Shoulder	76.7	74.5	65.0
Off-peak	28.3	28.2	28.3
All periods	49.1	48.0	44.0
EnergyAustralia			
Peak	106.7	103.6	91.0
Shoulder	50.8	49.8	45.7
Off-peak	29.6	29.6	30.1
All periods	55.6	54.4	49.8
Integral Energy			
Peak	116.9	113.3	99.0
Shoulder	49.6	48.9	45.1
Off-peak	31.5	31.5	31.9
All periods	57.8	56.7	52.2

Considerations on the need for an additional volatility allowance

Stakeholder submissions, and presentations made at the Tribunal's hearing on Frontier Economics' draft report, raised a number of issues about the appropriateness of the Tribunal adopting a point on Frontier Economics' efficient frontier as the allowance for market-based energy purchase costs, and the need to make additional allowances for the residual risk and volatility.

For example, EnergyAustralia noted that Frontier Economics' analysis does not compensate for all risks and exposure created through the removal of the ETEF. It argued that there is residual risk inherent at every point on the efficient frontier curve, and that the risk remaining at the most conservative portfolio position is still greater than is acceptable to its business. Specifically, EnergyAustralia⁵² noted that the standard deviation at the most conservative point is around \$3.50/MWh, so that there was significant risk remaining in the associated cost estimate.

EnergyAustralia proposed that one way to address this issue is to adopt a market-based cost allowance that is greater than the expected cost and has a lower probability of being exceeded. That is, to use a confidence interval approach. Integral Energy proposed that the residual volatility could be adjusted for in the retail margin.⁵³

⁵² EnergyAustralia presentation to public forum, 25 January 2007.

⁵³ Integral Energy presentation to public forum, 25 January 2007.

The Tribunal considered the issue of the residual volatility in the context of its objectives for the determination, and how risks are being taken into account in the allowances for retail operating costs and retail margin, and the estimation of the energy purchase costs. It concluded that the costs associated with the business withstanding this volatility should be factored into the allowance for the market-based cost of electricity purchase.

The efficient frontiers set out in Frontier Economics' final report represent the expected market-based costs of electricity purchase, so that there is a distribution of outcomes around each expected cost. In addition, while the conservative point represents the lowest risk position on the efficient frontier, there is residual risk associated with the portfolio of products at that point.

The Tribunal understands that it would be possible, in theory, to purchase additional 'hedging products' to substantially remove the residual volatility inherent in the conservative point portfolio. However, it also understands that such products are not readily available, and are likely to be expensive compared to the cost of factoring this volatility into the overall funding requirements of the business.

Frontier Economics estimates that the cost of significantly reducing the volatility is around \$9/MWh. This estimate is based on the theoretical cost of purchasing products specifically designed to manage the risk of actual market costs being greater than expected for more than 99 per cent of the time. In contrast, Frontier Economics estimates that the cost associated with the business maintaining sufficient additional funds to withstand the volatility more than 99 per cent of the time is much lower, with an annual cost of holding sufficient working capital of around \$1/MWh.

The Tribunal expects that commercial decision-making would, in general, drive a competitive retail business to choose to factor in the cost of managing this year-on-year volatility rather than pay the additional price of hedging.⁵⁴ The exact trade-off will depend on each business' detailed policies and risk appetites. However, the Tribunal considers that the level of volatility associated with conservative portfolio could be consistent with mass market retailer business practice. Further, it considers that the level of risk inherent in the conservative position is in line with the risk appetite and costs that it has taken into account in setting the retail operating costs and retail margin (see Chapter 7).

The Tribunal considered arguments about the consistency of assuming that the retailers will manage the volatility internally with the requirements for the current retailers to work within the Treasury Energy Trading Policy for Retailers⁵⁵ and board-approved trading policies. It also considered, by way of comparison, EnergyAustralia's proposal to adopt a market-based cost that is unlikely to be exceeded.

In relation to specific trading policies and risk management guidelines, the Tribunal's view is that the details of risk management trade-offs need to be managed by each business, and that the terms of reference for this review point the Tribunal towards considering the position of a hypothetical retailer rather than the position of a specific business with a specific trading policy and a specific shareholder. Therefore, the Tribunal does not believe it is relevant to test the specific portfolios resulting from Frontier Economics' analysis against each business' trading policy. However, the Tribunal has tested its view for broad consistency with the

⁵⁴ Note that this concept is similar to decisions business make about self insurance.

⁵⁵ http://www.treasury.nsw.gov.au/pubs/tpp99_5/etp_reta.htm

other assumptions in the draft determination – so that all risks are approached consistently; reflect efficient, commercial, prudent practice; are not double counted; and are not missed out.

In relation to EnergyAustralia's proposal to address volatility by adopting a market-based cost that has a very low chance of being exceeded, the Tribunal concluded that this approach was not appropriate for the following reasons:

- Where the actual outcomes are expected to be symmetrically distributed around the expected outcome, factoring in a cost above the expected mean (ie, one that is unlikely to be exceeded) effectively means that expected business profitability would be similarly positively skewed – so that the actual profit outcome would then be above the otherwise expected 'mean'.
- Most forecasts considered by the Tribunal can be expressed as similar 'expected' outcomes with an associated distribution of actual outcomes – for example, retail operating costs, network maintenance costs, etc. The Tribunal does not adopt a confidence interval approach in setting other cost allowances.
- Adoption of an interval other than the 50 per cent (or expected mean) level raises the issue of what level would be appropriate. The Tribunal considers that any adjustment would be a matter of judgement, and that to apply such an approach it would need to take a view on the specific risk policy adopted by each business and determine whether this was efficient.

On balance, the Tribunal considers that the most appropriate way to recognise the risks and issues raised by the retailers associated with forecasting and volatility is to add to the allowance for the market-based cost of electricity purchase costs an allowance for the costs associated with the business accessing sufficient additional working capital to withstand that risk over time.

The Tribunal favours this approach because it represents an efficient means of addressing the residual risk, it is consistent with the approach adopted in other decisions where working capital costs are taken into account, and it can be calculated in an objective and transparent way.

Frontier Economics has calculated such an allowance for each Standard Retailer, consistent with the relevant conservative points on the efficient frontier curves for each retailer.⁵⁶ The allowances represent the annual cost of the business having access to working capital sufficient to withstand adverse variation around the expected cost for over 99 per cent of the time.

The details of the calculation are set out in Frontier Economics' final report. In general, the calculation involves:

1. Calculating the annual dollar amount that is required to be 'held' each year to accommodate potential movements in the actual market costs relative to the expected or forecast costs. For the purposes of the calculation, Frontier Economics assumed that sufficient funds should be maintained to accommodate volatility for over 99 per cent of

⁵⁶ Frontier Economics, *Energy costs*, Final Report, March 2007, Section 5.3.5.

the time. This means that approximately \$10 needs to be held for each MWh purchased.⁵⁷

2. Assessing the cost of holding these funds by applying the WACC of 8.6 per cent used in analysis of the retail operating costs and margin (discussed in Chapter 7).

The Tribunal's draft finding is that these allowances (shown on Table 6.6) should be added to the Frontier Economics' assessment of the market-based cost of electricity purchases (conservative point).

Table 6.6 Allowance for working capital for volatility of market based costs (2006/07 \$/MWh)

Retailer	2007/08	2008/09	2009/10
Country Energy	0.7	0.7	0.7
EnergyAustralia	0.9	0.9	0.9
Integral Energy	1.1	1.1	1.1

Allowance for other costs and risks

Stakeholder submissions, particularly those from the Standard Retailers, argued that the Tribunal should provide an allowance for other costs and risks, such as an allowance for the costs of transitioning from the ETEF.

The Tribunal has considered these concerns and assessed the overall allowances and costs allowed for in the draft determination through the allowances for the retail margin, retail operating costs and energy purchase costs. While the Tribunal agrees that the businesses face a variety of risks, it considers that these have been taken into account in the allowances. In addition, it considers that the businesses have the capacity to and should be given incentives to manage risks efficiently. Therefore, it does not believe additional allowances are required.

Tribunal's assessment of the market-based cost of electricity purchase

Table 6.7 shows the total market-based electricity purchase cost the Tribunal adopted for the purpose of determining the energy purchase cost allowance to be taken into account in setting the regulated retail price controls. The costs shown on this table are the sum of Frontier Economics' conservative points (Table 6.5) and the allowance for volatility (Table 6.6).

Table 6.7 Tribunal's assessment the market-based cost of electricity purchase - Conservative point (2006/07 \$/MWh)

Retailer	2007/08	2008/09	2009/10
Country Energy	49.8	48.7	44.7
EnergyAustralia	56.5	55.3	50.7
Integral Energy	58.9	57.8	53.3

⁵⁷ Representing 3.5 standard deviations.

6.2.3 Why the Tribunal adopted the market-based purchase cost for setting electricity purchase cost allowance

The Tribunal considered whether to set the allowance for electricity purchase costs using the assessment of the long-run marginal cost of electricity generation, the assessment of the market-based cost of electricity purchase or some combination of these estimates. For the purposes of calculating the hypothetical retailer costs, the Tribunal decided to adopt the market-based cost of electricity purchase set out in Table 6.7 above.

The main reasons for this decision are as follows:

- The market-based approach directly addresses matters raised in the terms of reference about the costs and risks associated with removal of the ETEF arrangement, the load profile for regulated customers in each standard supply district, and the projected changes in these load profiles over the determination period. Therefore, it supports the Tribunal's objective of ensuring that the Standard Retailers charge prices at cost reflective levels by 2010.
- There was strong support for the market-based approach in stakeholder submissions; stakeholders see this approach as being less theoretical than the long-run marginal cost assessment. Therefore the market-based approach aligns with the Tribunal's objective for the determination to be practical, pragmatic and feasible.
- In a perfectly competitive market, the long-run marginal cost and market-based costs for each retailer would be expected to be the same. Even in the absence of perfect competition, the market-based costs are similar to, but slightly higher than, the long-run marginal cost in 2009/10.
- The disaggregated peak, shoulder and off-peak costs for the market-based estimates appear to be more realistic than those for the long-run marginal cost estimates (that is, they more closely reflect the actual cost faced by retailers in the market), and therefore are considered more appropriate for inclusion in hypothetical retailer costs.
- At an aggregate level, the use of blended costs (that is, a mix of long-run marginal cost and market-based costs) is very similar to the use of market-based costs under a smooth transition path. However, the option of combining the estimates is less attractive because it introduces complexity and reduces transparency when disaggregated into peak, shoulder and off-peak costs. Therefore, it is out of step with the Tribunal's objective for the determination to be to simple and understandable, which is an important principle of regulatory best practice.

6.3 Greenhouse and renewable energy cost allowance

The Tribunal's draft findings on the allowance for greenhouse and renewable energy costs to be taken into account in setting the regulated retail price controls are shown in Table 6.8.

Table 6.8 Tribunal's draft findings on the allowance for greenhouse and renewable energy costs (2006/07 \$/MWh)⁵⁸

Scheme	2007/08	2008/09	2009/10
NSW Renewable Energy Target Scheme	0.2	0.4	0.6
Commonwealth Mandatory Renewable Energy Target	0.9	1.2	1.5
Greenhouse Gas Reduction Scheme			
Country Energy	3.6	3.5	3.6
EnergyAustralia	3.2	3.2	3.3
Integral Energy	3.4	3.4	3.4

As part of its consultancy on energy costs, Frontier Economics was asked to provide specific advice on the allowance for the costs of complying with the Greenhouse Gas Reduction Scheme (GGAS)⁵⁹ and the Commonwealth Mandatory Renewable Energy Target (MRET).

In addition, during the course of the review, the NSW Government announced its intention to establish the NSW Renewable Energy Target Scheme (NRET). The Tribunal therefore asked Frontier Economics to advise on the cost of NRET based on known elements of the scheme at the time. Frontier Economics made a number of assumptions⁶⁰ including about the level of the NRET target, the renewable plant that would be eligible for NRET and the penalty for compliance shortfall. It noted that if the scheme changes as it develops, the cost associated with the scheme may need to be reconsidered.

The MRET and NRET schemes are designed to promote the generation of electricity from renewable energy sources and require retailers to annually surrender certificates that represent the generation of electricity from renewable energy sources. The costs of compliance per MWh are identical for serving regulated retail customers in each Standard Retailer's supply area.

The GGAS promotes the reduction of greenhouse gases associated with the production and use of electricity to a target level set for each year. Retailers must surrender certificates representing the abatement of greenhouse gases each year, based on their share of the target set for that year. Because compliance with GGAS is assessed at the customer meter, the number of certificates required by each retailer is influenced by the retailer's distribution loss factor. Therefore, Country Energy, with the highest distribution losses, is expected to face the highest costs per MWh of complying with GGAS, followed by Integral Energy then EnergyAustralia.

⁵⁸ GGAS costs are presented as costs at the regional reference node and they will be adjusted by appropriate transmission and distribution loss factors to convert the costs to costs at the customer meter.

⁵⁹ Formerly the Greenhouse Gas Abatement Scheme.

⁶⁰ Frontier Economics, *Energy costs*, Final Report, March 2007, p 39.

Frontier Economics recommended that the Tribunal adopt the estimates of long-run marginal cost of greenhouse and renewable energy schemes set out in Table 6.8.

Stakeholder submissions generally supported the approach of measuring retailers' costs of complying with renewable energy and greenhouse schemes by estimating the long-run marginal cost, although they submitted that the estimates were too low.

The Tribunal considered Frontier Economics' analysis, and the retailers' submissions. It has adopted Frontier Economics' recommendation in setting the energy purchase cost allowance to be taken into account in setting the regulated retail price controls.

6.4 NEMMCO Fees

The Tribunal's draft findings on the allowance for retailer NEM fees and ancillary charges to be taken into account in setting the regulated retail tariff controls are shown in Table 6.9.

Table 6.9 Tribunal's draft findings on the allowance for retailer NEM fees and ancillary fees (2006/07 \$/MWh)

	2007/08	2008/09	2009/10
General participant fees (\$/MWh)	0.35	0.33	0.32
FRC fees (\$/MWh)	0.06	0.06	0.05
Ancillary service costs (\$/MWh)	0.30	0.29	0.29
Total (\$/MWh)	0.71	0.68	0.68

Note: columns may not add due to rounding.

Frontier Economics was also asked to advise on an appropriate allowance for retailer NEM fees and ancillary charges over 2007-10.

NEM fees are levied on retailers, generators and market participants to cover NEMMCO's costs. Ancillary charges cover the cost of the ancillary services purchased by NEMMCO to ensure the power system remains in a secure state. Both NEM fees and ancillary charges are levied on retailers on a per MWh basis according to their electricity purchases. NEM fees do not vary according to retailer.

The allowance for NEM fees and ancillary charges are a relatively small component of retailers' total costs. NEM fees are relatively easy to predict as they are based on the operational expenditure of NEMMCO.⁶¹ Ancillary service costs are somewhat more difficult to estimate as these costs are likely to vary over time.

Stakeholders were broadly in agreement that Frontier Economics' allowance for NEM fees in its draft report was appropriate. However, TRUenergy submitted that Frontier Economics' estimation of ancillary service costs was too low.⁶²

⁶¹ NEMMCO outlines forecasts of operational expenditure relating to general participant fees and FRC fees for each year in its Statement of Corporate Intent.

⁶² TRUenergy submission, February 2007, p 2.

Frontier Economics has affirmed its draft recommendations on NEM fees and ancillary charges in its final report. The Tribunal is not aware of any information that would cause it to disagree with Frontier Economics' recommendations. Given Frontier's analysis and the fact that stakeholders are broadly in agreement with Frontier Economics' recommendations, the Tribunal considers the allowance for NEM fees and ancillary charges as set out in Table 6.9 to be appropriate.

6.5 Energy losses

The Tribunal's draft findings on the loss factors to be taken into account in setting the regulated retail price controls are shown in Table 6.10.

Table 6.10 Loss factors for 2007-10

Loss factors (transmission plus distribution loss factors)	%
EnergyAustralia	6.4
Integral Energy	9.0
Country Energy	12.6

'Energy losses' refers to the energy that is lost as energy flows through the transmission and distribution networks. As retailers record energy consumption at the customer's meter but are billed for the energy sent out from the generator, energy purchase costs need to be adjusted for these losses (the difference between total energy purchases and total sales).

The loss factors taken into account in the regulated retail price controls are total system losses. The system loss factors vary for each Standard Retailer and are calculated by multiplying transmission and distribution losses. Transmission losses are approved by NEMMCO and published on its website. Distribution losses are approved by the Tribunal and published on NEMMCO's website. In calculating the costs for a hypothetical retailer to be taken into account in setting the regulated retail price controls, the Tribunal has adopted the latest available published loss factors.

7 ALLOWANCES FOR RETAIL COSTS AND RETAIL MARGIN

The terms of reference specify that the allowances for retail operating costs and retail margin should reflect the retail costs and retail margin of a mass market new entrant, rather than those of the Standard Retailers who supply regulated customers. This represents a significant change from the approach the Tribunal has taken in previous determinations.

The terms of reference do not define a mass market new entrant. However, they do note that it should be a new market entrant that is of sufficient size to achieve economies of scale.

In considering the allowances for retail costs and retail margin, the Tribunal undertook extensive consultation and review, and sought independent expert advice. It engaged Frontier Economics to develop recommendations on these allowances. It also released Frontier Economics' draft methodology for calculating these allowances and held a public workshop on that methodology. It released Frontier Economics' draft report, held a hearing on the calculated results, and sought submissions on the draft report. Frontier Economics considered the submissions and has produced a final report, which the Tribunal has considered in making this draft determination. The Tribunal has also directly considered submissions on retail costs and margins in this draft determination.

The Tribunal's draft findings on the allowances for retail operating costs and margin are summarised in the section below. These allowances have been included in the hypothetical retailers costs, which the Tribunal considered in setting the regulated retail price controls (R values). This is further explained in Chapter 8.

The subsequent sections discuss in more detail:

- Mass market new entrant retail cost allowances, and the input assumptions of retail operating costs and customer acquisition costs.
- Mass market new entrant retail margin allowances.

7.1 Overview of draft findings of the allowances for retail costs and retail margin

The Tribunal's draft findings are that the allowances for retail costs and retail margin to be taken into account in setting the regulated retail price controls are those shown in Table 7.1.

Table 7.1 Tribunal's draft findings on allowances for retail costs and retail margin (\$2006/07 \$/customer, % sales)

Description	2007/08	2008/09	2009/10
All retailers			
Retail operating costs (\$2006/07 \$/customer)	75	75	75
Customer acquisition costs (\$2006/07 \$/customer)	35	35	35
Retail cost allowance (\$2006/07 \$/customer)	110	110	110
Retail margin (EBITDA, % of sales)	5%	5%	5%

These draft findings reflect the Tribunal's decision to accept Frontier Economics' interpretation of a mass market new entrant in calculating retail costs and margin. The Tribunal considers that its findings reflect the costs of a new market entrant that has achieved economies of scale but not all potential economies of scope, particularly those available through vertical integration.

The Tribunal considers that increased competition should place pressure on all retailers, including the Standard Retailers, to pursue efficiency gains to increase their competitiveness. This is in the long-term interest of customers. The Tribunal intends to further consider the possibility of efficiency gains in making its final determination.

The Tribunal also intends to investigate whether there are differences in the relationship between growth in GDP and electricity consumption of small retail customers, from the one to one relationship assumed by Frontier Economics, that would lead it to select a higher or lower retail margin.

7.2 Mass market new entrant retail costs

The Tribunal's draft findings on the allowance for mass market new entrant retail costs are shown in Table 7.2.

**Table 7.2 Tribunal's draft findings on mass market new entrant retail costs
(\$2006/07 \$/customer)**

Description	2007/08	2008/09	2009/10
All retailers			
Retail operating costs	75	75	75
Customer acquisition costs (residential customers)	34	34	34
Customer acquisition costs (business customers)	42	42	42
Customer acquisition costs (weighted average)	35	35	35

The Tribunal accepts that mass market new entrant retail costs include both retail operating costs and costs to acquire new customers. The Tribunal's considerations in relation to each of these costs are summarised below.

7.2.1 Mass market new entrant retail operating costs

In making its draft findings on mass market new entrant retail operating costs, the Tribunal considered Frontier Economics' recommendations on these costs, stakeholder submissions on this issue, and Frontier Economics' response to these submissions.

Frontier Economics recommended a range for retail operating costs of \$60 to \$80 per customer, per year (in 2006/07 dollars). Frontier Economics developed this range using a bottom-up approach based on cost information provided by the Standard Retailers as a proxy for mass market new entrant costs. Frontier Economics then benchmarked the results against regulatory decisions in other jurisdictions.⁶³

⁶³ Frontier Economics, *Mass market new entrant retail costs and retail margin*, Final Report, March 2007, p 28.

Several stakeholder submissions suggested that focusing on the costs of the Standard Retailers is likely to underestimate mass market new entrant costs because there is potential for significant cost sharing with the electricity distribution businesses carried out by these retailers (for example, refer to submissions from EnergyAustralia,⁶⁴ Country Energy,⁶⁵ AGL,⁶⁶ TRUenergy⁶⁷ and Origin Energy⁶⁸).

In response to these comments, Frontier Economics provided some information on the categories of costs that are most likely to be shared between different business operations and the contributions of these categories to the total retail operating costs of the Standard Retailers.⁶⁹ Frontier Economics also noted that second tier retailers have been able to win customers away from the Standard Retailers, which suggests that the additional costs associated with being a mass market new entrant retailer with no electricity distribution functions are unlikely to be large.⁷⁰

There is limited cost data in the public domain to allow the results of Frontier Economics' bottom up approach to be benchmarked against the actual costs of new entrant retailers competing in the NSW electricity retail market. The Tribunal did consider cost information provided by AGL on a confidential basis. It also noted that the Standard Retailers' actual reported retail operating costs are low compared to recent regulatory decisions.

On balance, the Tribunal agrees with Frontier Economics that the costs of a mass market new entrant retailer without access to economies of scope from a shared distribution/retail business are likely to be towards the top of the recommended range. For this reason, the Tribunal considers that a retail operating cost of \$75 per customer per year, which is towards the top of Frontier Economics' recommended range of \$60 to \$80, is appropriate.

The Tribunal's considerations on how the new entrant retail operating costs could change over time and what proportion of the costs should be recovered through fixed and variable charges are discussed below.

Expected changes in retail operating costs over the determination period

The Standard Retailers each projected increases in retail operating costs (in real terms) over the period 2006/07 to 2009/10. These were due to increases in both fixed and variable costs coupled with declining customer numbers. Submissions from other retailers tended to support the view that there will be upward pressure on retail operating costs during the determination period. However, having considered the submissions and Frontier Economics' response, the Tribunal is not persuaded that there will be a net increase in the efficient level of mass market new entrant retail operating costs over the determination period.

⁶⁴ EnergyAustralia submission, February 2007, p 29.

⁶⁵ Country Energy submission, February 2007, p 17.

⁶⁶ AGL submission, February 2007, p 10.

⁶⁷ TRUenergy submission, February 2007, p 3.

⁶⁸ Origin Energy submission, February 2007, p 5.

⁶⁹ Frontier Economics, *Mass market new entrant retail costs and retail margin*, Final Report, March 2007, p 38.

⁷⁰ Frontier Economics, *Mass market new entrant retail costs and retail margin*, Final Report, March 2007, p 38.

Several retailers submitted that increasing real wages will be a significant driver of increasing retail operating costs over the determination period (for example, see submissions from EnergyAustralia,⁷¹ Integral Energy⁷² and AGL⁷³). However, Frontier Economics considered that this view is not supported by the evidence, which shows that, historically, increasing input prices have not led to increasing retail operating costs. Frontier Economics noted that the expected increase in nominal wages is in line with past increases (4-5 per cent per year), and that productivity in the utilities sector was also low in the current determination period but is expected to increase in the future.⁷⁴ Overall, Frontier Economics expects downward pressure on retail operating costs due to improvements in productivity (especially related to IT, where costs are expected to fall over the 2007 to 2010 period).

On balance, the Tribunal considers that expected increases in labour productivity and technology are likely to result in productivity improvements over the determination period that should at least keep pace with those expected in the broader economy. The Tribunal also considers that a mass market new entrant retailer would be able to take advantage of these to some extent, although it accepts that the ability of existing retailers to do this may be somewhat limited (for example, due to existing investments in computer systems).

Submissions also referred to findings by Ofgem that retail costs in the UK were higher than the earlier costs quoted by Frontier Economics, and are expected to increase over time.⁷⁵ However, in its final report Frontier Economics noted that most of the costs discussed by Ofgem relate to full retail contestability, and such costs would have already been recovered by NSW retailers or included in the actual retail operating costs reported by these retailers. Frontier Economics argued that there is nothing to suggest that there will be any further increase in retail operating costs in NSW as a result of contestability related costs. It also noted that Ofgem did not expect costs to continue to rise but were more likely to reduce in the future.⁷⁶

The Tribunal expects that any future costs resulting from full retail contestability would be mainly related to information technology (such as, software, middleware and customer billing systems). Frontier Economics put the view that fixed retail operating costs will fall over the period as some investments that are currently part of fixed costs become scaleable (for example, billing systems) over time. This results from retailers having the capacity to scale shorter term investments to better match their operations.

The Tribunal acknowledges that many of the submissions it received on Frontier Economics' draft report disagreed with Frontier Economics' comments on scalability. The Tribunal agrees that it is difficult to determine the extent of scalability of retail investments. However, it also considers that future costs resulting from full retail contestability are most likely to relate to items of information technology expenditure for which it expects costs to reduce. Based on these issues, the Tribunal does not consider that additional full retail contestability costs are likely to drive higher costs over the determination period.

⁷¹ EnergyAustralia submission, February 2007, p 29 and 31.

⁷² Integral Energy submission, February 2007, p 41.

⁷³ AGL submission, February 2007, p 10.

⁷⁴ Frontier Economics, *Mass market new entrant retail costs and retail margin*, Final Report, March 2007, p 26.

⁷⁵ For example, Integral Energy submission, February 2007, p 39.

⁷⁶ Frontier Economics, *Mass market new entrant retail costs and retail margin*, Final Report, March 2007, p 26.

Submissions raised a number of other issues that stakeholders considered would drive increases in retail operating costs during the determination period, such as costs relating to introduction of time-of-use pricing⁷⁷ and costs of hardship programs.⁷⁸ The current costs associated with these activities are already accounted for in the retail operating costs selected by the Tribunal. However, where there are new regulatory requirements in relation to these costs that arise during the determination, they will be considered in accordance with the cost pass-through mechanism (see Chapter 5).

During the period 2007 to 2010, the Tribunal considers that an increase in competitive activity should deliver efficiency gains in retail costs. The Tribunal intends to further explore the likely extent of these prior to making its final determination.

Fixed and variable elements of mass market new entrant retail operating costs

Frontier Economics recommended that 75 per cent of mass market new entrant retail operating costs be considered fixed cost and 25 per cent be considered a variable cost.⁷⁹ Frontier Economics also recommended calculating a variable (\$/MWh) allowance for retail operating costs using the average level of consumption across the three Standard Retailers.⁸⁰

The Tribunal accepts the percentages recommended by Frontier Economics and that the variable element should be calculated with regard to average consumption not the consumption of each retailer. However, the Tribunal has used the average across the three Standard Retailers based on the most recent actual consumption information available to it, rather than forecast annual average consumption as recommended by Frontier Economics. The fixed and variable elements of mass market new entrant retail operating costs resulting from these decisions are shown in Table 7.3.

The Tribunal considered Country Energy's view that it is not appropriate to use average consumption for this calculation, as consumption varies across retailers and therefore using the average does not reflect the retailers' actual costs.⁸¹ It also considered AGL's comments on the importance of choosing an accurate conversion figure so that a retailer's costs can be fully recovered.⁸²

While the Tribunal has considered regulated load for each Standard Retailer in calculating energy purchase costs, the terms of reference require the Tribunal to include an allowance for retail operating costs that is based on the costs of a mass market new entrant and not the costs of the Standard Retailers. In developing its recommended range for these costs, Frontier Economics applied a definition of mass market new entrant that required it to identify the relevant size and scope of a hypothetical mass market new entrant retailer. This recommended range was developed with regard to the costs of the Standard Retailers and a number of other benchmarks, but ultimately the terms of reference require a departure from the costs that the Standard Retailers will actually incur.

⁷⁷ EnergyAustralia submission, February 2007, p 31.

⁷⁸ AGL submission, February 2007, pp 2-3.

⁷⁹ Frontier Economics, *Mass market new entrant retail costs and retail margin*, Final Report, March 2007, p 41.

⁸⁰ Frontier Economics, *Mass market new entrant retail costs and retail margin*, Final Report, March 2007, p 39.

⁸¹ Country Energy submission, February 2007, p 20.

⁸² AGL submission, February 2007, p 11.

The Tribunal considers that the use of average consumption to calculate fixed and variable allowances is consistent with Frontier Economics' notion of a hypothetical mass market new entrant retailer. It considers that incorporating different cost allowances for each Standard Retailer based on the level of consumption of their regulated retail customers would be a departure from the mass market new entrant approach and as such would introduce inconsistency into Frontier Economics' framework.

The Tribunal considers that using actual average consumption across the three retailers instead of forecast consumption will minimise the impact of forecasting errors. This approach is also consistent with Frontier Economics' decision to place greater emphasis on the Standard Retailers' actual costs than on their forecasts in determining mass market new entrant retail costs over the determination period.

Table 7.3 Fixed and variable elements of mass market new entrant retail operating costs (\$2006/07)

Description	2007/08	2008/09	2009/10
All retailers			
Fixed retail operating costs (\$/customer)	56.25	56.25	56.25
Variable retail operating costs (\$/MWh)	2.13	2.13	2.13
Total (expressed as \$/customer)	75	75	75

7.2.2 Customer acquisition costs

Frontier Economics found that the overall cost of acquiring customers was approximately \$200 per customer. Given Frontier Economics' analysis and the absence of submission comments on this figure, the Tribunal's draft decision is to accept this view.

Frontier Economics also recommended that the overall cost per customer be amortised over the expected number of years the customer will remain with a retailer. It recommended a range (\$/customer) for customer acquisition costs based on different expectations of this number of years. The Tribunal has formed its own view on the expected life of a customer and has selected a point in Frontier Economics' range that reflects its views. The customer acquisition costs recommended by Frontier Economics and the Tribunal's draft findings are set out in Table 7.4.

Table 7.4 Customer acquisition costs (2006/07 \$/customer)

Description	Assumption on the number of years customer is retained	Customer acquisition costs
Frontier Economics recommendation		
CAC for business customers	3-6 years	40-80
CAC for residential customers	6-10 years	25-40
Tribunal's draft findings		
CAC for business customers	6 years	42
CAC for residential customers	8 years	34

The Tribunal's considerations on the expected number of years customers will be retained and the fixed and variable elements of customer acquisition costs are set out below.

Number of years customers will be retained

To determine a figure for customer acquisition costs, the estimate of the overall cost of acquiring one new customer was amortised over the number of years a new entrant is expected to retain its customers. The Tribunal's draft finding on this number is based, in part, on its view of the competitiveness of the market over the determination period. This is because the higher the levels of customer switching each year, the fewer years a customer can be expected to remain with a given retailer.

There was a broad consensus in submissions from both Standard Retailers and second tier retailers that the period over which customers will be retained should be:

- 4-5 years for residential customers
- 3-4 years for business customers.

Submissions argued that customers will be retained for fewer years than the level suggested by current rates of switching in NSW, with several submissions putting the view that the Tribunal's determination is likely to increase levels of switching to rates similar to those currently observed in Victoria and South Australia.⁸³ The period of customer retention expected by retailers is at or below the low end of the ranges recommended in Frontier Economics' final report. Frontier Economics noted that at the low end of the range, the implied average churn rate, across both residential and business customers, is 17-18 per cent.⁸⁴

The Tribunal expects the level of competition in NSW to increase over the determination period. However, there is uncertainty about the impact of increased levels of competition on customer switching. The Tribunal is of the view that a market may deliver competitive outcomes (in terms of market conduct and performance) but still have relatively low levels of customer churn.

⁸³ For example, see Country Energy submission, February 2007, p 19, Origin Energy submission, February 2007, p 6 and TRUenergy submission, February 2007, p 2.

⁸⁴ Frontier Economics, *Mass market new entrant retail costs and retail margin*, Final Report, March 2007, p 18.

While it is difficult to predict the extent of customer switching over the determination period, the Tribunal considers that there are a number of reasons why the rate of churn in NSW is unlikely to approach the rates seen in Victoria and South Australia, including:

- there were high levels of dissatisfaction with the incumbent in South Australia⁸⁵
- the South Australian Government offered a \$50 cash rebate for concession card holders to encourage them to seek out a competitive market offer rather than stay with the franchise tariff⁸⁶
- Victoria and South Australia have comparative price information services for which there is currently no equivalent in NSW
- Victoria and South Australia are the 2nd and 3rd most active markets in the world.⁸⁷

A closer look at the experience of the member states in the European Union indicates that the level of switching among small retail customers is similar to the current levels of switching in NSW. During 2002, the average switching rate for small retail customers in the European Union was around 10 per cent.⁸⁸ Of the eight countries that had full retail contestability for small retail customers, only the United Kingdom and Norway (the 1st and 5th most active markets) had switching rates above 10 per cent (in both 2002⁸⁹ and 2003⁹⁰).

Similarly, in New Zealand, which has the longest history of full retail contestability, the switching rate was around 10 per cent in 2004. Although this rate has experienced high peaks – around 30 per cent per year in mid 2001 (due to a large price increase) – the Peace Vaasaemg report notes that switching in the range of 5 to 12.5 per cent per year is emerging as a stable active level.⁹¹

Frontier Economics' draft and final reports differentiated between residential and business customers, noting that business customers are likely to stay with a retailer for fewer years than residential customers, on average. The Tribunal has not found any detailed comparison or analysis of the rate of switching for small business customers (less than 160MWh per year) and same-sized residential customers. Experience in NSW to date suggests that the rate at which business customers in NSW have taken up negotiated contracts is not markedly different to the rate for residential customers.⁹²

These factors have led the Tribunal to expect that residential customers will remain with retailers for an average of 8 years and business customers for an average of 6 years.

⁸⁵ 'Introducing FRC in South Australia: Dreams and Realities' speech by Lew Owens, Chairperson, Essential Services Commission of SA, 29 April 2003.

⁸⁶ ICRC, *Retail Prices for Non-contestable Electricity Customers: Draft Decision*, April 2006, p 26. The ICRC notes that churn rates were relatively low until the introduction by the South Australian Government of the \$50 electricity transfer rebate for concession card holders in March 2004, following a significant increase in the regulated electricity tariff rates.

⁸⁷ Peace Vaasaemg, *World Retail Energy Market Rankings*, June 2005.

⁸⁸ FRC for small retail customers was introduced in these markets from 1996 onwards.

⁸⁹ European Commission, *Third Benchmarking Report on the Implementation of the Internal Electricity and Gas Market*, 2004, p 9.

⁹⁰ European Commission, *Fourth Benchmarking Report on the Implementation of the Internal Electricity and Gas Market*: Technical annexes, p 5.

⁹¹ Peace Vaasaemg, *World Retail Energy Market Rankings*, June 2005, p 5.

⁹² Based on information provided to the Tribunal by the Standard Retailers on a confidential basis.

Fixed and variable elements of mass market new entrant customer acquisition costs

Frontier Economics recommended that 100 per cent of customer acquisition costs be recovered on a per customer basis (with none to be recovered on a per MWh basis). The Tribunal agrees that this more closely reflects the nature of customer acquisition costs, which do not vary with energy usage.

7.3 Mass market new entrant retail margin

The Tribunal's draft finding is that a mass market new entrant retail margin of 5 per cent of sales (EBITDA) is to be taken into account in setting the regulated retail price controls.

The terms of reference require the Tribunal to include an allowance for a retail margin for a mass market new entrant. Frontier Economics' final report recommended a retail margin in the range of 4 per cent to 6 per cent of total sales (EBITDA). Frontier Economics developed this range after applying three approaches, which resulted in the outcomes below:

- bottom-up approach – 4.3 to 5 per cent
- expected returns approach – 4.3 to 6.4 per cent
- benchmarking approach – 4 to 6 per cent.

In their submissions to the review, retailers suggested that the margin should be set at a minimum of five per cent. The reasons offered in support of this view included that a mass market new entrant requires a higher margin than the Standard Retailers, it would be more consistent with market observations, and that the margin should recognise energy purchase risks and declining periods of customer retention.⁹³

A mass market new entrant retailer faces a number of risks, some of which are not currently faced by the Standard Retailers. While the role of the retail margin is to compensate the firm (and ultimately its investors) for bearing risk, not all of the risks facing a mass market new entrant will be compensated for in the retail margin. Frontier Economics' final report included a detailed discussion of which risks are recognised under its approach.⁹⁴

The bottom-up and expected returns approaches recommended by Frontier Economics did not include an allowance for non-systematic energy purchase risk or customer acquisition costs – these have each been addressed elsewhere in the cost allowances. Frontier Economics' benchmarking approach reviewed market evidence as well as recent regulatory decisions.⁹⁵ In reviewing the information provided by submissions and Frontier Economics, it is important to ensure that benchmarks are comparable in terms of the costs and risks they are designed to cover.

Differences in the operating cost breakdown of the retailing arms of energy firms also have an impact on the comparability of available benchmarks. For example, in some instances, the retail margin represents an EBIT margin while in other instances it represents EBITDA. In the work undertaken by Frontier Economics, depreciation has not been compensated for in

⁹³ For example, see Integral Energy submission, February 2007, pp 28-33 and AGL submission, February 2007, pp 2-3.

⁹⁴ Frontier Economics, *Mass market new entrant retail costs and retail margin*, Final Report, March 2007, pp 49-51.

⁹⁵ Frontier Economics, *Mass market new entrant retail costs and retail margin*, Final Report, March 2007, pp 63-67.

the retail cost allowance but is included as a component of the retail margin, making the EBITDA the appropriate comparator. Frontier Economics suggested that EBITDA margins for a mass market new entrant are about one per cent higher than EBIT margins.⁹⁶

In their submissions, Integral Energy and EnergyAustralia reviewed a range of evidence from company reports, independent experts' reports and brokers' reports.⁹⁷ The raw data for the listed firms provided coincides with the top of Frontier Economics' recommended ranges for EBITDA margins. In a report prepared for EnergyAustralia, KPMG also reviewed market evidence and concluded that this evidence suggests an appropriate EBIT margin in the range of 5–8 per cent. However, KPMG noted that estimated margins that exclude customer acquisition costs are likely to be significantly less than margins observed in the market.⁹⁸

While there is undoubtedly some circularity with benchmarking against other regulatory decisions, it can nevertheless provide useful information about the reasonableness of the retail margin estimated using the bottom-up and the expected returns approaches. The analysis suggests that the allowance for the retail margin should be in the range of 1.5 per cent to 8 per cent (1.5 per cent to 5 per cent if Charles River Associates' reports to Victoria's Department of Infrastructure are excluded from the benchmark group). However, it is important to recognise that not all of these decisions are comparable in terms of the risks and costs they are designed to cover. For example, some regulatory decisions have provided an allowance for customer acquisition costs in the retail margin. The analysis is further complicated by the fact that the margin is not clearly defined in a number of the regulatory decisions listed.

In addition to issues raised in submissions, the Tribunal notes that Frontier Economics has developed its expected returns approach assuming that there is a one-to-one relationship between growth in electricity consumption and growth in GDP. Frontier Economics noted that this relationship may not be the same if data on growth in electricity consumption is limited to small retail customers only. The Tribunal understands that there are difficulties in obtaining data relating to small retail customers for a sufficient period (at least three economic cycles) but intends to explore this further prior to making its final determination.

On the basis of the information available to it, the Tribunal considers that a retail margin of 5 per cent, which is the mid-point of the range recommended by Frontier Economics, is the appropriate allowance for its analysis.

⁹⁶ Frontier Economics, *Mass market new entrant retail costs and retail margin*, Final Report, March 2007, p 68.

⁹⁷ Integral Energy submission, February 2007, p 32 and attachment to EnergyAustralia submission, February 2007, report prepared by KPMG, *Benchmarking retail operating costs and margins*, p 14.

⁹⁸ Frontier Economics, *Mass market new entrant retail costs and retail margin*, Final Report, March 2007, p 63.

8 CALCULATING THE TOTAL COST ALLOWANCES AND SETTING THE REGULATED RETAIL PRICE CONTROLS

In setting the regulated retail price controls for the draft determination, the Tribunal was informed by its calculation of ‘hypothetical retailer’ costs, its assessment of how the Standard Retailers’ costs of supplying regulated customers will increase over the determination period, and its assessment of the associated increases required to regulated retail tariffs.

The section below provides an overview of the Tribunal’s draft decision on the regulated retail price controls for each year of the determination period (the R values used in calculating the WAPC). The subsequent sections explain the Tribunal’s calculation of hypothetical retailer costs for each year in the determination, and its break down of these hypothetical retailer costs per unit. The final section explains how the Tribunal made its draft decisions on the R values for each year of the determination.

8.1 Overview of draft decision on the regulated retail price controls

The Tribunal’s draft decision is to set the regulated retail price controls (R values) shown in Table 8.3.

These R values will be used in the calculation of the weighted average price cap. The Tribunal’s draft decision will allow regulated retail tariffs in 2009/10 to fully recover the assessed costs of the Tribunal’s ‘hypothetical retailer’, including energy purchase, retail operating and retail margin, consistent with the terms of reference. In 2007/08 and 2008/09, regulated retail tariffs will be able to increase in line with the Tribunals’ view on the net increase in costs associated with removal of ETEF.

8.2 Tribunal’s calculation of hypothetical retailer’s costs

As Chapters 6 and 7 discussed, in line with its terms of reference, the Tribunal assessed the allowances required to cover the costs of a hypothetical retailer, including:

- energy purchase costs, in the absence of the ETEF, for the regulated load for each Standard Retailer’s supply area
- retail operating costs and retail margin of a mass market new entrant retailer.

The Tribunal then added these allowances together to obtain an aggregated cost figure for a hypothetical retailer in each standard supply area.

These hypothetical retailer aggregated costs are likely to be higher than the efficient costs of the Standard Retailers, because:

- the hypothetical retailer cost figures include customer acquisition costs which, as noted in Chapter 7, Standard Retailers do not incur in relation to regulated customers
- Standard Retailers will still have access to the ETEF for a significant proportion of their regulated load until the end of the determination period, and therefore face less market risk than the Tribunal has allowed for

- the Tribunal has allowed for a retail margin appropriate for a mass market new entrant, which could be higher than the margin a Standard Retailer requires under current circumstances.

The hypothetical retailer aggregated costs could also be higher than those of efficient mass market new entrants, which may engage in a different (but also efficient) trading strategy to the one assumed by the Tribunal where they adopt a lower cost but higher risk portfolio. In addition, the terms of reference require the Tribunal to assess the energy cost allowance on the basis of the regulated load only, which ignores potential portfolio benefits that could be achieved by both Standard Retailers and mass market new entrant retailers in a broader market.

The need to consider hypothetical retailer costs rather than Standard Retailer costs has led to most of the differences between the assessed costs for this determination and the cost allowances in the 2004 determination. However, there are also other reasons for these differences – for example, depreciation is now accounted for in the retail margin instead of in retail operating costs.

Table 8.1 provides an overview of the Tribunal's calculation of the hypothetical retailer's costs in each standard supply area for each year of the determination, and compares these costs with the cost allowances used in the 2004 determination (expressed in 2006/07 dollars).

Table 8.1 Hypothetical retailer costs for each year of the determination compared with current cost allowances (\$2006/07)

Description	2006/07*	2007/08	2008/09	2009/10
	2004 determination	2007 draft determination		
Country Energy				
Electricity purchase cost (\$/MWh)	49	50	49	45
Green costs (\$/MWh)	3	5	5	6
NEM fees (\$/MWh)	1	1	1	1
Energy losses	13.6%	12.6%	12.6%	12.6%
Total energy purchase cost (\$/MWh)	61	62	61	58
Retail operating costs (\$/customer)	74	75	75	75
Customer acquisition costs (\$/customer)	-	35	35	35
Total retail costs (\$/customer)	74	110	110	110
Retail margin	2%	5%	5%	5%
EnergyAustralia				
Electricity purchase cost (\$/MWh)	49	57	55	51
Green costs (\$/MWh)	3	4	5	5
NEM fees (\$/MWh)	1	1	1	1
Energy losses	6.0%	6.4%	6.4%	6.4%
Total energy purchase cost (\$/MWh)	57	65	65	60
Retail operating costs (\$/customer)	74	75	75	75
Customer acquisition costs (\$/customer)	-	35	35	35
Total retail costs (\$/customer)	74	110	110	110
Retail margin	2%	5%	5%	5%
Integral Energy				
Electricity purchase cost (\$/MWh)	49	59	58	53
Green costs (\$/MWh)	3	5	5	6
NEM fees (\$/MWh)	1	1	1	1
Energy losses	8.6%	9.0%	9.0%	9.0%
Total energy purchase cost (\$/MWh)	58	70	69	65
Retail operating costs (\$/customer)	74	75	75	75
Customer acquisition costs (\$/customer)	-	35	35	35
Total retail costs (\$/customer)	74	110	110	110
Retail margin	2%	5%	5%	5%

Notes: * The 2006/07 allowance is based on the costs from the 2004 determination. Dollar values from the 2004 determination have been inflated from 2004/05 dollars to 2006/07 dollars.

8.3 Tribunal's calculation of hypothetical retailer costs per unit

The Tribunal calculated hypothetical retailer costs per unit for each year of the determination to inform its draft decision on the regulated retail price controls to apply to each Standard Retailer (R values).

The Tribunal broke down the hypothetical retailer costs on the same (or a similar) unit basis to the way prices are charged – for example, \$ per customer or \$ per MWh consumed. To do this it has disaggregated them using the following process:

- breaking down the assessed cost allowances down into fixed and variable costs
- expressing the fixed costs as dollars per customer per year
- allocating variable costs (based on sales) to the various types of supply for which energy purchase costs will vary (single rate, peak, shoulder, off-peak, controlled load A and controlled load B) and expressing them as cents per kWh values
- allowing a retail margin on these costs plus estimated network charges for each of the different types of supply.

Table 8.2 provides the hypothetical retailer costs per unit resulting from this process for each year of the determination period, and compares these with cost allowances per unit for 2006/07.

Table 8.2 Hypothetical retailer costs per unit in each year of the determination compared with current cost allowances per unit (\$2006/07)

Description	2006/07*	2007/08	2008/09	2009/10
	2004 determination	2007 draft determination		
Country Energy				
Fixed retail costs - \$ per customer	63	91	91	91
Variable retail costs - \$ per MWh:				
Single rate	73.4	80.1	79.1	74.2
Peak rate	73.4	99.8	97.6	87.8
Shoulder rate	73.4	106.7	104.6	94.5
Off peak/Controlled load A	43.7	43.8	44.1	45.1
Controlled load B	56.6	66.6	65.9	62.6
EnergyAustralia				
Fixed retail costs – \$ per customer	63	91	91	91
Variable retail costs - \$ per MWh:				
Single rate	64.1	78.7	78.0	73.4
Peak rate	64.1	132.9	129.9	116.8
Shoulder rate	64.1	68.1	67.6	63.8
Off peak/Controlled load A	41.1	42.4	42.9	44.2
Controlled load B	51.4	61.1	60.8	58.6
Integral Energy				
Fixed retail costs - \$ per customer	63	91	91	91
Variable retail costs - \$ per MWh:				
Single rate	66.9	85.3	84.4	79.0
Peak rate	66.9	147.7	144.2	128.6
Shoulder rate	66.9	69.3	69.0	65.5
Off peak/Controlled load A	41.9	45.8	46.3	47.5
Controlled load B	51.0	63.5	63.3	61.0

Notes: * The 2006/07 allowance is based on the R values included in the 2004 determination. Dollar values from the 2004 determination have been inflated from 2004/05 dollars to 2006/07 dollars. For Country Energy, costs are the weighted average urban and rural retail R values for Country Energy and (the former) Australian Inland Energy and Water.

8.4 How the Tribunal set the regulated retail price controls ('R values')

After reviewing the hypothetical retailer costs per unit, and considering the current level of regulated retail tariffs, the Tribunal considered what regulated retail price controls (R values) would best match its objectives for the review.

The Tribunal decided to set R values to reflect a transition to the hypothetical retailer costs in 2010. It considers that the use of a transition path is appropriate, given the gradual increase in Standard Retailers' risks and costs as the ETEF is phased out and the level of competition in the NSW market increases. Further, the Tribunal considers that the hypothetical retailer's cost allowances more than recover the costs of a Standard Retailer while the ETEF remains.

The Tribunal's developed its draft decision on the R values as follows:

- for 2009/10, the R values were set to reflect the hypothetical retailer costs (exactly)
- for 2007/08 and 2008/09, the R values were set to reflect the increase in regulated tariffs required to move tariffs smoothly from current levels to the hypothetical retailer costs in 2009/10.

The Tribunal's key reasons for adopting this approach are that:

- the Tribunal considers that the assessed cost allowances are likely to overstate the actual costs of supplying regulated retail customers in 2007/08 and 2009/10, as noted in section 8.2
- the Tribunal considers that there are benefits in providing for a stable and smooth tariff path – noting that the actual tariffs to customers will be affected by network prices and the individual retailer's decisions on tariffs
- the Tribunal considers that its approach phases in the full efficient cost of purchasing electricity in the market in line with the reduction in the proportion of regulated load supported by the ETEF.

The Tribunal's draft decisions on the R values for each Standard Retailer in each year of the determination period are shown in Table 8.3. These R values must be used by Standard Retailers in calculating the annual weighted average price cap for their regulated tariffs.

Table 8.3 R values in each year of the determination (\$2006/07)

Description	2007/08	2008/09	2009/10
Country Energy			
Fixed R	71	80	91
Variable R:			
Single rate	73.1	73.7	74.2
Peak rate	77.3	82.4	87.8
Shoulder rate	79.2	86.5	94.5
Off peak/Controlled load A	43.8	44.4	45.1
Controlled load B	58.2	60.4	62.6
EnergyAustralia			
Fixed R	71	80	91
Variable R:			
Single rate	67.1	70.1	73.4
Peak rate	78.3	95.6	116.8
Shoulder rate	64.0	63.9	63.8
Off peak/Controlled load A	42.1	43.1	44.2
Controlled load B	53.7	56.1	58.6
Integral Energy			
Fixed R	71	80	91
Variable R:			
Single rate	70.7	74.8	79.0
Peak rate	83.2	103.4	128.6
Shoulder rate	66.5	66.0	65.5
Off peak/Controlled load A	43.7	45.6	47.5
Controlled load B	54.1	57.5	61.0

Note: in the draft determination, the R values are expressed in 2007/08 dollars. In order to be comparable with the assessed cost allowances set out in this chapter the values from the draft determination have been deflated by a CPI of 3.1%.

The shoulder R-factor for Country Energy is higher than the peak R factor to reflect Country Energy's definition of daytime shoulder time. Country Energy's shoulder time, from 9am to 5pm, spans 3 hours of EnergyAustralia's peak time (2pm – 5pm) and 4 hours of Integral Energy's peak time (1pm to 5pm).

9 OUTCOMES FOR CUSTOMERS

In undertaking its review and making its draft determination, the Tribunal has been guided by the terms of reference provided by the Minister for Energy (see Appendix 1). These terms of reference differ significantly from those for previous reviews of retail prices, and these differences have resulted in increases in regulated prices.

The Tribunal considers that higher retail electricity prices in NSW are justified, and indeed necessary, to ensure that the people in this state continue to have access to a safe and reliable supply of electricity. Over the next three years, the Electricity Tariff Equalisation Fund (ETEF) will be phased out and, as a consequence, NSW electricity arrangements will more closely resemble those in Victoria and South Australia. The energy cost component of retail electricity prices needs to be sufficient to attract efficient and economic investment in generation to NSW, and to enable retailers to meet their obligations regarding greenhouse gas emissions and purchases of renewable energy. Retail prices also need to be sufficient to recover the costs incurred in selling electricity in a competitive market, and to compensate retailers for the risks that they face. In addition, they need to be sufficient to recover investments in the distribution network associated with increased reliability standards and higher peak demand.

The Tribunal's draft determination on regulated retail tariffs aims to meet these requirements and those set out in its terms of reference by providing for:

- higher allowances for electricity purchase costs for EnergyAustralia and Integral Energy
- higher allowances for retail operating costs and retail margin
- higher network costs to be pass through to customers.

As result of this draft determination, the total average regulated prices for EnergyAustralia, Integral Energy and Country Energy will increase in real terms by 4.5, 5.0 and 4.0 per cent respectively each year over the determination period. Taking into account the effect of inflation in each year, these increases are expected to be 7.7, 8.2 and 7.2 per cent.

The section below discusses the expected impact of the draft determination on customer bills in more detail. The information presented below takes into account expected changes in inflation.

9.1 Expected impact on customer bills

It is not possible to precisely forecast the increases in individual tariffs because, under the weighted average price cap (WAPC) approach, retailers have the flexibility to determine the level and structure of individual regulated tariffs. Under this form of regulation, the Tribunal stipulates the maximum increase in the level of average regulated prices a retailer can impose each year. At the individual tariff level, prices may increase at a higher or lower rate than the average. The impact on customer bills will also depend on the balance between fixed and variable changes and the structure of network tariffs.

However, the Tribunal has estimated the average nominal price increases for typical small customers of each Standard Retailer, which provide an indicative picture of likely nominal increases to bills for these customers (Tables 9.2, 9.3 and 9.4).⁹⁹

⁹⁹ This information is indicative only and is based on the Tribunal's assumptions that the increase in CPI is 3.1 per cent. The Tribunal has also assumed that the retail components of prices are the relevant fixed and variable R factors, and that fixed and variable network charges increase at the estimated average rate for each retailer.

Table 9.2 Indicative increases in annual bills for typical customers of Country Energy (\$/customer, nominal, ex-GST)

Description	2006/07 bill	2007/08 bill	2008/09 bill	2009/10 bill	Increase 2006/07 – 2007/08 (%)	Increase 2007/08 – 2008/09 (%)	Increase 2008/09 – 2009/10 (%)
Residential							
Low usage (3000 kWh per year)	624	676	723	774	8.3%	6.9%	7.0%
Medium usage – no controlled load (5600 kWh per year)	1,004	1,083	1,152	1,225	7.8%	6.4%	6.4%
Medium usage – with controlled load (8900 kWh per year)	1,199	1,292	1,372	1,457	7.8%	6.2%	6.2%
Business							
20 MWh per year	3,573	3,830	4,054	4,291	7.2%	5.8%	5.9%
40 MWh per year	6,915	7,404	7,827	8,273	7.1%	5.7%	5.7%
60 MWh per year	13,598	14,552	15,373	16,238	7.0%	5.6%	5.6%

Note: The 8900 kWh comprises 5,600 kWh on the single rate and 3,300 kWh on Controlled Load A.
The increases are expressed in nominal terms; therefore, they include expected changes in inflation over the period.

Table 9.3 Indicative increases in annual bills for typical customers of EnergyAustralia (\$/customer, nominal, ex-GST)

Description	2006/07 bill	2007/08 bill	2008/09 bill	2009/10 bill	Increase 2006/07 – 2007/08 (%)	Increase 2007/08 – 2008/09 (%)	Increase 2008/09 – 2009/10 (%)
Residential							
Low usage (3000kWh per year)	447	494	536	582	10.3%	8.7%	8.6%
Medium usage – no controlled load (5600 kWh per year)	737	810	876	946	9.8%	8.1%	8.0%
Medium usage – with controlled load (8900 kWh per year)	891	976	1,052	1,132	9.6%	7.7%	7.6%
Business							
20 MWh per year	2,468	2,693	2,895	3,108	9.1%	7.5%	7.3%
40 MWh per year	4,887	5,326	5,718	6,130	9.0%	7.4%	7.2%
60 MWh per year	9,724	10,591	11,364	12,173	8.9%	7.3%	7.1%

Note: The 8900 kWh comprises 5,600 kWh on the single rate and 3,300 kWh on Controlled Load A.
The increases are expressed in nominal terms; therefore, they include expected changes in inflation over the period.

Table 9.4 Indicative increases in annual bills for typical customers of Integral Energy (\$/customer, nominal, ex-GST)

Description	2006/07 bill	2007/08 bill	2008/09 bill	2009/10 bill	Increase 2006/07 – 2007/08 (%)	Increase 2007/08 – 2008/09 (%)	Increase 2008/09 – 2009/10 (%)
Residential							
Low usage (3000 kWh per year)	504	556	606	661	10.3%	8.9%	9.1%
Medium usage – no controlled load (5600 kWh per year)	824	906	983	1,068	10.0%	8.5%	8.6%
Medium usage – with controlled load (8900 kWh per year)	985	1,083	1,173	1,272	10.0%	8.3%	8.4%
Business							
20 MWh per year	2,726	2,983	3,223	3,484	9.4%	8.0%	8.1%
40 MWh per year	5,388	5,890	6,355	6,863	9.3%	7.9%	8.0%
60 MWh per year	10,712	11,703	12,621	13,622	9.2%	7.8%	7.9%

Note: The 8900 kWh comprises 5,600 kWh on the single rate and 3,300 kWh on Controlled Load A.

The increases are expressed in nominal terms; therefore, they include expected changes in inflation over the period.

These tables indicate that:

- In 2007/08, typical residential customer bills are expected to rise between 7.8 per cent and 10.3 per cent, while typical business customer bills are expected to rise between 7.0 per cent and 9.4 per cent. In the following two years, the annual increase in percentage terms for typical residential and business customer bills is expected to be slightly less than this.
- Integral Energy's typical customers are likely to face the largest bill increases over the determination period. This is due to an increase in the electricity purchase costs allowance for this retailer, which reflects the requirement in the terms of reference to take into account the load profile of each Standard Retailer. As discussed in Chapter 6, Integral Energy has the peakiest regulated customer load, and so has the highest electricity purchase costs.
- Country Energy's typical customers are expected to face the smallest bill increases in percentage terms over the period, due to a decrease in the electricity purchase costs to be recovered through Country Energy's regulated tariffs.

10 NON TARIFF CHARGES

The Tribunal has made draft decisions on the maximum allowable charge for each regulated retail charge (non-tariff charge) included in the *Electricity Supply Act 1995*. This Act defines a regulated retail charge as:

- a security deposit
- a late payment fee, or
- a fee for a dishonoured bank cheque.

In effect, this definition means that no other regulated retail charges may be imposed.

The Tribunal established a working group comprising representatives of retailers, community welfare organisations and the NSW Energy and Water Ombudsman (EWON) to provide information and comment on options for the above non-tariff charges. Its draft decisions and considerations in relation to each charge are outlined below.

10.1 Security deposits

10.1.1 Draft decisions

The Tribunal's draft decision is that:

- Security deposits will remain at the levels specified in the 2004 Determination. That is, they will be either:
 - 1.5 times the average quarterly electricity account, or
 - 1.75 times the average 2-monthly electricity account, or
 - 2.5 times the average monthly electricity account.
- The circumstances surrounding the charging and return of security deposits will be as set out in the 2004 Determination, with the following two additions:
 - In general, a security deposit may only be required from a residential customer prior to connection. However, a security deposit can also be required from a residential customer within 12 months of connection if the customer entered into a payment plan and subsequently cancelled that plan and the other circumstances where a security deposit may be required apply.
 - Centrepay is specified as an instalment plan for the purpose of applying the exemption on security deposits if a customer has agreed to pay by an instalment or payment plan.

10.1.2 Tribunal's considerations

The Tribunal considered the level of security deposits and the circumstances in which a customer can be required to pay such a deposit. In their submissions to the Tribunal, retailers generally considered the level of security deposits set in the 2004 Determination was appropriate. EWON submitted that there should be no increases. NCOSS, while preferring security deposits to be abolished, put the view that if they were to be retained a cap should be placed on the amount, as in the 2004 Determination. After considering the various stakeholder views, the Tribunal considers that the security deposit levels in the 2004

Determination, which are based on multiples of an average bill, are implicitly indexed and remain appropriate.

Under the 2004 Determination, a retail supplier may only require a customer to pay security deposit in the following circumstances:

- at or before connection, and
 - only where the customer has left a supply address without paying a debt, or
 - has been responsible for the illegal use of electricity within the previous two years, or
 - does not have a satisfactory credit history and the retail supplier has offered the customer an instalment or payment plan and the customer has refused or failed to agree to that offer.

Integral Energy proposed that security deposits should be able to be charged during the life of a supply agreement. EWON opposed this proposal, arguing that it would particularly disadvantage people in financial difficulty. Working group discussions narrowed the main issue to the retailer's desire to close what was seen as a loophole in the current arrangements, where a new customer could avoid paying a security deposit by agreeing to pay by an instalment plan and then cancel the plan once connected. The working group generally supported this issue being addressed in the new determination.

The Tribunal accepts the working group's view, and has made a draft decision to allow retailers to require a security deposit from a small residential customer within 12 months of connection where the retailer would have required a security deposit but did not as the customer entered into a payment plan, and the customer subsequently cancelled the payment plan.

EWON also observed that some retailers do not recognise 'Centrepay' as a payment plan for the purpose of applying the exemption from payment of a security deposit, and submitted that this was anomalous and places an unfair burden on people in receipt of government benefits. Centrepay is the free direct bill paying service offered to people receiving payment from Centrelink and allowing those people to pay for services (including electricity) by having a regular amount deducted from their Centrelink payment.

The Tribunal considers that Centrepay should qualify as a payment plan for the purpose of applying the restrictions on payment of security deposits and has made a draft decision to specify this in the 2007 determination.

10.2 Late payment fee

10.2.1 Draft decisions

The Tribunal has made a draft decision to set the maximum late payment fee at \$7.00, exclusive of GST. The Tribunal has also made a draft decision to retain the conditions set in the 2004 Determination for levying late payment fees.

10.2.2 Tribunal's considerations

The Tribunal considered both the level of the late payment fee, and the circumstances in which this fee can be charged. Under the 2000 and 2004 Determinations, the maximum late payment fee was set at \$5.00.

Stakeholder made a variety of comments on the level of this fee, including:

- that costs have increased since the fee was set at \$5.00
- that the fee should be increased to approximately \$10 to \$12, or retailers should be able to charge 'fair and reasonable' fees
- that late payment fees should be aligned with those levied in other jurisdictions
- that late payment fees should only be increased on the basis of firm evidence of costs incurred
- concern at the impact of late payment fees on low income households
- concern that some customers who are exempt from late payment fees are being charged.

The Tribunal considered these points of view, and the information provided by retailers on the estimated costs associated with late payment.

Many of the costs associated with late payments have been taken into account by Frontier Economics in its estimation of retail operating costs and these costs would be double-counted if they could also be recovered through late payment fees. On balance, the Tribunal considers the maximum late payment fee should be increased to \$7, which is within the range of costs provided by retailers.

In relation to the conditions under which late payment fees may or may not be levied, the Tribunal has made a draft decision to retain the conditions specified in the 2004 Determination. It notes the view put by EWON that it is not unusual for electricity customers to contact its office to complain that they have been charged a late payment fee even though they are exempt from the fee under the terms of the 2004 Determination. For example, EWON noticed that a person who paid his last payment prior to disconnection with \$90 of Energy Accounts Payment Assistance vouchers had nevertheless been charged a late payment fee.

The Tribunal reminds retailers that the exemptions and restrictions on charging of late payment fees are binding requirements under the Determination.

10.3 Dishonoured cheque fee

10.3.1 Draft decision

The Tribunal has made a draft decision to retain the level of the dishonoured cheque fee at two times the regular (GST-exclusive) fee charged by the bank or financial institution. This fee may only be charged where the retail supplier actually incurs a bank or financial institution fee for the dishonoured cheque.

10.3.2 Tribunal's considerations

Stakeholder submissions and the working group did not raise any significant concerns about the level of charge for a dishonoured cheque. The Tribunal notes that the average dishonoured cheque fees charged to customers have remained fairly constant since 2004. However, there were concerns about the circumstances in which retailers can charge fees related to dishonoured payments.

The Electricity Supply Act's definition of a regulated retail charge does not allow retailers to charge retail customers for non-cheque dishonoured payments. For example, retailers may incur a charge from the bank or financial institution when there is a default on payment by a direct debit or credit card. In submissions and through the working party, retailers did not support the differential treatment of defaults on cheques and defaults on other forms of payment. Most retailers argued that the Electricity Supply Act should be amended to allow dishonour fees to be charged on other payment options. Retailers incur additional costs when payments are dishonoured, such as cancelling and reestablishing direct debit plans, customer contact and mail outs.

EWON cautioned that customers defaulting on non-cheque payments will also be charged a fee by the bank or financial institution and a further fee from the retailer may have a significant impact on disadvantaged customers.

It is difficult to generalise from the data provided by retailers on costs incurred by retail suppliers associated with non-cheque defaults. However, one retailer's financial institution charges for dishonoured non-cheque payments were five times the charges it incurred for defaults on cheque payments. The Tribunal considers it anomalous that retailers are unable to charge a dishonour fee for non-cheque forms of dishonoured payments.

The Tribunal recommends that the Government amend the Electricity Supply Act to allow Standard Retail Suppliers to charge a fee for dishonoured direct debit payments.

APPENDIX 1 TERMS OF REFERENCE

Terms of reference for an investigation and report by the Independent Pricing and Regulatory Tribunal on regulated retail tariffs and regulated retail charges to apply between 1 July 2007 and 30 June 2010 under Division 5 of Part 4 of the *Electricity Supply Act 1995*.

Reference to the Tribunal under section 43EA

The Minister refers to the Tribunal for investigation and report under section 43EB of the Act:

The determination of regulated retail tariffs and regulated retail charges to apply to small retail customers in each standard retail supplier's supply district in New South Wales for the period from 1 July 2007 to 30 June 2010.

Background

In accordance with its commitment to retain the offer of regulated retail tariffs, the Government has extended the current scheme for regulated retail tariffs and charges to apply to small retail customers supplied under a standard form contract. A regulatory amendment will be made for these purposes under section 43EJ of the *Electricity Supply Act 1995* to allow the Tribunal to make a further determination of regulated retail tariffs and charges that will apply from 1 July 2007 to 30 June 2010. The Electricity Tariff Equalisation Fund (ETEF) arrangement will be phased out between September 2008 and June 2010 in accordance with the recently revised ETEF Payment Rules.

Since January 2002, every electricity customer in NSW has had the option to negotiate a retail supply contract with any licensed retailer. Small retail customers who do not seek supply from the competitive market are deemed to receive electricity under a 'standard form' customer supply contract from their 'standard retail supplier'. Customers can also switch backwards and forwards between these alternatives. These arrangements were designed to encourage customers to test the market by providing an assurance that they can return to regulated retail tariffs. Approximately six hundred thousand NSW customers have now moved on to negotiated tariffs at lower prices.

While retail competition has delivered benefits for those participating in the market, the majority of residential and some small business customers have chosen to remain on standard form customer supply contracts which include regulated retail tariffs and charges determined by the Tribunal.

International and national experience shows that the level of regulated retail tariffs relative to market based prices is the key determinant of how many eligible customers remain on regulated arrangements. For example, if regulated retail tariffs do not adequately reflect all of the costs of supply to small retail customers, both those customers and prospective competing retailers have little incentive to enter the competitive market. Regulated tariffs set below the cost of supply will also inhibit investment in the new generation required as the demand/supply balance tightens, as investors will not be able to recover their costs. Therefore, in order to promote retail competition and investment, regulated retail tariffs which are below the cost of supply should be moved to full cost reflectivity.

Matters for consideration

For the purposes of section 43EB (2)(a) of the *Electricity Supply Act 1995*, the matters the Tribunal is to consider in making its investigation and report on the setting of tariffs for small retail customers to apply from 1 July 2007 to 30 June 2010 include:

- An allowance for electricity purchase costs based on an assessment of the long-run marginal cost of electricity generation from a portfolio of new entrant generation to supply the load profile of customers remaining on regulated retail tariffs.
- Mass market new entrant retail costs.
- Mass market new entrant retail margin.
- An allowance based on long run marginal cost for retailer compliance with any Commonwealth mandatory renewable energy target (MRET) requirements and the licence requirements relating to the NSW Greenhouse Gas Benchmark Scheme, which takes in to account price and volume.
- Energy losses as published by the National Electricity Market Management Company (NEMMCO).
- A mechanism to ensure network charges as determined by the Tribunal and the Australian Competition and Consumer Commission (ACCC) and the Australian Energy Regulator (AER) are fully recovered.
- Fees (including charges for ancillary services) as imposed by NEMMCO under the National Electricity Code.
- An allowance for expected movements in regulated components and NEMMCO fees.
- A mechanism to address any new, compulsory scheme that imposes material costs on the retailer. For example, the potential for an inter-jurisdictional emission trading scheme.
- Recognition that ETEF will cease operation within the determination period.
- Recognition of hedging, risk management and transaction costs faced by retailers in the absence of the ETEF.
- Recognition of the forecasting risks faced by retailers in the absence of the ETEF.
- Recognition of Net System Load Profiles (NSLP's) for each standard retailer, as well as projected future changes in those net system load profiles.
- The requirement in the NSW Greenhouse Plan to require energy retailers to offer a 10% Green Power component to all new (or moving) residential customer.
- The potential to simplify regulated tariff structures including the potential to remove obsolete tariffs.

For the purposes of section 43EB (2)(b) of the *Electricity Supply Act 1995*, the Tribunal must consider the Government's policy aim of reducing 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. More specifically, the Tribunal is to take account of the following matters in undertaking its review:

- ensuring regulated tariffs cover the costs listed above
- consider the impact on demand management.

The determination should ensure that:

- regulated retail tariffs and regulated retail charges are at cost reflective levels (including all the costs listed above) for all small retail customers by 30 June 2010
- the setting of any 'price constraint' should allow the further rationalisation of regulated retail tariffs and movement to full cost recovery over the determination period.

The Tribunal should also consider and report on the basis for regulating miscellaneous charges and security deposits.

Consultation

The Tribunal should consult with stakeholders, conduct public hearings or workshops and consider submissions, within the timetable for the investigation and report. The Tribunal must make its report available to the public.

Timing

The Tribunal is to investigate and provide a report of its determination of regulated retail tariffs and charges by 14 June 2007.

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 160MWh 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*.

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

Mass market new entrant means a new market entrant that is of sufficient size to achieve economies of scale.

APPENDIX 2 BACKGROUND AND REGULATION OF ELECTRICITY

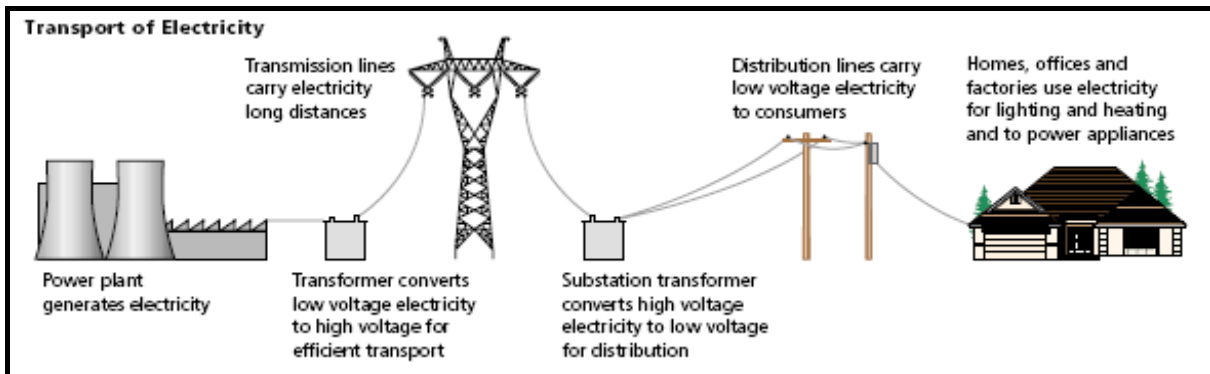
This appendix gives an overview of the electricity supply chain, what is regulated by this determination, and the components of regulated retail prices.

The energy reform process introduced in the 1990s by the Council of Australian Governments involved restructuring the traditionally vertically integrated energy industry so that consumers could benefit from competition where possible. Within the national framework for competition, State governments have also pursued their own reform policies and regulatory arrangements in retail energy markets.

A2.1 Structure of the electricity industry

Traditionally the electricity industry in NSW was made up of large vertically integrated companies that controlled most parts of the supply chain, including generation, transportation and retail of electricity (see Figure A2.1).

Figure A2.1 The Electricity Supply Chain



Source: NEMMCO An introduction to Australia's national electricity market, June 2005, p 3.

As part of the process of industry reform, these vertically integrated companies were broken into segments so that customers could benefit from competition in the areas that could be contestable – electricity generation and retail. Legislation was introduced to regulate the areas that relied on monopoly owned infrastructure – transmission and distribution (now regulated via the *National Electricity Rules*) – to ensure that access to necessary infrastructure was made available on reasonable terms and conditions.

Initially, parts of the retail market remained a monopoly and were regulated. However, over the past few years, the NSW Government has progressively introduced retail competition into the electricity market. Large consumption electricity customers have been able to choose their retailer since 1 July 1998. Competition, or contestability, for other customers was introduced in stages, with all customers able to choose their electricity retailer from 1 January 2002.

A2.2 Regulation of retail prices in NSW

The Tribunal has been asked to continue to regulate retail prices for small retail customers (defined as customers that use less than 160MWh of electricity per year, equivalent to an annual bill of approximately \$20,000) who do not choose to enter the competitive electricity market by signing a negotiated contract. These customers remain on a standard electricity supply contract. This determination regulates the prices of electricity for small retail customers on standard electricity supply contracts.

Each area in NSW has a nominated Standard Retail Supplier. The *Electricity Supply Act 1995* (the Act) requires Standard Retail Suppliers to make supply available on the tariffs and charges set by a determination of the Tribunal. Standard Retail Suppliers and new entrant retailers may also offer customers competitive or negotiated contracts. These contracts are not regulated by the Tribunal and the prices charged under them are negotiated between retailer and customer.

There are three Standard Retail Suppliers in NSW for which the Tribunal determines regulated retail tariffs. Each is Government-owned and is also involved in the distribution of electricity in NSW. The Standard Retail Suppliers and the areas in which they are required to offer regulated tariffs are:

- EnergyAustralia – Sydney, Central Coast and Hunter regions.
- Integral Energy – Western Sydney, Blue Mountains, Southern Highlands, Illawarra and Shoalhaven regions.
- Country Energy – remainder of NSW.

A2.3 How tariffs are structured

There are two main components of retail electricity tariffs – network charges and retail charges. Network charges (N) are governed by the Tribunal's 2004 network determination and are passed through directly into the retail tariffs.¹⁰⁰ This determination sets the retail component (R) of the charge. Within both components there are fixed (that do not vary with electricity usage) and variable charges (that depend on the amount of electricity used). A customer's total bill is the sum the network and retail components.

The components of the tariffs are explained in more detail in the table below.

¹⁰⁰ The Tribunal's 2004 network determination applies from 1 July 2004 to 30 June 2009. It is expected that the Australian Energy Regulator will make a price determination to apply from 1 July 2009.

Table A2.1 Components of regulated retail tariffs

Component of target	Elements of each component	Nature of the elements	Factors that affect the value of each element
N component	Applicable network tariff	May be a combination of a fixed network charge (\$/customer), variable network charges (c/kWh) and any other charge (e.g. maximum demand/capacity charge)	Network tariffs are set outside the retail determination and differ between regions and customers with different characteristics (eg, business/residential). The same network tariff applies to a customer irrespective of its retailer
R component	'Fixed R'	Fixed retail charge expressed in \$ per customer per year	Fixed R is set by the retail determination at the same level for every customer in NSW. Fixed R is set to enable retailers to recover retail costs that do not vary with electricity usage
	'Variable R'	Variable retail charge expressed in cents per kWh	Variable R is set by the retail determination and is different for: <ul style="list-style-type: none"> - each retailer - urban and rural areas - different types of supply Variable R is set to enable retailers to recover retail costs that do vary with electricity usage

A2.4 Interstate comparison of electricity bills

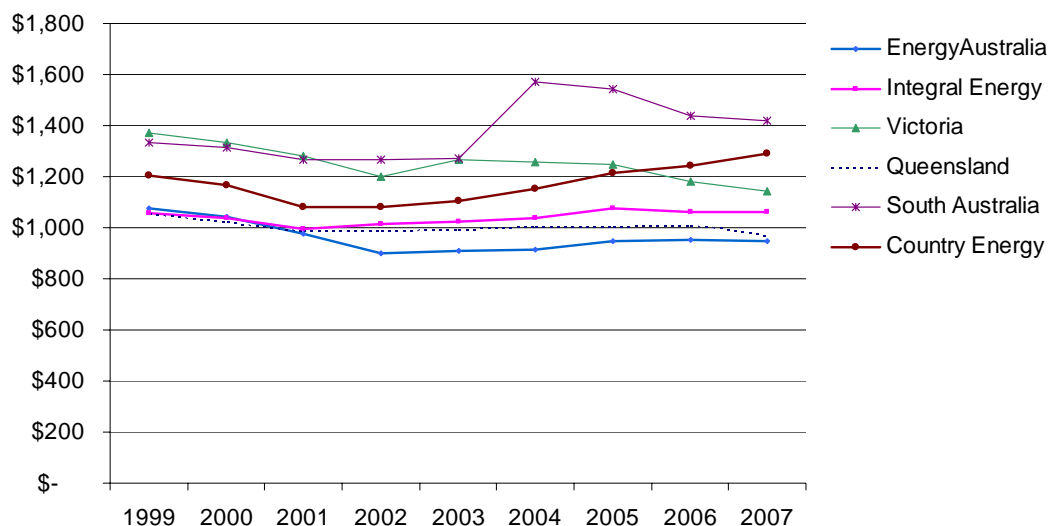
Figures A2.2 and A2.3 compare annual electricity bills since 1999 for small retail customers on regulated tariffs in Queensland, Victoria, South Australia and New South Wales.

For this purpose, two scenarios have been chosen:

- Small residential customers on a standard regulated tariff consuming 7,500 kWh pa (no off peak) – Figure A2.2.
- Small business customers consuming 30 MWh pa (no off peak) on a standard regulated tariff – Figure A2.3.

It should be noted that some of the differences in tariffs can be explained by differing network charges which vary between geographic regions.

Figure A2.2 Interstate comparison of annual bills for residential customers
Standard regulated residential tariffs – 7,500 kWh without off peak
(\$2006/07)

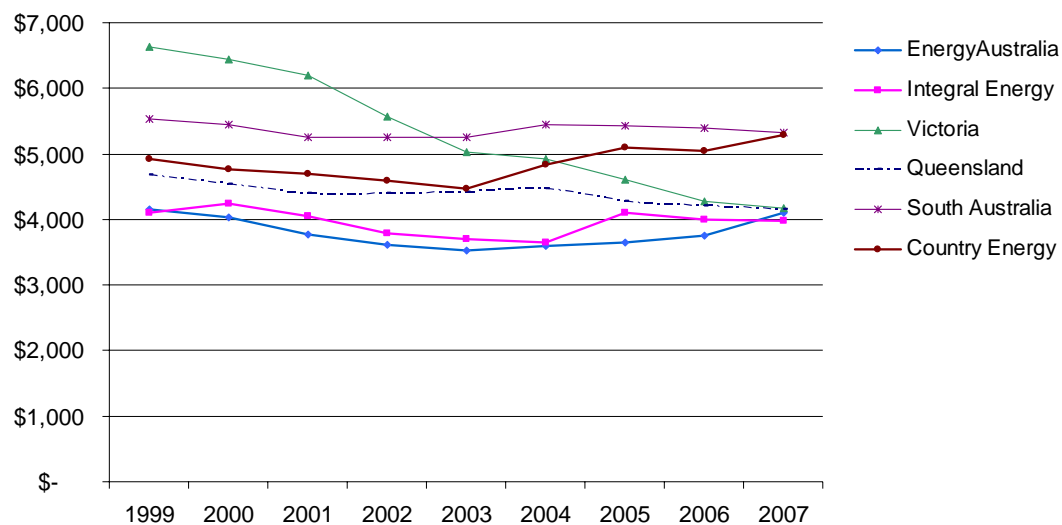


Source: Data obtained from: ESAA Electricity Prices (1999-2004); NSW regulated retail price submissions to IPART (2005-06); Victoria, South Australia, Queensland Government Gazettes (2005/06).

Residential customers on regulated tariffs in NSW have generally paid less for electricity than their equivalents in South Australia and Victoria, although since 2005 the Country Energy residential customer bill has exceeded the Victorian annual bill. This pattern is also true for residential customers on off peak electricity tariffs.

The trend for business customers on regulated tariffs is similar, with NSW prices consistently below those for South Australia. A sustained fall in the annual bills for business customers in Victoria has meant that Queensland, Integral Energy, EnergyAustralia and Victorian annual bills are currently at similar levels. Country Energy annual bills have risen gradually and are now equivalent to those paid by Queensland small business customers.

Figure A2.3 Interstate comparison of annual electricity bills for small business customers
Standard regulated small business tariffs – 30 MWh without off peak
(\$2006/07)



Source: Data obtained from: ESAA Electricity Prices (1999-2004); NSW regulated retail price submissions to IPART (2005-06); Victoria, South Australia, Queensland Government Gazettes (2005/06).

APPENDIX 3 LIST OF SUBMISSIONS

List of submissions received on the Issues Paper:

Organisation	Date
ActewAGL*	29 September 2006
AGL	13 October 2006
Country Energy	7 September 2006
Delta Electricity	9 October 2006
Energy and Water Ombudsman (EWON)	6 October 2006
Energy Retailers Association of Australia (ERAA)	9 October 2006
EnergyAustralia	7 September 2006
ER Walshe Heat Treatment	25 October 2006
ER Walshe Heat Treatment	8 November 2006
Integral Energy	7 September 2006
Macquarie Generation	6 October 2006
National Council of Social Services (NCSS)	5 October 2006
Origin Energy	10 October 2006
Public Interest Advocacy Centre (PIAC)	17 October 2006
The Pastoralists' Association of West Darling	4 October 2006
Total Environment Centre (TEC)	5 October 2006
TRUenergy	6 October 2006

* Confidential submission

List of submissions received on Frontier Economics' draft reports:

Organisation	Date
AGL	2 February 2007
Country Energy	2 February 2007
Delta Electricity	6 February 2007
EnergyAustralia	6 February 2007
Eraring Energy	2 February 2007
Integral Energy	2 February 2007
Macquarie Generation	2 February 2007
Origin Energy	7 February 2007
Public Interest Advocacy Centre (PIAC)	7 February 2007
TRUenergy	2 February 2007

APPENDIX 4 WEIGHTED AVERAGE COST OF CAPITAL (WACC)

The calculation of cost allowances for the long-run marginal cost of electricity, the retail margin and the customer acquisition cost allowance, require the use of a discount rate as an input assumption.

The weighted average cost of capital (WACC) for a business is typically used as the discount rate. The WACC for a business is the expected cost of the various classes of capital (such as debt and equity), weighted to take into account the proportion of its total capital that each class represents.

Typically the Tribunal has considered an appropriate WACC for network businesses such as electricity and gas networks, rail networks or metropolitan and bulk water delivery. However, this review is for a retail function which arguably is more risky.

There are a number of input parameters to consider in determining an appropriate WACC range. **Interest rates, inflation and debt margin** are dependent on current market rates. The **market risk premium, tax rate and dividend imputation factor** do not vary with the nature of the business. However, the **equity beta, capital structure and debt margin** vary with the nature of the business.

The Tribunal recognises that the appropriate rate of return for an electricity retail business would not necessarily be the same as that for any other business for which the Tribunal has determined a rate of return.

In its draft report, Frontier Economics adopted a pre-tax real WACC of 8.1 per cent. Following the release of the draft report, the Tribunal updated the parameters to reflect current market rates (interest rates, inflation and debt margin).¹⁰¹ As Table A4.1 depicts, the resulting real pre tax rate of return range is 7.3 to 9.9 per cent with a mid point of 8.6 per cent. The Tribunal requested Frontier Economics to use the resulting pre-tax real WACC of 8.6 per cent in its long-run marginal cost, retail margin and customer acquisition cost allowance calculations.

¹⁰¹ The methodology used to calculate interest rates, inflation and the debt margin is consistent with the Tribunal's approach in its most recent WACC decision. See IPART, *Bulk Water Prices for State Water Corporation and Water Administration Ministerial Corporation from 1 October 2006 to 30 June 2010 - Final Report*, September 2006.

The parameters that underlie the WACC of 8.6 per cent are set out in Table A4.1 below.

Table A4.1 Rate of return range and parameters

Parameters	
Nominal risk free rate	5.9%
Real risk free rate	2.8%
Inflation	3.0%
Market risk premium	5.5 - 6.5%
Debt margin	1.1 – 1.4%
Debt to total assets (capital structure)	30-40%
Dividend imputation factor (gamma)	0.5 - 0.3
Tax rate	30%
Asset beta	0.6 – 0.8
Equity beta	0.80 – 1.2
Cost of equity (nominal post tax)	10.3 – 13.7%
Cost of debt (nominal pre-tax)	6.9 - 7.2%
WACC range (real pre-tax)	7.3 – 9.9%
WACC (real pre-tax) mid-point	8.6%

Parameters as at 5 February 2007.

The Tribunal notes that the range for the debt to total assets ratio is 30 - 40 per cent. The Tribunal considers it appropriate to adopt a lower level of notional gearing for a retail business than its usual assumption for a network business (60 per cent), as an electricity retailer is likely to have more fluctuating cashflows and higher operational risk and therefore may support less debt funding.

The range for the asset beta of 0.6 – 0.8 was based on its analysis of comparable firms both in Australia, the United Kingdom and in the United States and the WACC parameters adopted by ESCOSA in its recent retail determination.

The Tribunal notes that the market risk premium, tax rate and the dividend imputation factor parameters set out in Table A4.1 are consistent with its most recent WACC decision.¹⁰²

The Tribunal asked Frontier Economics to provide analysis on the sensitivity of the long-run marginal cost calculation to a change in the WACC. As indicated in Frontier Economics' report, a 1 percentage point change in the WACC produces a variation in the long-run marginal cost of about 6.5 per cent or \$2.50 to \$3.50 per MWh.¹⁰³

¹⁰² See IPART, *Bulk Water Prices for State Water Corporation and Water Administration Ministerial Corporation from 1 October 2006 to 30 June 2010 - Final Report*, September 2006.

¹⁰³ Frontier Economics, *Energy costs*, Final Report, March 2007, p 16.

The Tribunal also asked Frontier Economics to provide analysis on the sensitivity of the retail margin to a change in the WACC. In its report, Frontier Economics notes that changing the WACC can have a number of different effects depending on whether the value of the business and consequently the estimated value per customer are held constant.¹⁰⁴ As such the Tribunal notes that the net effect of changing the WACC on the retail margin is uncertain. In its draft report, Frontier Economics' expected returns approach provided an EBITDA margin of 4.4 – 6.4 per cent using a WACC of 8.1 per cent. As indicated in Frontier Economics' final report, increasing the WACC to 8.6 per cent, and adjusting other inputs to the expected returns approach to reflect updated results for energy costs and retail costs, resulted in the EBITDA margin being 4.3 – 6.4 per cent.¹⁰⁵

In its report, Frontier Economics notes that changing the WACC has an impact on the customer acquisition cost allowance. As indicated in Frontier Economics' report, a 1 per cent increase in the WACC will lead to a \$1 increase in the customer acquisition cost allowance, while a 1 per cent decrease in the WACC will lead to a \$1 decrease in the customer acquisition cost allowance.¹⁰⁶

Having had regard to Frontier Economics' analysis, its own research, and the sensitivity analysis, the Tribunal concluded that it is appropriate to use in its draft report and determination a real pre tax rate of return of 8.6 per cent as a discount rate in calculating cost allowances for long-run marginal cost, the retail margin and customer acquisition costs.

Before finalising its report and determination the Tribunal will ask Frontier Economics to update its forecasts of cost allowances for long-run marginal cost, the retail margin and the customer acquisition cost allowance to account for movements in the current market conditions for interest rates, inflation and the debt margin.

¹⁰⁴ Frontier Economics, *Mass market new entrant retail costs and retail margin*, Final Report, March 2007, p 62.

¹⁰⁵ Frontier Economics, *Mass market new entrant retail costs and retail margin*, Final Report, March 2007, p 68.

¹⁰⁶ Frontier Economics, *Mass market new entrant retail costs and retail margin*, Final Report, March 2007, p 19.

Draft Determination No 1, 2007

NSW Electricity Regulated Retail Tariffs and Charges 2007 to 2010

**Independent Pricing and Regulatory Tribunal
of New South Wales**

Reference No: 06/40

Part 1

Preliminary

1. Background

- (1) The *Tribunal* received a referral from the *Minister* dated 30 June 2006 under section 43EA of the *ESA* to investigate and report on the determination of *regulated retail tariffs* and *regulated retail charges* to apply to *small retail customers* in each *standard retail supplier's supply district* in New South Wales for the period from 1 July 2007 to 30 June 2010.
- (2) In its investigation the *Tribunal* consulted with *standard retail suppliers*, undertook a public consultation and received information and submissions from the *standard retail suppliers*, *second-tier retail suppliers* and other interested parties in accordance with section 43EE of the *ESA*.
- (3) This determination is made under section 43EB of the *ESA*, pursuant to the *Minister's referral*. The *Tribunal's* report on its investigation accompanies this determination.
- (4) Under section 34 of the *ESA*, all *small retail customers* who own or occupy *premises* that are within a *standard retail supplier's supply district*, and that are connected or have a right to be connected to a *distribution system*, have a right to elect to be *supplied* with electricity at those *premises* by the *standard retail supplier* under a *standard form customer supply contract*.
- (5) Under section 36 of the *ESA*, it is a condition of a licence held by a *standard retail supplier* that the *standard retail supplier*, in imposing tariffs and charges for or in relation to the *supply* of electricity under a *standard form customer supply contract*, must impose them in accordance with this determination.

2. Application of this determination

- (1) This determination commences on the date of its publication in the *Gazette* by the *Minister*.
- (2) This determination applies to all *standard retail suppliers*, namely:
 - (a) EnergyAustralia
 - (b) Integral Energy Australia
 - (c) Country Energy.
- (3) This determination specifies the methodology for determining the *regulated retail tariffs* and *regulated retail charges* that *standard retail suppliers* can charge *small retail customers*:
 - (a) whose *premises* are in the *standard retail supplier's supply district*; and

- (b) who are *supplied* electricity at those *premises* by the *standard retail supplier* under a *standard form customer supply contract*,

during the period from 1 July 2007 to 30 June 2010.

3. Replacement of Determination No. 1 of 2004

- (1) From 1 July 2007, this determination replaces the *Tribunal's previous retail determination*.
- (2) The replacement does not affect anything done or omitted to be done, or rights or obligations accrued, under that determination prior to its replacement.

4. Structure

- (1) Part 2 specifies the methodology for determining *regulated retail tariffs* to apply during the *period of this determination*.
- (2) Part 3 specifies the procedures for determining compliance with Part 2.
- (3) Part 4 specifies the maximum *regulated retail charges* to apply during the *period of this determination* and the manner in which such charges may be imposed.

5. Definitions and interpretation

Italicised words and phrases are defined in Part 5. Interpretation provisions are also set out in that Part.

Part 2

Regulated Retail Tariffs

6. Application

This Part specifies the methodology for determining *regulated retail tariffs* to apply during the *period of this determination*.

7. Weighted average price cap

7.1 Weighted average price cap formula

A *standard retail supplier* must ensure that, for each *year of this determination*, all of its *regulated retail tariffs* comply with the following weighted average price cap formula:

$$\sum_{i=1}^n \sum_{j=1}^m P_{ij}^t . q_{ij}^{t-1} \leq \sum_{i=1}^n \sum_{j=1}^m C_{ij}^t . q_{ij}^{t-1} + PT^t \quad i=1,2,\dots,n \text{ and } j=1,2,\dots,m$$

Where:

the *standard retail supplier* has *n* *regulated retail tariffs* which each have up to *m* *components*

P_{ij}^t is the proposed price to be charged by the *standard retail supplier* for *component j* of *regulated retail tariff i* in *year t* (exclusive of any rebates offered to the *customer* and funded by the *standard retail supplier*)

q_{ij}^{t-1} is the quantity of *component j* of *regulated retail tariff i* in *year t-1* (being the *year* immediately preceding *year t*), calculated as follows:

(a) where quantity relates to electricity consumption or demand, this is equal to the consumption or demand for *year t-1* estimated by the *standard retail supplier* (in MWh or other relevant units) and approved by the *Tribunal* under clause 14.4

(b) where quantity relates to number of *customers*, this is equal to the actual number of *customers* of that *standard retail supplier* on 31 December in *year t-1*

C_{ij}^t is the value set by the *Tribunal* for *component j* of *regulated retail tariff i* in relation to *year t* in accordance with clause 7.2

PT^t is the *annual pass through amount* allowed or required by the *Tribunal* for *year t* in accordance with clause 15.

An illustrated example of the application of the formula is set out in the report accompanying this determination.

7.2 Value of C: regulated price control (N+R)

For the purpose of clause 7.1, C_{ij}^t is calculated as follows:

$$C_{ij}^t = N_{ij}^t + R_{ij}^t$$

Where:

N_{ij}^t is the actual *network use of system charge* plus any *demand management levy* payable by the *standard retail supplier* to the DNSP for component *j* of regulated retail tariff *i* in the year *t*

R_{ij}^t is the retail value set by the *Tribunal*, comprising:

- (i) for each *customer* of the *standard retail supplier*, the relevant amount for each *standard retail supplier* set out in clause 7.3 ($FixedR_c^t$); and
- (ii) for component *j* of regulated retail tariff *i* in the year *t*, the relevant amount for each *standard retail supplier* set out in clause 7.4 ($VariableR_{ij}^t$).

For the purpose of (i), each *customer* is counted only once, even if more than one *regulated retail tariff* applies to that *customer* (such as a *primary tariff* and a *controlled load tariff*) or any of those *regulated retail tariffs* has more than one *component*.

7.3 Value of Fixed R

For the purpose of clause 7.2(i), $FixedR_c^t$ for each *standard retail supplier* is calculated as follows:

- (a) for the 2007/08 year:

$FixedR_c^{2007/8}$ is the relevant amount for 2007/08 set out in the following table

- (b) for the 2008/09 year:

$FixedR_c^{2008/9}$ is the relevant amount for 2008/09 set out in the following table x $(1 + \Delta CPI_{07})$

- (c) for the 2009/10 year:

$FixedR_c^{2009/10}$ is the relevant amount for 2009/10 set out in the following table x $(1 + \Delta CPI_{07}) \times (1 + \Delta CPI_{08})$

Fixed R (\$ per customer per year, exclusive of GST)

Year	Fixed R
2007/08	73.03
2008/09	82.75
2009/10	93.76

7.4 Value of Variable R

For the purpose of clause 7.2(ii), $VariableR_{ij}^t$ is calculated as follows:

(a) for the 2007/08 year:

$VariableR_{ij}^{2007/8}$ is the relevant amount for each *standard retail supplier* for 2007/08 set out in the relevant table below

(b) for the 2008/09 year:

$VariableR_{ij}^{2008/9}$ is the relevant amount for each *standard retail supplier* for 2008/09 set out in the relevant table below $\times (1 + \Delta CPI_{07})$

(c) for the 2009/10 year:

$VariableR_{ij}^{2009/10}$ is the relevant amount for each *standard retail supplier* for 2009/10 set out in the relevant table below $\times (1 + \Delta CPI_{07}) \times (1 + \Delta CPI_{08})$

Variable R (c/kWh, exclusive of GST): EnergyAustralia

Year	standard	peak	shoulder	off-peak/ controlled load A	controlled load B
2007/08	6.91	8.07	6.60	4.34	5.54
2008/09	7.23	9.86	6.59	4.45	5.78
2009/10	7.56	12.04	6.57	4.56	6.04

Variable R (c/kWh, exclusive of GST): Integral Energy Australia

Year	standard	peak	shoulder	off-peak/ controlled load A	controlled load B
2007/08	7.29	8.58	6.85	4.51	5.58
2008/09	7.71	10.66	6.80	4.70	5.92
2009/10	8.15	13.26	6.76	4.90	6.29

Variable R (c/kWh, exclusive of GST): Country Energy

Year	standard	peak	shoulder	off-peak/ controlled load A	controlled load B
2007/08	7.53	7.97	8.16	4.52	6.00
2008/09	7.59	8.49	8.92	4.58	6.22
2009/10	7.65	9.05	9.74	4.65	6.46

For the purposes of the above tables:

standard rates apply, where a *customer* is not on a *time of use tariff* or a *controlled load tariff*, to all of that *customer's* electricity consumption

peak rates apply, where a *customer* is on a *time of use tariff*, to that *customer's* electricity consumption during *peak periods*

shoulder rates apply, where a *customer* is on a *time of use tariff*, to that *customer's* electricity consumption during *shoulder periods*

off-peak rates apply, where a *customer* is on a *time of use tariff*, to that *customer's* electricity consumption during *off-peak periods*

controlled load A rates apply in respect of a *customer's* *controlled load* where that load is active only during *off-peak periods*

controlled load B rates apply in respect of a *customer's* *controlled load* where that load is active both during *off-peak periods* and at times other than *off-peak periods*.

8. Threshold for price increases (Country Energy)

8.1 Threshold

Subject to clause 8.2, Country Energy must ensure that, for each *year of this determination*, each of its *regulated retail tariffs* complies with the following formula:

$$\frac{\sum_{j=1}^m P_{ij}^t \cdot q_{ij}^{t-1}}{\sum_{j=1}^m P_{ij}^{t-1} \cdot q_{ij}^{t-1}} \leq \frac{\sum_{i=1}^n \sum_{j=1}^m C_{ij}^t \cdot q_{ij}^{t-1} + PT^{t-1}}{\sum_{i=1}^n \sum_{j=1}^m C_{ij}^{t-1} \cdot q_{ij}^{t-1} + PT^{t-1}} + 0.05 \quad i=1,2,\dots,n \text{ and } j=1,2,\dots,m$$

Where:

Country Energy has *n* regulated retail tariffs which each have up to *m* components

P_{ij}^t , q_{ij}^{t-1} , C_{ij}^t and PT^{t-1} have the meanings given to those terms in clause 7

P_{ij}^{t-1} is the price charged by the standard retail supplier for component *j* of regulated retail tariff *i* in year *t-1*

C_{ij}^{t-1} is the value set by the Tribunal for component *j* of regulated retail tariff *i* in relation to year *t-1* in accordance with:

- (a) the Tribunal's previous retail determination (where the year *t* is the 2007/08 year); and
- (b) clause 7.2 (where the year *t* is any other year of this determination)

PT^{t-1} is the annual pass through amount allowed or required by the Tribunal for year *t-1* in accordance with clause 15 (which, where the year *t* is the 2007/08 year, is zero).

An illustrated example of the application of the formula is set out in the report accompanying this determination.

8.2 Justified non-compliance

Country Energy need not comply with clause 8.1 with respect to any particular regulated retail tariff if the Tribunal has notified Country Energy in writing that it is satisfied that the proposed increase in that regulated retail tariff would increase cost-reflectivity.

8.3 Price changes

- (a) A standard retail supplier may only change the price for any regulated retail tariff or regulated retail tariff component for any year of this determination:
 - (i) with effect from 1 July of that year (or from any other date in that year determined by the Tribunal); and
 - (ii) if the Tribunal has notified the standard retail supplier in writing that it is satisfied that the proposed price changes comply with this determination.
- (b) Clause 8.3(a) applies even where a pass through event occurs.

9. Introducing new tariffs

- (a) A *standard retail supplier* may only introduce a *new regulated retail tariff* for any year of this determination:
 - (i) with effect from 1 July of that *year* (or from any other date in that *year* determined by the *Tribunal*); and
 - (ii) if the *Tribunal* has notified the *standard retail supplier* in writing that the *Tribunal* is satisfied that:
 - (A) exceptional circumstances exist which warrant the introduction of the *new regulated retail tariff*; and
 - (B) the *standard retail supplier* complies with this determination.
- (b) Nothing in this clause 9 prevents a *standard retail supplier* from introducing a *new regulated retail tariff component* to form part of an existing *regulated retail tariff*.

10. Abolition of tariffs

10.1 Abolishing obsolete tariffs

- (a) A *standard retail supplier* may cause any of its *regulated retail tariffs* to become *obsolete* at any time during the *period of this determination*.
- (b) A *standard retail supplier* may only abolish a *regulated retail tariff*:
 - (i) with effect from 1 July of any *year of this determination* (or from any other date in that *year* determined by the *Tribunal*);
 - (ii) if the *regulated retail tariff* is *obsolete*; and
 - (iii) if the *Tribunal* has notified the *standard retail supplier* in writing that the *Tribunal* is satisfied that the *standard retail supplier* complies with this determination.
- (c) Nothing in this clause 10.1 prevents a *standard retail supplier* from removing a *regulated retail tariff component* from an existing *regulated retail tariff*.

10.2 Additional conditions for Country Energy

Country Energy must ensure that:

- (a) if it abolishes a *regulated retail tariff*; and
- (b) as a result a *customer* is transferred from the abolished *regulated retail tariff* to another *regulated retail tariff*,

then either:

- (c) the price applying to the two *regulated retail tariffs* (including level and structure) is the same; or
- (d) the *Tribunal* has notified Country Energy in writing that it is satisfied that the proposed abolition and consequent customer transfers are appropriate (having regard to the information submitted by Country Energy under clause 14.3(d)(iv)).

11. Green premiums

Nothing in this determination affects the ability of a *standard retail supplier* to charge a *customer* for *green premiums*, in addition to *regulated retail tariffs*, where the *customer* so elects.

12. Pass through of other network charges

Nothing in this determination prevents a *standard retail supplier* from passing through to a *customer* any network charges other than *network use of system charges* charged by the *customer's DNSP* that are specific to that *customer* (for example, meter test fees), if the *standard retail supplier* would otherwise be entitled to do so. However, the *standard retail supplier* may not charge any additional fees in respect of the pass through of these charges (for example, for administration).

Part 3

Compliance

13. Application

This Part specifies the procedures for determining compliance with Part 2.

14. Annual pricing proposal

14.1 Timetable

Set out below is the timetable referred to in this clause 14.

Action	Due Date
1 <i>Standard retail suppliers to submit to the Tribunal details of any pass through event</i>	1 March of the year <i>t-1</i> <i>(or other date set by the Tribunal)</i>
2 <i>Standard retail suppliers to submit to the Tribunal their annual pricing proposal (for the year t)</i>	1 June of the year <i>t-1</i> <i>(or other date set by the Tribunal)</i>
3 <i>Tribunal to notify standard retail suppliers whether satisfied/not satisfied with annual pricing proposal</i>	10 business days after submission by <i>standard retail suppliers of annual pricing proposal</i> <i>(or other date set by the Tribunal)</i>
4 <i>Final date for standard retail suppliers to submit to the Tribunal an alternative annual pricing proposal (for the year t)</i>	20 June of the year <i>t-1</i> <i>(or other date set by the Tribunal)</i>
5 <i>Final date for Tribunal to notify whether satisfied/not satisfied with alternative annual pricing proposal</i>	26 June of the year <i>t-1</i> <i>(or other date set by the Tribunal)</i>
6 <i>Commencement of retail price changes</i>	1 July of the year <i>t</i> <i>(or other date set by the Tribunal)</i>

14.2 Submission and assessment

- (a) For prices to apply during each *year of this determination* (the *year t* for the purposes of this clause 14.20) each *standard retail supplier* must submit to the *Tribunal* an *annual pricing proposal* for that *year*, containing the information in clause 14.3.
- (b) The *annual pricing proposal* must be submitted to the *Tribunal* by no later than:
 - (i) 18 June 2007 (for the 2007/08 *year*); and
 - (ii) the date specified in item 2 of the timetable in clause 14.1 (for any other *year*).

14.3 Contents

The *annual pricing proposal* submitted by a *standard retail supplier* under clause 14.2(a) for each *year of this determination* must contain the following information:

- (a) the *standard retail supplier's* application of the weighted average price cap formula set out in clause 7.1 to all of its *regulated retail tariffs*, together with all necessary supporting calculations and information including:
 - (i) the proposed prices to be charged by the *standard retail supplier* for each of the *standard retail supplier's regulated retail tariff components* in the *year t*;
 - (ii) estimated quantities of each of the *standard retail supplier's regulated retail tariff components* supplied by the *standard retail supplier* in the *year t-1* and the basis for those estimates; and
 - (iii) details of how the proposed prices incorporate any *annual pass through amount* allowed or required by the *Tribunal* under clause 15;
- (b) if the *standard retail supplier* proposes to introduce a new *regulated retail tariff*:
 - (i) details of the proposed *new regulated retail tariff*; and
 - (ii) why the *standard retail supplier* considers that:
 - (A) exceptional circumstances exist; and
 - (B) those circumstances warrant the introduction of the proposed *new regulated retail tariff*;
- (c) details of any *regulated retail tariffs* that:
 - (i) have become *obsolete* in the *year t-1*;
 - (ii) the *standard retail supplier* proposes to make *obsolete* in the *year t*; and
 - (iii) the *standard retail supplier* proposes to abolish in the *year t*;

- (d) for Country Energy:
 - (i) Country Energy's application of the threshold for price increases set out in clause 8 to each of its *regulated retail tariffs* proposed for the *year t* (together with all necessary supporting calculations and information);
 - (ii) a list of those proposed *regulated retail tariffs* (if any) that would exceed this threshold, and by how much;
 - (iii) for those *regulated retail tariffs*, an explanation of why Country Energy considers that the price increases proposed would increase cost-reflectivity; and
 - (iv) for those *regulated retail tariffs* that Country Energy proposes to abolish which would result in a *customer* being transferred from that *regulated retail tariff* to another *regulated retail tariff*, an explanation of whether the price applying to the two *regulated retail tariffs* (including level and structure) is the same, or if not, why Country Energy considers that the abolition and transfer is nonetheless appropriate;
- (e) the amounts of the relevant average *electricity retail bills* (as referred to in clause 20.2(b)); and
- (f) any other information required by the *Tribunal* to satisfy itself that the *standard retail supplier's annual pricing proposal* complies with this determination.

14.4 Notification of whether or not the Tribunal is satisfied

By the date specified in item 3 of the timetable in clause 14.1 (or before 1 July 2007, for the 2007/08 year), the *Tribunal* will notify the *standard retail supplier* whether or not the *Tribunal* is satisfied:

- (a) that the *annual pricing proposal* complies with the requirements of clause 14.3;
- (b) with the *standard retail supplier's* estimates of quantities; and
- (c) that the *regulated retail tariffs* set out in those documents comply with all applicable requirements of this determination, including where relevant:
 - (i) the weighted average price cap formula under clause 7.1;
 - (ii) the restriction on introducing new *regulated retail tariffs* under clause 9, except to the extent approved by the *Tribunal*;
 - (iii) the threshold for price increases for Country Energy under clause 8.1, except to the extent of any non-compliance approved by the *Tribunal*; and
 - (iv) the additional conditions for Country Energy under clause 10.2.

14.5 If the Tribunal is satisfied

- (a) If the *Tribunal* notifies the *standard retail supplier* that it is satisfied about each of the matters referred to in clause 14.4, then the *regulated retail tariff* prices set out in the *annual pricing proposal* will be the applicable prices for those *regulated retail tariffs* for the year to which the *annual pricing proposal* relates.
- (b) A *standard retail supplier* must comply with any relevant regulatory requirements in relation to the publication of changes to its *regulated retail tariff* prices (for example, under clause 21 of the *Electricity Supply (General) Regulation 2001 (NSW)*).

14.6 If the Tribunal is not satisfied: alternative pricing proposal

- (a) If the *Tribunal* notifies the *standard retail supplier* that it is not satisfied about any of the matters referred to in clause 14.3, the *standard retail supplier* must submit to the *Tribunal* an alternative *annual pricing proposal* by the date specified in item 4 of the timetable in clause 14.1.
- (b) If the *standard retail supplier* has submitted an alternative *annual pricing proposal* under clause 14.6(a), the *Tribunal* will notify the *standard retail supplier* whether or not the *Tribunal* is satisfied about each of the matters referred to in clause 14.4 in respect of the *standard retail supplier's* alternative *annual pricing proposal*, by the date specified in item 5 of the timetable in clause 14.1.
- (c) If the *Tribunal* notifies the *standard retail supplier* that it is so satisfied, then clause 14.5 will apply in respect of the *standard retail supplier's* alternative *annual pricing proposal*.
- (d) If the *Tribunal* notifies the *standard retail supplier* that it is not so satisfied, then the default arrangements in clause 14.7 apply.

14.7 Default arrangements

- (a) Subject to clause 14.7(b), if for any year of this determination (year *t*, for the purposes of this clause 14.7) the *Tribunal* has not received from a *standard retail supplier* a compliant *annual pricing proposal* for that year by:
 - (i) 1 July 2007 (where that year *t* is the first year of this determination); or
 - (ii) the date specified in item 4 of the timetable in clause 14.1 (for any other year of this determination),

then the *standard retail supplier's* prices for that year *t* will be the same as those for the immediately preceding year *t-1*.

- (b) If clause 14.7(a) applies to a *standard retail supplier* for any year of this determination, then the *Tribunal* may allow (on a date set by the *Tribunal*) the *standard retail supplier* to change its *regulated retail tariff* prices during that year so as to reflect the *regulated retail tariff* prices set out in any compliant *annual pricing proposal* subsequently submitted by the *standard retail supplier*.

14.8 Submission of information separate from annual pricing proposal

If, for the purposes of clauses 8.3, 9 or 10 the *Tribunal* determines a date other than 1 July for price changes, introduction of *new regulated retail tariffs* or abolition of *regulated retail tariffs*, the *Tribunal* may require a *standard retail supplier* to submit any of the information referred to in clause 14.3 separately from an *annual pricing proposal*.

15. Cost pass throughs

15.1 Materiality threshold

For the purposes of this clause 15:

- (a) *positive change event*, for a *standard retail supplier*, means a *pass through event* which entails the *standard retail supplier* incurring *materially* higher costs in providing *pass through services* than it would have incurred but for that event;
- (b) *negative change event*, for a *standard retail supplier*, means a *pass through event* which entails the *standard retail supplier* incurring *materially* lower costs in providing *pass through services* than it would have incurred but for that event; and
- (c) *materially*:
 - (i) an event that occurs in a *year of this determination* results in a *standard retail supplier* incurring *materially* higher costs if the *standard retail supplier's* efficient, incremental and justified costs incurred or likely to be incurred in that *year* in respect of that event (as conclusively evidenced by the *Tribunal's* determination of an *annual positive pass through amount* for that *year*) exceed 0.25% of the *standard retail supplier's* revenue from the previous *year*;
 - (ii) an event that occurs in a *year of this determination* results in a *standard retail supplier* incurring *materially* lower costs if the *standard retail supplier's* costs saved or likely to be saved in that *year* (after taking all reasonable steps to maximise those cost savings) in respect of that event (as conclusively evidenced by the *Tribunal's* determination of an *annual negative pass through amount* for that *year*) exceed 0.25% of the *standard retail supplier's* revenue from the previous *year*.

15.2 Pass through event

- (a) If a *standard retail supplier* reasonably considers that a *positive change event* for that *standard retail supplier* has occurred, the *standard retail supplier* may seek the *Tribunal's* approval to pass through to *customers* an amount in respect of that *positive change event*.
- (b) If a *standard retail supplier* or the *Tribunal* reasonably considers that a *negative change event* for that *standard retail supplier* has occurred, the *Tribunal* may require the *standard retail supplier* to pass through to *customers* an amount in respect of that *negative change event*.

- (c) If a *standard retail supplier* wishes to pass through an amount to *customers* in the year *t* in respect of a *positive change event*, the *standard retail supplier* must give notice to the *Tribunal* by the date specified in item 1 of the timetable in clause 14.1.
- (d) A *standard retail supplier* must give the *Tribunal* notice of a *negative change event* by the date specified in item 1 of the timetable in clause 14.1, where the *standard retail supplier*:
 - (i) becomes aware before that date that the *negative change event* has occurred; and
 - (ii) has not previously notified the *Tribunal* of that *negative change event*.
- (e) The notices under clauses 15.2(c) and (d) must contain the information required under clauses 15.3 and 15.4.

15.3 Positive change event

- (a) The *standard retail supplier's* notice under clause 15.2(c) must be in writing and must specify:
 - (i) the details of the *positive change event*;
 - (ii) the date the *positive change event* occurred;
 - (iii) the increase in costs in the provision of *pass through services* that the *standard retail supplier* has incurred since 1 July 2007 and is likely to incur during the *period of this determination* as a result of the *positive change event*, including supporting documentation demonstrating that the cost increase is efficient, incremental and justified;
 - (iv) the total amount that the *standard retail supplier* proposes to pass through to *customers*; and
 - (v) the amount that the *standard retail supplier* proposes to pass through to *customers* in each year of this determination.
- (b) If the *Tribunal* receives a statement under clause 15.3(a) in relation to a *positive change event*:
 - (i) the *Tribunal* will determine whether that *positive change event* occurred; and
 - (ii) if the *Tribunal* determines that the *positive change event* occurred, the *Tribunal*, taking into account the matters referred to in clause 15.5, will determine:
 - (A) the amount which should be passed through to *customers* (the *total positive pass through amount* in respect of that *positive change event* for the *standard retail supplier*); and

- (B) the amount of that *total positive pass through amount* that should be passed through to *customers* in each *year of this determination* (each an *annual positive pass through amount* in respect of the relevant *year*).
- (c) The *Tribunal* may, if it so chooses, determine the *annual positive pass through amount* one *year* at a time, and may delay any decision regarding the *total positive pass through amount* for one or more *years*.
- (d) A *standard retail supplier* must provide the *Tribunal* with such information as the *Tribunal* requires for the purpose of making a determination under clause 15.3(b) within the time specified by the *Tribunal* in a notice provided to the *standard retail supplier* for that purpose.

15.4 Negative change event

- (a) The *standard retail supplier's* notice under clause 15.2(d) must be in writing and must specify:
 - (i) the details of the *negative change event*;
 - (ii) the date the *negative change event* occurred;
 - (iii) the costs in the provision of *pass through services* that the *standard retail supplier* has saved since 1 July 2007 and is likely to save during the *period of this determination* as a result of the *negative change event*, including supporting documentation demonstrating that all reasonable steps have been taken to maximise the cost savings;
 - (iv) the total amount of those saved costs that the *standard retail supplier* proposes should be passed through to *customers*; and
 - (v) the amount of those saved costs that the *standard retail supplier* proposes should be passed through to *customers* in each *year of this determination*.
- (b) If a *negative change event* for a *standard retail supplier* occurs (whether or not the *standard retail supplier* notifies the *Tribunal* of the occurrence of that *negative change event*) and the *Tribunal* determines to impose a requirement on the *standard retail supplier* in relation to that *negative change event* as described in clause 15.2(b), the *Tribunal* will determine:
 - (i) the required *pass through amount* in respect of that *negative change event* for the *standard retail supplier*; and
 - (ii) taking into account the matters referred to in clause 15.5:
 - (A) the amount which should be passed through to *customers* (the *total negative pass through amount* in respect of that *negative change event* for the *standard retail supplier*); and
 - (B) the amount of that *total negative pass through amount* that should be passed through to *customers* in each *year of this determination*

(each an *annual negative pass through amount* in respect of the relevant year).

- (c) The *Tribunal* may, if it so chooses, determine the *annual negative pass through amount* one year at a time, and may delay any decision regarding the *total negative pass through amount* for one or more years.
- (d) A *standard retail supplier* must provide the *Tribunal* with such information as the *Tribunal* requires for the purpose of making a determination under clause 15.4(b) within the time specified by the *Tribunal* in a notice provided to the *standard retail supplier* for that purpose.

15.5 Consultation and factors to be taken into account in determination

- (a) Prior to making a determination under clause 15.3(b) or 15.4(b), the *Tribunal* will consult on such matters arising out of the relevant *pass through event* as the *Tribunal* considers appropriate with the relevant *standard retail suppliers* and such other persons as the *Tribunal* considers appropriate.
- (b) In making a determination under clause 15.3(b) or 15.4(b), the *Tribunal* will take into account:
 - (i) the matters and proposals set out in any statement given to the *Tribunal* by the relevant *standard retail supplier* under clause 15.3(a) or 15.4(a);
 - (ii) in the case of a *positive change event*, the increase in costs in the provision of *pass through services* that the *standard retail supplier* has incurred since 1 July 2007 and is likely to incur until the end of the *period of this determination* as a result of the *positive change event*;
 - (iii) the implications for efficient costs of the *standard retail supplier's* decisions and actions, including whether:
 - (A) in the case of a *positive change event*, the *standard retail supplier* has taken or omitted to take any action where such action or omission has increased the magnitude of the costs incurred in respect of that *positive change event*;
 - (B) in the case of a *negative change event*, the *standard retail supplier* has taken all reasonable steps to maximise the cost savings in respect of that *negative change event*;
 - (iv) the time cost of money based on the rate of return on capital of the *standard retail supplier* (being 8.6% real pre-tax weighted average cost of capital);
 - (v) the need to ensure that the *standard retail supplier* does not recover costs under this clause 15 to the extent provision for such costs has already been made or otherwise taken into account for the purposes of this determination;

- (vi) the need to ensure that the *standard retail supplier* only recovers any actual or likely increment in efficient costs under this clause 15 to the extent that such increment is solely as a consequence of a *pass through event*;
- (vii) in the case of a *regulatory change event* that is a *positive change event*, any costs that the *standard retail supplier* has incurred prior to, but in preparation for, the occurrence of that *regulatory change event*;
- (viii) in the case of a *tax change event*, any change in the way another tax is calculated, or the removal or imposition of another tax, which, in the *Tribunal's* opinion, is complementary to the *tax change event* concerned;
- (ix) any delay on the part of the *standard retail supplier* in seeking the *Tribunal's* approval to pass through to *customers* an amount in respect of any *positive change event*; and
- (x) any other factors the *Tribunal* considers relevant.

Part 4

Regulated Retail Charges

16. Application

- (a) This Part specifies:
- (i) the maximum *regulated retail charges* to apply during the *period of this determination*; and
 - (ii) the manner in which such charges may be imposed.
- (b) A *standard retail supplier* may not impose on or require from a *customer* a security deposit, late payment fee or fee for a dishonoured cheque (whether or not described in those terms) except as permitted by this Part.

17. Maximum regulated retail charges

Set out below is the Table referred to in this Part.

Table

Maximum regulated retail charges (exclusive of GST)

Item	Regulated retail charge	Maximum amount
1	Fee for a dishonoured cheque	2 times the regular GST-exclusive fee charged by the bank or other financial institution to which the cheque is presented.
2	Late payment fee	\$7.00
3	Security deposit	<ul style="list-style-type: none">For <i>customers</i> whose <i>electricity retail bills</i> are issued quarterly, 1.5 times the <i>standard retail supplier's</i> average quarterly <i>electricity retail bill</i>; orFor <i>customers</i> whose <i>electricity retail bills</i> are issued 2-monthly, 1.75 times the <i>standard retail supplier's</i> average 2-monthly <i>electricity retail bill</i>; orFor <i>customers</i> whose <i>electricity retail bills</i> are issued monthly, 2.5 times the <i>standard retail supplier's</i> average monthly <i>electricity retail bill</i>, where the relevant amounts are the GST-exclusive amounts of those bills.

18. Fee for a dishonoured cheque

- (a) The maximum that a *standard retail supplier* may charge a *customer* for a dishonoured cheque is the corresponding amount listed in item 1 of the Table.
- (b) A *standard retail supplier* may only impose such a charge if the *standard retail supplier* actually incurs a bank or other financial institution fee for that dishonoured cheque.

19. Late payment fee

19.1 Maximum amount of a late payment fee

The maximum late payment fee that a *standard retail supplier* may charge a *customer* for late payment of an *electricity retail bill* is the corresponding amount listed in item 2 of the Table.

19.2 Imposing a late payment fee

- (a) A maximum of one late payment fee may be levied on each *electricity retail bill*.
- (b) A late payment fee may only be levied:
 - (i) on or after the date which is at least 5 *business days* after the due date shown on the *electricity retail bill* that is the subject of the late payment; and
 - (ii) after the *customer* has been notified in advance that the late payment fee will be charged if the bill is not paid, or alternative payment arrangements entered into, within 5 *business days* of the due date.
- (c) A late payment fee must not be levied in relation to an *electricity retail bill*:
 - (i) during the period of an extension of time within which the *customer* may pay the *electricity retail bill*, agreed between the *standard retail supplier* and the *customer*; or
 - (ii) where a *customer* has made a billing related complaint in relation to the *electricity retail bill* to the *Ombudsman* or another external dispute resolution body where that complaint is unresolved; or
 - (iii) during the period of an instalment arrangement entered into between a *customer* and the *standard retail supplier* to pay the *electricity retail bill*.

19.3 Waiver of late payment fee

A late payment fee must be waived:

- (a) where the *customer* has contacted a welfare agency or support service for assistance; or
- (b) where payment or part payment is made by *EAPA voucher*; or

- (c) on a case by case basis as considered appropriate by the *Ombudsman*.

20. Security deposit

20.1 Types of security deposit

- (a) A *standard retail supplier* must accept the following types of security deposits:
 - (i) those methods of payment referred to in clause 30 of the *Electricity Supply (General) Regulation 2001*;
 - (ii) *annual security levies* from business customers only;
 - (iii) bankers' guarantees from business customers only; and
 - (iv) Department of Housing guarantees from residential customers only.
- (b) A *standard retail supplier* may not require a residential customer to provide an *annual security levy* or a banker's guarantee.

20.2 Maximum amount of a security deposit

- (a) The maximum security deposit that a *standard retail supplier* may require from a customer is the corresponding amount calculated in accordance with one of the methods shown in item 3 of the Table.
- (b) The amounts of the relevant average *electricity retail bills* will vary between *standard retail suppliers*, depending on average *regulated retail tariff* levels and average consumption. For the purpose of calculating the maximum amount of a security deposit in item 3 of the Table, the *standard retail supplier* must calculate the amounts of the relevant average *electricity retail bills* as part of the process of setting *regulated retail tariffs*, and post the amount of the required security deposits on its tariff schedule.

20.3 Requiring a security deposit

A *standard retail supplier* may only require a customer to provide a security deposit:

- (a) in the case of a residential customer, in the circumstances set out in clause 20.4;
- (b) in the case of a business customer, in the circumstances set out in clause 20.5.

20.4 Security deposits from residential customers

- (a) Prior to the commencement of *supply* under a *standard form customer supply contract* with a residential customer, a *standard retail supplier* may require a security deposit from that customer only if the customer:
 - (i) has an outstanding debt owed to the *standard retail supplier* in relation to an *electricity retail bill* and the customer has refused and refuses to make an arrangement to pay that debt; or
 - (ii) has been responsible for the illegal use of electricity within the previous two years; or

- (iii) does not have a satisfactory credit history in the reasonable opinion of the *standard retail supplier*, and the *standard retail supplier* has offered the *customer* a *payment plan* and the *customer* has refused or failed to agree to the offer.
- (b) After the commencement of *supply* under a *standard form customer supply contract* with a residential *customer*, a *standard retail supplier* may require a security deposit from that *customer* only if:
 - (i) the security deposit is sought within 12 months after the commencement of the *standard form customer supply contract*;
 - (ii) the *customer* entered into a *payment plan* with the *standard retail supplier* at the commencement of the *standard form customer supply contract*;
 - (iii) the *customer* has cancelled or defaulted on that *payment plan* but has not requested that the *standard retail supplier* cease supplying electricity to the *customer's supply address*; and
 - (iv) one or more of the circumstances in clause 20.4(a) (i) to (iii) exists.
- (c) Nothing in this clause prevents a *standard retail supplier* from requiring that a security deposit be topped up to its original level after the *standard retail supplier* has had recourse to it in accordance with clause 20.6.

20.5 Security deposits from business customers

- (a) Prior to the commencement of *supply* under a *standard form customer supply contract* with a business *customer*, a *standard retail supplier* may require a security deposit from that *customer* only if the *customer*:
 - (i) does not have a satisfactory credit history in the reasonable opinion of the *standard retail supplier*; or
 - (ii) is a new business; or
 - (iii) has been responsible for the illegal use of electricity within the previous two years.
- (b) After the commencement of *supply* under a *standard form customer supply contract* with a business *customer*, a *standard retail supplier* must not require a security deposit from that *customer*.
- (c) Nothing in this clause prevents a *standard retail supplier* from requiring that a security deposit be topped up to its original level after the *standard retail supplier* has had recourse to it in accordance with clause 20.6.

20.6 Recourse to a security deposit

A *standard retail supplier* may have recourse to a security deposit only to recover amounts due to the *standard retail supplier* in respect of charges related to the *supply* of electricity or connection services arranged by the *standard retail supplier*.

20.7 Return of security deposits

- (a) Subject to clause 20.9, a *customer* who is required to pay a security deposit and who pays in a form contemplated by clause 30 of the *Electricity Supply (General) Regulation 2001* (other than for an *annual security levy*) is eligible for that deposit to be refunded when the *customer* has completed:
 - (i) for residential *customers* - on time payment of all *electricity retail bills* for one year from the date of the first *electricity retail bill*; or
 - (ii) for business *customers* - on time payment of all *electricity retail bills* for two years from the date of the first *electricity retail bill* and has maintained a satisfactory credit rating in the reasonable opinion of the *standard retail supplier* over that period.
- (b) The *standard retail supplier* must, within 10 *business days* of the relevant events in clause 20.7(a) occurring:
 - (i) inform the *customer* in writing of the amount that is refundable; and
 - (ii) repay the security deposit as directed by the *customer*.

20.8 Maximum duration of requirement for annual security levy or guarantee

- (a) Subject to clause 20.9, a *customer* who is required to pay a security deposit and does so in the form of an *annual security levy* or guarantee is eligible for the *annual security levy* to cease or the guarantee to be discharged when the *customer* has completed:
 - (i) for residential *customers* – on time payment of all *electricity retail bills* for one year from the date of the first *electricity retail bill*; or
 - (ii) for business *customers* – on time payment of all *electricity retail bills* for two years from the date of the first *electricity retail* and has maintained a satisfactory credit rating in the reasonable opinion of the *standard retail supplier* over that period.
- (b) The *standard retail supplier* must, within 10 *business days* of the relevant events in clause 20.8(a) occurring, inform the *customer* that an *annual security levy* or guarantee is no longer required and (in the case of a guarantee) discharge the guarantee.

20.9 Cessation of supply

- (a) If a *standard retail supplier* requires a *customer* to pay a security deposit (other than in the form of an *annual security levy* or guarantee), and the *customer* requests that the *standard retail supplier* ceases supplying electricity to the *customer's supply address* under a *standard form customer supply contract*, the *standard retail supplier* must, within 10 *business days* of the *customer* ceasing to take supply:
 - (i) inform the *customer* in writing of the amount of that is refundable; and

- (ii) repay the security deposit as directed by the *customer*.
- (b) If a *standard retail supplier* requires a *customer* to provide a security deposit in the form of a guarantee, and the *customer* requests that the *standard retail supplier* ceases *supplying* electricity to the *customer's supply address* under a *standard form customer supply contract*, the *standard retail supplier* must, within 10 *business days* of the *customer* ceasing to take *supply*, inform the *customer* in writing that the guarantee is no longer required and discharge the guarantee.
- (c) Clauses 20.9(a) and (b) do not apply if the *customer*, upon the cessation of *supply* at a *supply address*, commences taking *supply* from the *standard retail supplier* at another *supply address* under a *standard form customer supply contract*.

Part 5

Definitions and Interpretation

21. Definitions

In this determination:

2007/08 year means the period from 1 July 2007 to 30 June 2008

2008/09 year means the period from 1 July 2008 to 30 June 2009

2009/10 year means the period from 1 July 2009 to 30 June 2010

annual negative pass through amount is defined in clause 15.4(b)

annual pass through amount, for any year, means any *annual positive pass through amount* for that year less any *annual negative pass through amount* for that year

annual positive pass through amount is defined in clause 15.3(b)

annual pricing proposal means the document described in clause 14

annual security levy means a form of security deposit which is not refundable to the customer

applicable law means:

- (a) any legislation of the Commonwealth Parliament or the Parliament of New South Wales, and any regulation, order, rule or other instrument made under such legislation (including the *National Electricity Law*, *NERs* and rules made under section 63C of the *ESA*);
- (b) any *retail supplier's licence*; and
- (c) any code, rules and guidelines which is or are binding on a *standard retail supplier*

authority means:

- (a) any government or any Minister, agency, department, instrumentality or other authority of government; and
- (b) the *Tribunal*, the Australian Energy Markets Commission, the Australian Energy Regulator or *NEMMCO*,

but does not include a State owned corporation as that expression is defined in the *State Owned Corporations Act 1989 (NSW)*

business day means a day other than a Saturday, Sunday, public holiday or bank holiday in all of New South Wales

compliant annual pricing proposal means a *standard retail supplier's annual pricing proposal* for which the *Tribunal* has notified the *standard retail supplier* that the *Tribunal* is satisfied of each of the matters referred to in clause 14.4

component means *regulated retail tariff component*

controlled load means a load which is active only at certain times, where such times are determined and controlled by the network

controlled load tariff means a *regulated retail tariff* in respect of a *controlled load*

CPI means the consumer price index, All Groups for the weighted average of eight capital cities as published by the Australian Bureau of Statistics, or if the Australian Bureau of Statistics does not or ceases to publish the index, then *CPI* will mean an index determined by the *Tribunal* that is its best estimate of the index

ΔCPI_{07} means the change in *CPI* between the 2006 and 2007 calendar years, calculated as follows:

$$\Delta CPI_{07} = \left(\frac{CPI_{Mar\ 2007} + CPI_{June\ 2007} + CPI_{Sep\ 2007} + CPI_{Dec\ 2007}}{CPI_{Mar\ 2006} + CPI_{Jun\ 2006} + CPI_{Sep\ 2006} + CPI_{Dec\ 2006}} - 1 \right)$$

where *CPI* is as defined above and where the corresponding subtext (for example Jun2007) means the *CPI* for the quarter and of the year indicated (in the example, the quarter ending in June of the year 2007)

ΔCPI_{08} means the change in *CPI* between the 2007 and 2008 calendar years, calculated as follows:

$$\Delta CPI_{08} = \left(\frac{CPI_{Mar\ 2008} + CPI_{June\ 2008} + CPI_{Sep\ 2008} + CPI_{Dec\ 2008}}{CPI_{Mar\ 2007} + CPI_{Jun\ 2007} + CPI_{Sep\ 2007} + CPI_{Dec\ 2007}} - 1 \right)$$

where *CPI* is as defined above and where the corresponding subtext (for example Jun2007) means the *CPI* for the quarter and of the year indicated (in the example, the quarter ending in June of the year 2007)

customer means a *small retail customer* under a *standard form customer supply contract*. For any purpose under this determination that involves counting or determining the number of customers, each relevant *NMI* is to be regarded as one customer

customer hardship program means any program which imposes obligations on a *standard retail supplier* to assist *customers* in financial or other difficulty, to the extent that compliance with such obligations is not funded by a government or third party

demand management levy means any levy, tariff, fee, charge, duty, tax or impost of any kind imposed on a *DNISP* by the Government of New South Wales or the Commonwealth Government in connection with or relating to the supply of electricity to, or the consumption of electricity by, any *distribution customer*

distribution customer has the meaning given to that term under the *NERs*

distribution system has the meaning given to that term under the *ESA*

DNSP means a distribution network service provider (as that term is defined in the *ESA*)

EAPA voucher means a voucher issued under the Energy Accounts Payments Assistance Scheme administered by the NSW Department of Energy, Utilities and Sustainability

electricity retail bill means a bill issued by a *standard retail supplier* for the supply of electricity, or connection services arranged, by the *standard retail supplier*

energy loss factor means a factor that is applied to adjust cost or quantities in relation to the wholesale purchase of electricity to reflect the physical losses of energy arising from transporting energy over transmission systems and *distribution systems*

ESA means the *Electricity Supply Act 1995 (NSW)*

Gazette means the New South Wales Government Gazette

green energy outcome means:

- (a) an increase in the amount of electricity that is generated from renewable energy sources or other sources of energy that provide improved environmental outcomes; or
- (b) additional investment in technologies that reduce or offset greenhouse gas emissions from electricity generation; or
- (c) reduced consumption of electricity

green energy scheme means any mandatory scheme that imposes financial obligations on a *standard retail supplier* in order to produce one or more *green energy outcomes*, but does not include any scheme to the extent to which the *standard retail supplier* can recover its costs of that scheme from *customers* through *green premiums*

green premium means an amount voluntarily payable by a *customer* that is intended to result in, or contribute towards, one or more *green energy outcomes*. Where a *tariff* for the supply of such electricity does not separately identify the component attributable to *green energy outcomes*, the green premium is that part of the *tariff* that exceeds the *tariff* that would apply to a *customer* in the same circumstances were it not for the *green energy outcomes*

GST means the Goods and Services Tax as defined in *A New Tax System (Goods and Services Tax) Act 1999 (Cth)*

inclining block tariff means a *regulated retail tariff* under which *customers* pay an initial lower price per kWh for energy consumed up to a defined threshold level of consumption and a higher price per kWh for energy consumed above that threshold

kWh means kilowatt hours

last resort supply event has the meaning given to that term under clause 59 of the *Electricity Supply (General) Regulation 2001 (NSW)*

materially is defined in clause 15.1

Minister means the Minister for Energy

Minister's referral means the referral to the *Tribunal* from the *Minister* referred to in clause 1(1)

MWh means megawatt hours

National Electricity Law means the National Electricity Law set out in the Schedule to the *National Electricity (South Australia) Act 1996 (SA)*

negative change event is defined in clause 15.1

negative pass through amount means an amount to be passed through to *customers* as a result of a *negative change event*

NEMMCO means the National Electricity Market Management Company Limited ACN 072 010 327

NEMMCO direction fees means fees imposed by *NEMMCO* under clause 3.15.8 of the *NERs*

NEMMCO participant fees means "Participant fees" as defined under the *NERs*

NEMMCO reserve trader fees means fees imposed by *NEMMCO* under clause 3.15.9 of the *NERs*

NERs means the National Electricity Rules approved in accordance with the *National Electricity Law*

network use of system charge means the charge levied by a *DNSP* on a *standard retail supplier* for use of system services provided by a network service provider (being a "Network Tariff" as defined in the *Tribunal's network determination*)

new regulated retail tariff means a *regulated retail tariff* that was not in existence as at 30 June 2007

NMI means National Metering Identifier, and is as defined in the *NERs*

obsolete, in relation to a *regulated retail tariff*, means a *regulated retail tariff* that is no longer being offered to new *customers*

off-peak periods means:

- (a) in relation to a *standard retail supplier's time of use tariffs*, those periods that the *standard retail supplier* applied as off-peak periods for that purpose, as at 30 June 2007, or any variations to those times which are notified to the *Tribunal*, applied and published by the *standard retail supplier* on its website; and

- (b) in relation to a *standard retail supplier's controlled load tariffs*, those periods (whether fixed or variable) that the *standard retail supplier* from time to time applies as off-peak periods for that purpose

Ombudsman means the Energy and Water Ombudsman NSW or any other electricity industry ombudsman under an approved electricity industry ombudsman scheme under the *ESA*

pass through event means a *regulatory change event* or a *tax change event*

pass through services means services of or in relation to *supplying* electricity to *small retail customers* under a *standard form customer supply contract*

payment plan means an arrangement entered into between a *standard retail supplier* and a *customer*, for the payment of charges incurred after the commencement of the plan, that involves either or both of:

- (a) automated payment, including;
 - (i) direct debit; or
 - (ii) CentrePay, the free direct bill-paying service offered to persons receiving payments from Centrelink allowing those persons to pay for services (including *electricity retail bills*) by having a regular amount deducted from their Centrelink payment; or
- (b) advance payment (whether in advance of the services being provided, or after the services have been provided but in advance of the time that an *electricity retail bill* would ordinarily be issued), but not including a security deposit

peak periods means, for a *standard retail supplier*, those periods that the *standard retail supplier* applied as peak periods, for the purposes of its *time of use tariffs*, as at 30 June 2007, or any variations to those times which are notified to the *Tribunal*, applied and published by the *standard retail supplier* on its website

period of this determination means the period referred to in clause 2(3)

positive change event is defined in clause 15.1

positive pass through amount means an amount to be passed through to *customers* as a result of a *positive change event*

premises has the meaning given to that term in the *ESA*

regulated retail charge means a security deposit, late payment fee or fee for a dishonoured cheque of an amount specified in this determination

regulated retail tariff:

- (a) when used in clause 1(1), has the meaning given to that term in the *ESA*; and

(b) when used anywhere else in this determination, means a *tariff* for or in relation to the supply of electricity charged by a *standard retail supplier* to a *small retail customer* under a *standard form customer supply contract*, excluding:

- (i) *green premiums*; and
- (ii) *regulated retail charges*,

which may include a number of *regulated retail tariff components* (if offered by the *standard retail supplier* as a single *tariff*)

regulated retail tariff component means a component of a *regulated retail tariff*; for example:

- (a) a *time of use tariff* might have 4 components, for example:
 - (i) peak, shoulder and off-peak components (each expressed in cents/kWh)
 - (ii) a service availability charge (expressed in cents/day)
- (b) an *inclining block tariff* might have 3 components, for example:
 - (i) a price (expressed in cents/kWh) for that part of the consumption which is between 0 and X kWh
 - (ii) another (higher) price (also expressed in cents/kWh) for that part of the consumption that exceeds X kWh
 - (iii) a service availability charge (expressed in cents/day)

regulatory change event means:

- (a) a decision made by any *authority*;
- (b) the coming into operation of an *applicable law*; or
- (c) the coming into operation of an amendment to or revocation of an *applicable law*,

on or after 1 July 2007 that:

- (d) has the effect of substantially varying:
 - (i) the nature, scope, standard or risk of the *pass through services*; or
 - (ii) the manner in which a *standard retail supplier* is required to undertake any activity in order to provide the *pass through services*, including obligations under any:
 - (A) *green energy scheme*;
 - (B) *customer hardship program*; or
 - (C) *last resort supply event*; and

- (e) results in a *standard retail supplier* incurring *materially* higher or *materially* lower costs in providing the *pass through services* than it would have incurred but for that event,

but does not include:

- (f) the making of this determination;
- (g) a *tax change event*;
- (h) any decision, determination or ruling in relation to *energy loss factors*; or
- (i) the phasing out of the Electricity Tariff Equalisation Fund (as defined in the *ESA*)

relevant tax means any tax, levy, impost, deduction, charge, rate, duty or withholding which is levied or imposed by a government or any Minister, agency, department, instrumentality or other *authority* payable by a *standard retail supplier* other than:

- (a) income tax and capital gains tax;
- (b) stamp duty, financial institutions duty and bank accounts debits tax;
- (c) *NEMMCO participant fees*;
- (d) fees payable by a *standard retail supplier* in respect of a *retail supplier's licence*;
- (e) penalties, charges, fees and interest on late payments, or deficiencies in payments, relating to any tax; or
- (f) any tax that replaces or is equivalent or similar to any of the taxes referred to in (a) to (d) above (including any State equivalent tax),

but including *NEMMCO reserve trader fees* and *NEMMCO direction fees*

retail supplier's licence means any licence that authorises operations in the electricity retail market in New South Wales (including any retail supplier's licence granted under the *ESA*)

second-tier retail supplier means a second-tier customer under the *NERs* that also holds a *retail supplier's licence*

shoulder periods means, for a *standard retail supplier*, those periods that the *standard retail supplier* applied as shoulder periods, for the purposes of its *time of use tariffs*, as at 30 June 2007, or any variations to those times which are notified to the *Tribunal*, applied and published by the *standard retail supplier* on its website

small retail customer has the meaning given to that term in the *ESA*

standard form customer supply contract has the meaning given to that term in the *ESA*

standard retail supplier has the meaning given to that term in the *ESA* (namely, EnergyAustralia, Integral Energy Australia and Country Energy)

supply has the meaning given to that term in the *ESA*

supply address: each *NMI* is considered to be a single supply address

supply district has the meaning given to that term in the *ESA*

tariff means, depending on the context:

- (a) a price (or set of prices for different components); and/or
- (b) the set of circumstances in which (including the group of persons to whom) that price or set of prices will apply

tax change event means:

- (a) the imposition of a *relevant tax*,
- (b) the removal of a *relevant tax*; or
- (c) a change in (or a change in the application or official interpretation of) a *relevant tax* or the way in which a *relevant tax* is calculated;

which:

- (d) occurs on or after 1 July 2007; and
- (e) results in a *standard retail supplier* incurring *materially* higher or *materially* lower costs in providing *pass through services* than it would have incurred but for that event

taxable supply is as defined in *A New Tax System (Goods and Services Tax) Act 1999 (Cth)*

time of use tariff means a *regulated retail tariff* for which different rates apply depending upon the time of consumption

total negative pass through amount is defined in clause 15.4(b)

total positive pass through amount is defined in clause 15.3(b)

Tribunal means the Independent Pricing and Regulatory Tribunal of New South Wales established under the *Independent Pricing and Regulatory Tribunal Act 1992 (NSW)*

Tribunal's network determination means the Tribunal's determination entitled "NSW Electricity Distribution Pricing 2004/05 to 2008/09" (Determination No. 2 of 2004)

Tribunal's previous retail determination means Determination No. 1 of 2004

use of system services has the meaning given to that term under the *NERs*

year means *year of this determination*

year of this determination means the 2007/08 *year*, the 2008/09 *year* or the 2009/10 *year*.

22. Interpretation

In this determination:

- (a) a construction that would promote the purpose or object expressly or impliedly underlying the *ESA* is to be preferred to a construction that would not promote that purpose or object;
- (b) the reference to an Act, legislation or law includes regulations, rules, codes and other instruments under it and consolidations, amendments, re-enactments or replacements of them;
- (c) words importing the singular include the plural and vice versa (for instance, the reference to a *regulated retail tariff* includes *regulated retail tariffs* and vice versa);
- (d) where a word is defined, other grammatical forms of that word have a corresponding meaning;
- (e) headings are for convenience only and do not affect the interpretation of this determination;
- (f) a reference to a person includes any company, partnership, joint venture, association, corporation, other body corporate or government agency; and
- (g) a reference to any agency or body (including a *standard retail supplier*), if that agency or body ceases to exist or is reconstituted, renamed or replaced, or has its powers or functions removed (**defunct body**), means the agency or body which performs most closely the functions of the defunct body.

23. GST

All prices and calculations under this schedule are exclusive of *GST*. A *standard retail supplier* may charge *customers* an additional amount equal to the *GST* payable by the *standard retail supplier* in respect of any *taxable supply* to which the amounts relate.

24. Clarification

The *Tribunal* may publish a clarification notice in the *Gazette* to correct any manifest error or to clarify any part of this determination as if that clarification notice formed part of this determination.

