INDEPENDENT PRICING AND REGULATORY TRIBUNAL

RETAIL ELECTRICITY MID-TERM REVIEW
PUBLIC FORUM

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Held at Meeting Room 1, Level 2
44 Market Street, Sydney NSW 2000

On Friday, 3 May 2002, at 9.35am

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MR COX: Ladies and gentlemen, we will now start the forum. I am Jim Cox, I am a member of the tribunal, and my colleagues Mr Tom Parry and Ms Cifuentes will join us a little later during discussion.

Thank you for coming along. The purpose of the forum is that it is part of our public participation process, so it is to give you an opportunity to raise issues which are of concern to you and we will also share some of our analysis with you. Then we will have some discussion of issues.

This is a public workshop and we would like you to sign the attendance sheet at the back of the room if you have not already done that.

The way we will organise it is that first of all Michael Seery will speak a little bit about the scope of the review. Then we will have three sessions. The first session will look at the issues of target tariffs and it will discuss questions that we think are appropriate. After that we will look at issues involved in achieving the target tariffs, how quickly prices can be increased to necessarily do that, and also we will look at questions concerning side constraints. The final session will deal with a number of specific issues about regulated retail tariffs.

That is the plan. The way we will do it is get members of the secretariat to introduce each topic, then we will go round the table, giving people sitting at the table the opportunity to have their say. I suggest the way we do that is to limit each speaker to about five minutes, not have interruptions during the time that each person is speaking, and have only have one member from each organisation speak per topic. Once everyone around the table has spoken, I will give people a chance to respond to comments made, then give people sitting in the back of the room a chance to make some comments or make suggestions if there is time to do that.

We are transcribing the proceedings to help us finalise our work on this topic, so if people could introduce themselves before they speak, particularly if you are at the back of the room and you are speaking for the first time.

That is by way of rules. What I would like to do now is to go around the table and give everyone at the table the chance to introduce themselves; and I will start by introducing myself, I am Jim Cox, a member of the Tribunal.

MR SEERY: Michael Seery, Program Manager, Electricity Pricing with the tribunal.



MR BEARD: James Beard, the Centre for International Economics, working with the tribunal on this review.

MS HARMAN: Christine Harman, TXU.

MR EGAN: Gerry Egan, also with TXU.

MR NASH: Andrew Nash, Integral Energy.

MR NEVILLE: David Neville, Integral Energy.

MS WALDMAN: Karen Waldman, Integral Energy.

MR WELFARE: Luke Welfare, Macquarie Generation.

MR KELLY: Sean Kelly, AGL Retail.

MS BANICEVIC: Nathalie Banicevic, Country Energy.

MS TERRI BENSON: Terri Benson, Country Energy.

MS TRISH BENSON: Trish Benson, PIAC.

MR JIM WELLSMORE: PIAC.

MR STEPHEN BORAS: Stephen Boras, Eraring Energy.

MR GRAEME LEES: Graeme Less, EnergyAustralia.

MR COX: Thank you very much. We will now have Michael speak a bit about the review.

MR SEERY: I will not be long in this session. I just want to talk about, as Jim says, the review and how we propose to finish the review.

As you will recall, the Minister requested the tribunal to undertake a review of its determination put in place in 2000 for regulated retail tariffs. In conducting the review it is necessary to remember that we are talking about regulated retail tariffs and these are the tariffs that apply to small retail customers who elect to stay on a standard form customer supply contract or who move away from such tariff and then come back to a standard form of customer supply contract.

In its determination the tribunal limited the number of regulated retail tariffs and this was basically for simplicity. The tribunal's view was that a regulated retail tariff should be a no frills tariff, that there should be as few options as possible and no special features to those tariffs. The question then is what should be in a regulated retail tariff. It really relates to the cost to supply but it needs to reflect efficiency costs and there needs to be a balance between whether those tariffs are too high or too low.

If the tariffs are too high, it would disadvantage those customers who cannot enter into the contestable market. As noticed in the terms of reference, it is basically in that respect a safety net tariff. If the regulated retail tariff is set too low, that would hinder competition.

The terms of reference of the tribunal, if you look at the document put to us by the Minister, breaks down into three main areas: has there been a material change in the costs, including the retail contestability cost, to justify change in the target tariffs, and that will be the basis of discussion session one; secondly, do the participants believe the tariff target level will undermine operation of the competitive retail market and what are the impacts of side constraints, which will be the basis of discussion session two.

Finally, the tribunal is to consider other things like whether there should be new tariffs, for example, green tariffs, and to look at off-peak tariffs, including the merits of a shoulder tariff. Those issues are the basis of our discussion in discussion session three.

The timetable for the review is that we have the public forum today and the tribunal anticipates it will be able to release its determination towards the end of June so that the retailers can make notifications to the tribunal on price changes by 1 July for those price changes to be effective from 1 August this year.

MR COX: Thank you, Michael. The first session is going to be on target tariffs. To introduce this topic I will ask James beard to speak. James is a consultant from the Centre for International Economics who is working with us to assist us in this inquiry, so I will ask James to lead off.

MR BEARD: Thank you, Jim. The target tariff is built up, as you know, between an NEM and an R component. The NEM is a pass-through component and the R is the retail margin or mark-up. I will just talk a little bit about the analysis we have done in terms of examining that R component and if there has been any material changes since the original determination.

Just to refresh your memory, the tribunal has taken an approach where it has benchmarked the various cost components of the R and those cost components are long-run marginal costs which reflect the costs of energy purchasers, including green energy, retail operating costs, retail net profit margin, international market fees and transmission



and distribution losses.

As part of the mid-term review the tribunal is required to examine the circumstances to see if there have been any changes, any material changes, to those factors that would mean those allowances should be shifted up or down.

This morning I will focus on the analysis we have done in terms of long-run marginal cost, retail operating costs and net profit margin and I will just briefly indicate where our analysis is heading on those issues. It should not preclude you from raising issues in the forum on NEM fees and transmission and distribution losses, which we have not progressed the analysis on that far yet.

In terms of long-run marginal cost, the current allowance is based on some modelling commissioned by the tribunal at the time of the original determination and also other relevant studies of long-run marginal cost which have indicated a fairly large range of between $36 and $56 per megawatt hour. In terms of the submissions we have received, they have again highlighted the divergence in long-run marginal cost estimates that are floating around.

We received submissions which suggested long-run marginal costs between $32 and $58 per megawatt hour. The submissions also raised some questions about the assumptions underlying the original modelling in terms of the peakness of demand, costs of gas, costs of coal plant and the forecast load, which has also been updated.

In terms of investigating those assumptions, we have taken those and tested what those variations and assumptions would mean in terms of the output of the original modelling framework. The one that had the most significant effect on the range is the cost of coal plant. In the original model it was assumed at $950 per kilowatt and we have tested $1200 per kilowatt, which is an average used by NEMMCO in some of its analysis, and that shifts the range from $36 to $56 to $39 to $58. So it is not a significant or large change but it may warrant a shifting of the long-run marginal cost allowance to that order of magnitude.

In terms of the green allowance, or incorporating the green requirements, there have been two main changes since the original determination. One, the Commonwealth mandatory renewable energy target scheme has now been finalised and implemented. The other change has been that the New South Wales benchmark licence requirements have been or are in the process of being tightened.

I will talk about the Commonwealth scheme. Some of the modelling suggested by the New South Wales Treasury in support of the New South Wales benchmark licence requirements has incorporated the effect of the Commonwealth scheme on the system and that modelling suggests that costs of up to 38 cents per megawatt hour might be a reasonable compliance cost over the first couple of years of the scheme, which corresponds to the two years remaining in the determination.

Submissions by retailers have suggested a value closer to 25 cents per megawatt hour so in terms of where we are coming at, it looks like an allowance of between 25 cents and 38 cents a megawatt hour would appear to be sufficient to cover that cost element.

In terms of the New South Wales benchmark licence requirements, the licence requirements were in place at the time of the original determination but the proposed changes mean that the targets will become binding on retailers and other users by 2006/7. The Government has modelled the costs of that using a linear programming model and has looked at the compliance costs of the benchmark scheme over and above compliance with the Commonwealth scheme, which forms part of the baseline, and their modelling indicates that over the two years that remains in the determination that compliance costs of around 50 cents per megawatt hour would be incurred, although these do rise over a longer time frame. As the target becomes closer, it becomes more difficult to meet that, so they rise to over $1 a megawatt hour.

One of the key issues for the tribunal is that the outcome, the final scope of the licence requirements is still uncertain and some issues regarding trading of interstate trade in electricity, recognition of the Commonwealth scheme, those are yet to be finalised.

Going back to the original determina tion, the original determination made an allowance for green electricity, for the licence requirements. It is not explicit, the range or the allowance that is in the modelling, but basically the range for long-run marginal cost estimates was estimated on the assumption that there would be sufficient electricity purchases, green electricity purchases that met the licence requirements, so they assumed that the 5 per cent target, as it was then, was actually binding, so the modelling assumed that the target was binding, as it will be under the proposed changes.



We have calculated what the effect of removing that target would mean to the model, to the range, the long-run marginal cost range, and that comes out between 50 cents and $1 a megawatt hour. The implication is that the original range for long-run marginal cost actually included between 50 cents and $1 per megawatt hour for the benchmark licence requirements in New South Wales.

Going back to the work that has been done, Treasury or the government estimated compliance costs from the scheme would fall within that range but the costs submitted by retailers and others would fall outside the range. Submissions have also included costs which are higher than that range.

The other important point that we have to think about in this analysis is that the target tariff was based on a long-run marginal cost estimate so it is the costs of energy based on a long-run marginal cost concept and we have to think a little bit about how we compare that with premiums over and above market prices which have been put in submissions, so the two concepts are separate and they are not necessarily comparable. We need to be careful how we incorporate that into the target tariff.

On retail operating costs, the original determination allowed costs of between $40 and $60 per customer inclusive of the $50 FRC allowance. If you take away that allowance, $35 to 55 dollars per customer. Again, that range was set based on benchmarks and those benchmarks were to cover costs such as billing, IT, call centres, those sorts of overheads.

We have had a look at those benchmarks and looked around for new benchmarks and there does not appear to be a lot of new evidence to suggest that those benchmarks are inappropriate or need to be adjusted upwards or downwards. Retailers in their submissions have forecast increasing costs and I guess that is the same as with the original determination, there was the same sort of profile, a rise in operating costs.

The final point is that the range comes up with the allowa nce. That depends heavily on the amount of the FRC work that is going on.

The final point to talk about is the retail net profit margin. That is the margin that covers the return to capital of retailers. The current range is between 1.5 and 2.5 per cent. That range was based upon benchmarks established in other jurisdictions and looking at those benchmarks and looking around for new benchmarks there does not appear to be other new information that has emerged since the original determination which would suggest it is appropriate to change those.

It was also based on the expectation that the ETEF fund would be established and that would eliminate energy purchase risks for regulated customers, so that it would be inappropriate to allow a margin to account for the risk of retail energy purchase, wholesale energy purchase, given that that has been absorbed by the ETEF fund.

The range of 1.5 and 2.5 per cent was also based on a view that it is inappropriate from an equity or economic efficiency point of view to include anadditional allowance to encourage customer switching. Another consideration in that range is that as FRC progresses it is likely that the customer base will become more risky as there is competition and the regulated basis drives lower value customers. In that case it may be desirable for the net profit margin to increase but I guess that will determine the position within the range, whether there is a shifting of the range, so really whereabouts within the 1.5 to 2.5 per cent do you go rather than shifting that range to a higher level? At this stage of the analysis, there does not appear to be much of a material case for shifting the net margin range from its current levels.

The final question - this is something we perhaps would appreciate any input on - is the current split between fixed and variable costs in terms of retail operating costs. Currently the majority of those were covered through a fixed charge. We need to consider whether there have been any material changes or other considerations that would suggest a shift in the balance between fixed and variable components.

That, I guess, hopefully brings you up to date on where our analysis is up to or heading in terms of those components. We have still to do some more work on the NEM fees and transmission and distribution losses, so discussion would be useful there.

MR COX: Thank you, James, very much. We will now proceed to comments. Someone has to go first, so I thought today I would ask Integral Energy to start.

MR NEVILLE: Thank you, and thank you also to IPART for the opportunity to participate in today's forum. We believe the outcome from today's discussion and the report to the Minister will be quite critical to supporting the ongoing development of the competitive market in New South Wales.



If we go back to basics, the purpose of electricity deregulation is to provide competition and customer choice. That is customer choice for all New South Wales customers, not 10 per cent of the market, not 20 per cent of the market, but 100 per cent of the market. The systems and processes that have been put in place by the industry reflect the fact that 100 per cent of the market now has that choice. We also believe that it is now critical that the target tariffs that are in place also reflect this fact.

The New South Wales Government has previously stated that its three guiding principles for deregulation of the industry are to protect consumers' interests, to make sure a consistent approach is taken nationally and that there is a fair and equitable outcome for electricity businesses. Integral strongly supports these principles as the basis for promoting competition and for reviewing the existing target tariffs. From a regulatory perspective, we also believe it is essential that the principle of cost reflectivity be adopted in the resetting of the target tariffs, otherwise it will be impossible to achieve commercial outcomes which will be to the overall detriment of the competitive market.

We have been asked to comment on material changes and we note the comments from the Centre for International Economics. We actually believe there are a number of areas that have changed since the original determination and therefore need to be reviewed.

In relation to the long-run marginal cost, we believe that new entrant retailers would have difficulty in purchasing supply to match the shape and volatility of the regulated market at the LRMC. This is mainly due to the volatility of demand within the regulated market resulting in additional supply being required in peak periods rather than flat across the day. It is our view that the LRMC allowance within the target allowance should accurately reflect the energy purchase cost for new entrant suppliers.

On the green component, we have argued that the current allowance of 1.5 per cent is insufficient. We have maintained that view. Firstly, we don't think that the 1.5 per cent allowance includes the costs associated with the mandatory renewable energy target as set by the Federal Government and, secondly, as has just been noted, the guidelines for implementing the mandatory $CO_2$ omissions abatement scheme have yet to be finalised and the full impact of those measures has not been finalised. We believe that the green component should be increased to cover the additional costs associated with green compliance.

On retail costs and net margins, we believe that the benchmark set in the current determination have been set too low. In setting the costs to serve allowance, the original determination drew on international benchmarks. We don't think it allowed for the differences in market structure and size. The UK has a substantially larger customer number so efficiencies can be achieved that are not available in a smaller market such as New South Wales.

We also believe that it is inappropriate to set the retail cost component at the same level for all regulated suppliers. Each supplier has its own efficiencies and economies of scale which can lead to market advantage being gained by much larger retailers if a one size fits all cost to serve is applied. We have also argued that the net margin currently achievable from the regulated tariff is insufficient to promote competition. Currently it does not allow for savings to be offered to customers while still allowing retailers to earn sufficient returns given the risk involved in the market, and those risks include the volume of loss load at $10,000 a megawatt hour. Without an increase in the target tariff, the net margin required to attract new entrants to the market will not be available and competition and its benefits to customers we think will be restricted.

On market fees, the regulated tariff is a bundled rate that does not allow for the pass-through of actual market fees as with contestable rates. This poses an obvious risk to retailers. We have reviewed the wholesale market and our analysis indicated that the forward costs for ancillary services, fees, where they are tradeable are priced in line with the regulated allowance. So based on this we support the allowance for ancillary services being kept at its current level.

We have also reviewed the appropriateness of the split between fixed and variable components of the target tariff and we believe that for the tariffs to be cost reflective, the fixed component needs to be a larger component of the tariff as a result of the large fixed costs associated with operating in the market. Thank you.

MR COX: I now move on to Macquarie Generation, Luke Welfare.

MR WELFARE: Good morning and thank you for the opportunity to speak.



I won't go back through our submission again. The new information that has come to mind from your discussions already is that we are concerned about the level of green and how much money is to be allocated for that. We have done our own modelling based on the information that was supplied by Treasury and, looking at it over the long run, for what they would allow, we are looking at at least double the costs that you have allowed there. We are looking at the order of $2 to $3 a megawatt hour and we will provide an additional submission to you on that.

Also, it is a difficult position because you are actually going to put a tariff in from the 1st of August effectively without the full ramifications of what is currently underdevelopment within the Ministry of Energy Utilities and I think we need to think seriously about what the outcome of that might be because if you don't allow interstate trade, which is some of the feedback that we are getting at this stage, that rate could go to $5 or $6 quite easily per megawatt hour. We will provide some additional information to you and some modelling that we have done to date as such.

MR COX: Thank you very much. We will now move on to AGL.

MR KELLY: Thank you for the opportunity to speak. I suppose I have some additional comments from the perspective of new entrants into the market and support the view that David made that the long-run marginal cost of energy does not reflect the actual market for the new entrant. Similarly, the arrangements for the ETEF is also not available to the new entrants and therefore that changes the risk profile of a new entrant into the marketplace.

In terms of the retail costs, a particular focus for a new entrant is that in winning customers there is a significant acquisition cost that is incurred in attracting customers to your business and therefore we not only need to look at the ongoing operation costs in terms of servicing a customer over time but also the cost of that acquisition.

Our experience to date is that that acquisition cost, in terms of successful returns, can be of the order of $100. Similarly, if we flow that down through into the FRC costs, it's important to recognise that within the various energy markets, if you take AGL for instance, which is obviously the incumbent gas retailer, it doesn't achieve synergies in a number of those FRC costs because the arrangements in place for the electricity industry have a different set of systems and rules than the gas.

The incremental amount as to unencumbered, such as AGL and gas, still incurs the full inventory costs on systems for electricity. Similarly, when we look at the net margin allowed on customers, what we find is that instead of achieving the Government's objective of opening competition to all customers, it is severely restricting the number of customers which would be potential candidates for offers.

THE CHAIRMAN: Could we now move on to Country Energy.

MS TERRI BENSON: I am Terri Benson from Country Energy. Country Energy believes, as has already been outlined, that it is appropriate to revisit the R because things have changed since it was set. We will focus on financial aspects that we believe have changed materially and to support this we need to ensure that we do have cost reflective tariffs.

First of all, with respect to the green component - we'll focus on that - that has probably been the area where there has been the most change. As outlined by James earlier, there have been changes to the proposed New South Wales greenhouse gas licence requirements. There has also been the implementation of the MRT requirements.

Everyone has indicated, based on their modelling, that they're getting numbers that are higher than is the current allowed and our modelling also shows that we would expect it to be significantly higher than what is in that and we are happy to provide that modelling.

With respect to the standard gross margin, we have similar views to those outlined by David earlier. We don't believe it is appropriate to have one standard gross margin across all retailers. That standard approach doesn't recognise the different operating environments or economies of scale possible for retailers with large customer bases and also customer density.

With respect to Country Energy, which has a significant real customer base, there is a degree of responsibility and social obligation in providing services to those customers who choose to stay in a regulated tariff. It is a very different operating environment. We have a dispersed customer base. We think some of the retail component should be recognised in the standard gross margin.

In terms of FRC cost recovery we've given, subject to the final record, whatever are the amounts that come out of that report should flow



through to the target tariffs, to ensure that those cost tariffs are reflective of the costs of FRC. There is one difficulty in including it in the target tariff for that.

We say that if the allowance goes into the target tariff, the only way those costs are recovered are if the tariffs are at the target level. If the tariffs aren't at the target level, you're not recovering the FRC costs. That I think reinforces the importance of transitioning those existing tariffs to target levels, which would be the subject of the next session. I will leave further comment on transitioning to them.

In relation to the fixed and variable mix, in Country Energy's case the fixed and variable mix is constantly changing because we're going through a lot of change at the moment. We believe the mix at the moment is probably appropriate. However, with the onset of FRC and as the customer mix changes, that fixed and variable mix will need to change as well. That is really all we have to say. Thank you.

THE CHAIRMAN: Thank you very much.

MS TRISH BENSON: I must admit we feel as if we're probably the only ones that are going to advocate that we don't have higher prices, so I'll put that on the table. Where we're coming from is we don't actually support the premise that higher prices will actually encourage competition.

The retailers need to think reasonably carefully about this because they're still going to have significant numbers of customers who are going to remain with the incumbents and that will particularly be households on low incomes and that's for a variety of reasons.

If we actually contemplate price increases, I think what we're going to have is profits for the incumbents. It is our understanding that the way competition has worked up until now is that the incumbents in the main are signing their high usage customers on to negotiated contracts. I think this is borne out by some of the research that the Ministry has done. They are signing up their high usage customers and there hasn't been much change between retailers.

Just a word of caution on the specifics. We would like the Tribunal to think very carefully about the greenhouse costs, particularly around the MEU modelling. This is actually a two year determination. The MEU modelling goes up to 2006-2007. There is a bit of concern there. We take issue with Integral and their costs of service model. We are really concerned about this. It is not as if they're not recovering those costs. What we're actually doing is smearing those costs.

If we start talking about getting people to move on to less cost methods of payment, we might end up with some people paying much more because they don't have any other choice or options and we're very concerned about that.

Within their submission Energy Australia raise the issue about bad debt. We don't think they're going to have any more than they've got now. We actually don't think they should be compensated for that in the retail tariff.

THE CHAIRMAN: Thank you very much. Could we now move on to Eraring Energy.

MR BORAS: Our comments are more to be seen in the context of the overall competitive energy market and the implications we see with the end of retail tariffs. The main concern that Eraring has is that cross-subsidising between different classes of customers under the one tariff jeopardises some of the goals of the competitive energy market.

The particular issue we see there was touched on earlier in the introduction, the fact that all customers under the tariff are treated in a like manner, assuming similar consumption patterns. That is far from the reality. We believe that by breaking it down into subclasses everyone would get a much more accurate picture. Some broad subcategories could be something like all electric homes with off-peak water heaters but no gas and others, all electric homes without off-peak water heaters, homes with air-conditioning and so on.

Continuing with one tariff for all the different customer classes would allow competitive retailers to cherry pick the more attractive customers as far as the load profile is concerned and leave the retailers the unattractive part of the tariff customers, which then leaves them to carry the higher burden of costs associated with the less attractive part.

From a generator's point of view, the implications are as follows: currently the tariff customer load risk is carried by the generators via the mechanism that is known as ETEF. Again, the generators need to put a generation capacity to follow the load. If the general tariff load becomes more spiky, less attractive, because the good customers have wandered off to competitive retailers, then we believe the reference energy



costs part of the ETEF arrangement would need to increase.

Could I add just one word on long run marginal costs, or just a general observation. There will be increasing pressure on long-run marginal costs coming from the need to put environmentally prudent measures in place - cleaner technology, new power station location, mandatory renewable energy targets. Just recently, New Zealand introduced the carbon tax. This has had an upward pressure on the long-run marginal cost of generation and should be signalled in the domestic tariff.

In summary, in light of the above, it is argued that the tariff review should consider subdividing the domestic tariff classes into a number of subclasses with different cost characteristics and should also allow for a program of tariff movement in acceptable increments to cost reflective levels. We believe that it would be consistent with economic efficiency arguments and would help to promote competition on a more level playing field.

THE CHAIRMAN: Thank you very much. Could we now move to EnergyAustralia.

MR LEES: Thank you, Jim. With respect to the target tariff situation, we see these target tariffs as a mechanism but unfortunately this is probably the most important part of the discussion we will have today, because it doesn't matter what you set the net margin range at and it doesn't matter what you say side constraints are if target patterns aren't cost reflective.

If they are set incorrectly it means we don't get increases, even modest increases, and net margin, whatever the range is, doesn't really matter. The net margin range can be 2.5 or 10 per cent but we'll still get 1 per cent.

I won't buy into the argument about needing to increase tariffs to assist competition. We don't support that argument and we would agree with Trish on that. All we're saying here is that these are what the targets should be. We think they should be cost reflective. That would give us a modest increase in our tariffs per year, which would give us a margin of about 2.5 per cent, not a 400 per cent increase. As Jim said, if I got 400 per cent I'd certainly get my bonus for the year. I don't really think that that's where we are with it.

Talking about the actual components of the build up, first of all, we think there should be different target tariffs for OP1 and OP2 because the wholesale cost components are obviously different. There should be different target tariffs for business and residential because the operating cost is different and the wholesale component is different.

We don't just think that we should be talking about what has changed since the determination, what is the new evidence, as James called it, because we don't think the IPART consultants got it right first time. We are also harking back to a lot of what we said at the last determination. Basically, I'm trying to talk about benchmarks for the whole industry. I will contradict myself a couple of times on that because it's obvious we're only privy to our own information.

With respect to long-run marginal costs, yes, CAP Gemini did the modelling for IPART in the first place and we got the same consultants to do it again so as to try and pin it down to something narrower than a range of 36 to 56. Obviously, that range is problematic as well. It is so wide, what figure do you pick within that range to actually develop your target tariff?

At the time even CAP Gemini accepted for Energy Australia - and I'm contradicting myself here now - that the top 5 per cent, which would be the peak load, is probably a bit low; remodelling that, we'd get to 6 per cent. We also think the gas purchasing price was low. Basically, that gives us a long-run marginal cost of about $49.

On top of that, you have to add the green component. Yes, I am disappointed in what James was saying about maybe 25 to 30 cents for the rack and then more than 50 cents for jurisdiction. We are disappointed with that. There were a lot of assumptions in coming up with that 50 cents: that there was full recovery of interstate, there was effectively new generation and they were going to be pricing at $7 or $8. I don't think that that is going to happen.

Basically, we're going to price anything new up to penalty. We'd work that out to be about $50 million a year over the next couple of years for EnergyAustralia, which is $1.55 which you'll have to add on to the long run marginal cost to get the wholesale cost in that sense. That is still within CAP Gemini's range; it is still 36 to 56. It comes down to what you think it should now be.

With respect to operating costs, again, I was disappointed when James said he didn't think there was any new evidence. We are now going from annual licence compliance to quarterly compliance; that



must increase costs. There are green compliance costs as well. There are significant green costs that we have to absorb when trying to meet that benchmark in terms of demand management initiatives and in terms of trying to source this green generation.

Forty to 60? Well, we don't want to say that another jurisdiction is doing it better. We modelled it and came up with about 65 to 70. As I say, this is a State benchmark. Our operating costs forecast is $465 and as we're the biggest we should be at the low end. I just don't think 40 to 60 is reasonable.

David has covered ancillary services and other transmission distribution. We have to remember that our customers haven't had a price rise in two years. We have a situation where if you live on one side of Pennant Hills Road what you pay is significantly different to what you would pay if you lived on the other side. I want to emphasise how important setting these target tariffs are. They dictate the rest of the agenda.

The mix between fixed and variable and for domestic is probably about right, except that they're both too low. For business, no, the business effect should be higher because they are the ones which are going on to negotiate contracts. They are the ones which are moving away and we have to cover those fixed costs at the end of the term for the ones which remain. Thank you.

THE CHAIRMAN: Thank you very much. Finally, sitting in the corner, Gerry Egan from TXU.

MR EGAN: As you would know, we are a Victorian retailer. We are interested in extending beyond Victoria and have indeed extended into the contestable market in New South Wales in a small way. We see ourselves as a new entrant into this New South Wales market, so that some of those competition issues come up.

What we need to see is that the tariffs actually paid by people are cost reflective. If they are not cost reflective, if they are less than cost reflective, there is no way a new entrant can come in and compete for those customers and competition may well not proceed as it should.

The cost reflectiveness that I'm speaking about is the cost faced by a new entrant. We don't believe that the long-run marginal cost argument as implemented by ETEF does represent the cost faced by a new entrant trying to enter this market, nor does it represent the real cost to the industry.

Other speakers have spoken about the impact of load shape and that is a most important effect. I am sure customers in Victoria and New South Wales do expect that electricity will be there when they want it, even on the hottest summer day or the coldest winter day. Capacity must be available to supply that load. Someone has to pay for that capacity. Ultimately, the customer has to pay for that capacity.

Tariffs must be calculated in a way that gathers the funds to pay for that capacity. When you have plant megawatts required for very few hours of the year, that can move your weighted average cost up significantly.

In terms of what has changed, the load has become more peaky, I understand - certainly we've had that experience in Victoria - and that exacerbates this capacity effect and hence moves the long-run marginal cost upwards.

On the cost to serve area I would not have mentioned the Victorian benchmark because I wouldn't be game to do that in this audience; however, it is probably relevant. We as a Victorian retailer believe that benchmarking is difficult. Our argument in Victoria for our own franchise base has been that one should look at the actual costs incurred and debate then perhaps whether there are inefficiencies or not, but to start from some difficult to determine benchmark can lead you in the wrong direction, we believe.

We see that our costs are indeed higher than what Energy Australia has just mentioned. We do, of course, have a smaller number of customers and that may well lead to some consistency there.

On the net margin question, any business needs a return on its capital. The capital required to run a retail business is significant and cost of capital in electricity in many areas, but particularly in the energy industry, has increased markedly recently. We have had companies like Enron causing banks to reflect on their investments, on their exposure to the industry. We have had the $10,000 VOLL issue and the consequent prudentials, again causing the banks to reassess their exposures and we find our cost of capital is going up noticeably.

If you need capital - and it does cost money to get that capital - that must be reflected in the margin. The risk can perhaps be lessened if you are a party to ETEF or a retailer being supplied by ETEF. That of course is not available to a new



entrant retailer. On the green area and on fees we don't have anything to add to what has already been said. Thank you.

THE CHAIRMAN: Thank you very much. I wonder if James would like to comment on this stage.

MR BEARD: I want to comment on retail operating costs margins. When I said there was no new evidence regarding the margin, I was talking about benchmarks rather than retail operating costs per se. I just wanted to clarify that.

THE CHAIRMAN: Trish, perhaps we should let you come in here.

MS TRISH BENSON: AGL and TXU have mentioned second tier retailers not having access to the ETEF. I would like to point out people with the incumbent on contracts don't have access to ETEF either. I am not sure if you actually understand how it works, that's all.

MR BORAS: Would you say that again?

MS TRISH BENSON: I think I'm right in saying - and someone from Treasury might have to tell me if I'm wrong - that the second tier retailers keep making the point that they don't have access to the ETEF. The reality is that the incumbent retailers, who put people on negotiated contracts, those customers aren't in the ETEF either. That is the point I want to make.

MR EGAN: I believe that you're correct. We may not understand everything about ETEF.

MS TRISH BENSON: The Victorians have a hard time understanding ETEF.

MR EGAN: I understand why customers are attracted away from regulated tariffs to a contestable offer and it will, I think, be those whose regulated tariffs are already above or certainly at the cost reflective area. We understand that there is a large bunch of customers who are not yet at that target level and even if they were, we don't believe that that's the fully cost reflective position.

THE CHAIRMAN: I wonder if the members of the panel would like to make further comments?

MR NEVILLE: Could I make a clarifying comment on Integral's behalf? Trish raised the issue of the payment process and what we had proposed in our submission there and I just wanted to clarify what we have actually proposed. There are various payment methods available to customers in paying their accounts, ranging from direct debit to Australia Post, et cetera.

The cost per transaction for those that we've noted in our submission ranges from 30 cents to around $4. That variation is not reflected in the customers' account. We think there should be a means by which the actual cost of those payment processing costs should be passed through to customers and we see that as a means of encouraging customers to use the more efficient method, the less expensive method and that is another way of reducing the overall cost to serve.

MS TRISH BENSON: Can I reply to that?

THE CHAIRMAN: Yes.

MS TRISH BENSON: I didn't say it in my opening statement. We were very concerned that the numbers are actually confidential. We haven't got a clue what costs 30 cents and what costs $4. As I said before, our main concern is that you recover those costs anyway, as far as we're concerned. It is just that it could be inequitable if some people don't have the ability to move to least cost options; that is all I'm saying. I am saying it is potentially inequitable.

MR NEVILLE: Can I reply to that, Mr Chairman?

THE CHAIRMAN: Yes.

MR NEVILLE: That information is confidential because obviously we're sitting in a room full of competitors, but we are more than happy to sit down with PIAC on a confidential basis and talk through that information. The second point I'd make there is that it is included in our cost to serve but we've argued that our cost to serve is inadequate.

MS TRISH BENSON: You might say that.

MR NEVILLE: We have.

THE CHAIRMAN: From listening to the debate it seems to me that from the utilities we're getting the argument that what has been allowed, lower marginal cost, isn't accurate. We are also getting the argument that it is certainly not enough to enable new retailers to come in and compete. From the customers' point of view we're getting the argument that well, if you were to move up to where the utilities would like us to be, they would in fact be rewarded for costs of actually running and making handsome windfall profits.

Can anyone say anything that might try and move



the two sides together or do we simply have to accept different views?

MS TRISH BENSON: Given that these debates have been around and we indeed had this debate from the formulation of the last determination, except the line was more run by the second tier retailers than the incumbents, I actually think it is up to the Tribunal to be perfectly frank. That is part of the balancing act.

THE CHAIRMAN: At the end of the day that is true. I wonder if anyone can say anything to bring the sides a bit closer together; otherwise, it does leave it up to us.

MR LEES: Can I make a comment here about windfall profits? We are asking for a CPI increase. 90 per cent of our costs are out of our control and they go up by CPI. We are asking for a CPI increase to pass through to customers. We are asking for target tariffs to be set where we can have that CPI increase. To us the CPI increase is important.

The CPI increase to our 3 meg an hour customer - we'll call them our low income customer - that's $11, they are the ones we're worrying about. We haven't talked about the re-balancing of peak yet but even when we're trying to re-balance our peak we're talking about $17.

These aren't windfall profits; these aren't extraordinary profits we're talking about. We are talking about increasing Energy Australia's net margin from 1 per cent to 2.5 per cent. This isn't dot.com kind of stuff. We have to put in context what we're actually talking about. If you ask the man in the street whether he thought it was unreasonable to have a 2.87 per cent increase in his electricity prices, it's going to cost him on average $20. He is not going to think that that's prohibitive. I think we have to think about that.

MR WELLSMORE: It may well be that the Tribunal has to decide what that reasonable outcome is. Our position is to put up ambit in the opposite direction. One of the concerns that we have is that the argument about unprofitable or loss making or non-cost reflective customers is that that is an argument we've heard in other regulated markets in New South Wales of late as well.

An enormous proportion of our customers are not paying a price which reflects the cost of supplying those people. This was an issue last year and it was an issue five or even 10 years ago. It seems to be a bit opportunistic. As Trish mentioned last time the regulated traffic was discussed, the second tier retailers said, "Let's have a bit of head room and we'll all jump in the market". Everybody else suddenly discovered all of their loss making customers and said, "We didn't realise they were loss making for the last 10 years". From our perspective, yes, we're happy to put up a counterbalancing ambit. We will leave it to you, Jim.

MR LEES: I think we're coming together there. What I was trying to get across earlier was that really everyone thinks what we're talking about is reasonable. We shouldn't let the mechanism of the target tariff drag us down until we're talking about levels of detail that stop us getting to what everyone thinks is a reasonable outcome. That is my concern with the target tariff. Do you think we should have target tariffs at all?

THE CHAIRMAN: It is a useful method of clarifying matters. Does anyone have any further comments? I might take comments and statements from people sitting in the back of the room, if anyone wishes to make one.

MR MARTINSON: Mike Martinson from EnergyAustralia. I support all the comments Graeme made. I would also like to put on the record that while it was mentioned, in the context of the retail operating costs, that there may be benchmarks out there that have been factored in, clearly the benchmark that has not been mentioned in this debate as yet is the recent one of the ORG for the net margin, where in New South Wales it's 1.5 to 2.5 per cent and yet, the ORG, which is the one which has been out there in the public arena, is 2.5 to 5 per cent.

People should be aware of the fact that there are benchmarks and that probably the applicable one is the ORG benchmark of 2.5 to 5 per cent. Thank you.

MR BEARD: Could I point out that all the consultants recommended that benchmark because it included an allowance for energy wholesale purchase rates. That has been specifically excluded from the New South Wales thinking because of the ETEF. There is that additional allowance and that risk.

MR EGAN: Could I comment on that? My recollection is that the ORG attem pted to capture all or nearly all wholesale market risk in the benchmark cost of energy, including all sorts of credit risk and stuff like that and management risk. While there may have been a little left over, the 2.5 to 5 was predominantly to be regarded as being the margin for operating a retail business.



THE CHAIRMAN: Thank you.

MR KELLY: That is my understanding of how the Victorian benchmarks were constructed. I support that view.

MR BEDFORD: My name is Greg Bedford and I am from Treasury. Could I supply a bit of a follow up to Mike's comment in terms of net margin. It is worthwhile pointing out that the net margin can't be looked at in isolation to what the allowed operating cost is. It is certainly a 1.5 to 2 per cent net margin if your operating costs are set too skinny; in other words, you won't achieve that. That is an already reasonably skinny margin.

From the Treasury's perspective it's fine to be talking about appropriate net margins, but let's make sure we get the operating cost targets right to ensure that businesses will earn it. Thank you.

THE CHAIRMAN: Does anyone wish to make any further comments? I suggest that we rule off this session. Essentially, you have left it to the Tribunal to decide between the points of view that have been expressed at this stage. We might take a short break now and resume at 11 o'clock.

(Short adjournment)

ACHIEVING TARGET TARIFFS

MR COX: I suggest we now resume for the second session on achieving target tariffs. We might ask Michael to introduce this topic.

MR SEERY: Thank you, Jim. I will be very brief on this. As I said earlier, one of the things that the Minister asked us to look at was whether the target level currently undermines the competitive retail market and, secondly, what are the impacts and whether the side constraints should vary from where they are now.

Before we start in that area, what we need to do is understand what a target tariff is. Graeme asked earlier whether Jim thought that there should be a target tariff. I won't answer that question but what I will say is ask what do we see a target tariff is and how do you assess that target tariff. In 2000 when the tribunal did the determination the tribunal set targets in real terms. Certainly looked at from that perspective, the target we set is actually a number which will vary with inflation.

The target is there at the start of the period, it is the same target at the end if there is no inflation, and that needs to be remembered because one of the questions that we get asked is when do you have to achieve the target or when is that target for. The point is that the target is the same number if there is no inflation and if there is no change in network tariffs. That is important.

Unfortunately the network tariffs do change, therefore the target will vary a little bit and, secondly, there is inflation, so the number will change over time.

Those numbers that were set were set in 2001 dollars so, with inflation over the last period, the target will move this year. Next year the target will move again but it is only moving by inflation, for no other reason.

What is the path for getting to the target tariff. As you are aware, a number of tariffs are under-recovering. A number of tariffs are over-recovering. In the determination those tariffs above the target level can't move. This is the point Graeme made earlier, he has a lot of tariffs that are currently above the target level and therefore they can't move with inflation because even with inflation they are still above the target level.

Each year business haves to assess whether the tariff is above or below target. Then they can increase the under-recovering tariff by CPI, if it is a residential tariff, or by CPI plus 5 if it is a retail tariff. Underlying that is the network side constraints that overall the network tariff can increase by CPI but the residential tariff can actually increase by CPI plus 2 per cent or $30. Yet on the retail side, the tariffs can increase by CPI for residential or $25, so that the retail tariffs are unable to pick up the difference between the network and the retail side constraint.

One problem with the side constraints as they are now is that this would mean that a number - this is the point that Terry was alluding to - a number of their tariffs are well below the target level and because of the side constraints and CPI they can't achieve that target level over the period.

What are some of the issues that need to be considered in this area? I think one of the issues that needs to be considered, and there has been a bit of a question over what the answer is, is how do you assess if you have reached the target tariff. Is it based on the components? In other words, if your fixed charge is less than the fixed charge in the target then your usage charge is less than the usage charge so are you below target, or is it based on a total revenue approach?



Another issue is how do minimum charges fit with the concept of target tariffs. A number of the retailers still have minimum charges and do they necessarily fit in with this concept of a fixed component and a usage component only?

Probably one of the most contentious issues is to what extent are side constraints limiting achieving targets and in this regard are there some innovative ways of using the side constraints. I think in Country Energy's submission they have suggested that they use what they termed a tiller to increase tariffs by CPI but effectively rebate customers who have reached the side constraints.

The question then is, perhaps there is scope for the side constraints to be relaxed. In other words, rather than being a CPI side constraint, perhaps it could be a CPI plus 1 or more side constraints?

Finally, does the fact that some tariffs are below target impact on competition? We had some discussion about that earlier. This is a concern that PIAC had, that not all customers are likely to become contestable, and this is because their consumptions are so low that a competitive retailer would not be able to offer them a competitive contract.

They are basically the issues that need to be considered in this session.

MR COX: Thank you, and I will ask Graeme Lees to lead off.

MR LEES: If we take the EnergyAustralia view of where we would all be by now, everyone has accepted that all the targets have been rebalanced, the optimum view as Jim said, you are right, we don't need these target tariffs and we threw them all out altogether. We can only talk about this in the context of having appropriate target types. EnergyAustralia thinks there should be different target types for residential and business and they should be cost reflective, so we make the assumption that is where you set them.

Under that assumption, side constraints are as they are, we are quite happy with them, we think they are reasonable and we think there is obviously good reason why they should be there. The only thing is that where there is a resetting of the target it is also logical that you relax the side constraints to try to get that target. If you adopt our principle that the OP2 target isn't cost reflective because of the long-run marginal cost issue, you should be able to relax the side constraints to allow us to get to that target within a reasonable period, otherwise you get the situation where you have targets set right but you have never got any chance of getting to the targets.

Just talking about the off-peak issue, I think everyone accepts that those tariffs aren't cost reflective. What we should get to the idea is that off-peak customers are also low income customers, because they are not. Jim is an off-peak customer, Mike is, we know that --

MR COX: I told him.

MR LEES: We don't have dossiers on them! They are not that because they are low income earners, so we should not have the argument of you cannot increase off-peak by more than the side constraints because it will penalise low income customers. If you want to protect low income customers, which are a different subset to low peak but do overlap, you have to have something else in place to protect them because what we are trying to do with these off-peak customers is not to make windfall profits from them by increasing the charge to them, what we are trying to do is give them the incentive to do something else. Jim and Mike would get gas connected if it was cost effective to do so because they have got gas down their streets. That is what we are trying to do.

By leaving it where it is and not bringing it up to where it should be, you have the issue. It is contrary to what we are trying to do or the Government is trying to do with green, send the right messages, because basically we don't want the off-peak component to go up so we make more money out of them, we want it to go up so we can give them gas or solar. We are also happy for them to stay with gas. The green penalty on the off-peak is exactly the same as on general supply and that is really the issue.

Basically the only other thing I want to say is, does the target tariff hinder competition. I don't know. Certainly if it is set incorrectly, it does. No one would dispute that. If it is set correctly, I don't really have a view on that, but you have to set them correctly.

That is all I wanted to say.

MS HARMAN: We will address briefly the issue of if you have target tariffs set appropriately, side constraints necessarily will impede actually meeting those tariffs anyway, and in regard to that, for reasons of cost reflectivity, we support them being relaxed. We certainly recognise the balance between



tariffs being set at an appropriate level and the safety net issues and see that as a transition period as well.

We would encourage the transition to be happening sooner rather than later, and it leaves a rather important issue that I am sure PIAC would like to address, the low income consumers. We see that as being addressed largely through two different manners: one is the social obligations or CSOs which we believe should exist but, two, is also the responsibilities on the energy industry to come up with an innovative solution to that and innovative products to meet the requirements of those customers.

MS WALDMAN: I would like to start with the target tariff and support TXU. In the words of the original IPART determination, the target tariff is based on the costs of supplying electricity and so therefore it should cover that cost. In practical terms the current target tariffs set for Integral do not cover the costs of supplying electricity to all customers and they do not provide an adequate allowance for cost to serve.

So while we agree with the definition of what a target tariff is, current arrangements which have entrenched under-recovering tariffs do not reflect this definition. In terms of actually improving the definition of what a target tariff is we believe it should be expanded to cover the cost of supply and also include a sufficient net margin to cover the risk associated with the competitive market.

As far as the path to target tariffs goes, given that we believe they are too low and they need to be increased and that we are going through this process in order to test the building blocks, the elements, we believe this needs to be urgently addressed and that we do need to establish an appropriate commercial return for the retail sector and therefore promote wider competition in the market. Our view in relation to the path is that IPART should provide the scope for retailers to move from the current and often under-recovering tariffs to new increased tariffs from the next retail price adjustment date of 1 August 2002.

In relation to the side constraints, again we actually agree with TXU that there are two issues associated with the side constraints in achieving those target tariffs. Firstly, there is the current asymmetry between the network and the retail side constraints which effectively means for retail tariffs below target they cannot be increased to achieve that target level and in fact where the full network side constraints pass through the under-recovering retail tariff moves further away from the target.

The second point in relation to side constraints is that it provides for efficient transfer to those new target tariffs from 1 August and we recommend that IPART allow a relaxation of the side constraints to enable the current target tariffs to efficiently transfer to any new increased target tariffs in the competitive marketplace.

As far as whether the target tariffs hinder competition, I think however you define it we agree with EA, that they are not set correctly so in some way, because of that, whether they are rebalanced or they are inappropriate, at that point they are hindering competition and that from an overall industry perspective new entrants will be reluctant to enter the market based on those current target tariffs if there is insufficient margin to recover their costs. This can only be addressed by increasing the target tariffs and allowing new entrants to move to those as quickly and efficiently as possible.

MR WELFARE: I probably don't have a great deal to say other than I prefer Jim and Mike to stay on off-peak. If you actually think logically about that, if people move to other forms of energy outside the off-peak range that they have, it is likely to become more peaky and as a generator we will have to buy the bits of junk that cover that load shape. They are expensive and if the rates are not set correctly and do not reflect it all the way back to the producers, the lights will eventually go out because we will not be able to fund the purchase of the bits of junk that supply energy in the long run.

MR COX: We might now move to AGL.

MR KELLY: Our position is obviously that we support any arrangements which allow flexibility in pricing to customers but recognising that in consideration of the target tariffs there are really three aspects that need to be considered. One is obviously the level of the target tariffs, two is the actual time taken to achieve those target tariffs and in that consideration there is obviously the impact of the side constraints on the timeliness of that achievement balanced against the social aspect of any price shock to customers. And the third step that needs to be considered is the extent of any embedded cross-subsidies in those target tariffs, how we actually get to the position where we get cost reflectivity in the tariffs.

MS TERRI BENSON: As Michael highlighted at the



beginning, side constraints and transition tariffs are probably a key issue to Country Energy. We are in the position where we have a significant number of tariffs below the target and therefore transition tariffs to the target level is important for us. For us the target tariff is the tariff that represents the cost to supply and it should ensure a commercial return to the retailer. It should also achieve equitable pricing across all customers and it should not undermine competition.

As came out during the last session, it is a huge balancing act for a tariff to do all those things and often each of those things are in conflict, so trying to get a balance is difficult. However, if we agree that the target tariffs are appropriate and that they have been designed and send the appropriate pricing signals, the tariffs need to get the target levels.

We support the transitional approach in the determination. We have also maintained that it would be inappropriate to suddenly introduce target tariffs and have price shocks to customers. Therefore we support the transitional approach. However, we probably would like more flexibility on the side constraints in order to get there. The way the side constraints work at the moment is that our tariffs won't get to the target.

We believe that relaxing the side constraints won't mean price shocks, it can still be managed in a way that customers will not be impacted adversely. At the moment the way the side constraints work is that at the customer level it only takes one customer in your model to breach the side constraint and you are impeded from the whole tariff. It is that inflexibility that makes it difficult for transitioning tariffs.

The other point with the side constraint is the disconnect to the network side constraint which Karen already has mentioned. If networks utilise their CPI plus 2 per cent or $30, effectively there is no room for the retail price to move at all, the whole side constraint is taken up.

On the question of does the tariff hinder competition, if tariffs are not cost reflective obviously competition would be undermined because it is difficult to offer a customer a better price. However, there is a trade-off, as we talked about before in the balancing act, in transitioning the tariffs to meet the full cost of supply, to balance the interests against competition and therefore ensure customer choice isn't reduced. However, the longer that transition takes in recognising the balance the larger the risk to retailers because as customers churn away on the more profitable tariffs the mix of non-cost reflective tariffs to the retailers increase, therefore affecting profitability for the retailer, which we think should be borne in mind.

In relation to the approach to determining whether a tariff is at target or not, whether you take a component approach or average cents per kilowatt hour, this is something we have grappled with because we have a range of tariff structures, probably every combination you could possibly want, or not want, and we believe that for us it should depend on the impact on customers and it should not be a question of how to interpret that. Whatever achieves the transition to a target level is the more appropriate way of treating it. If that means for some tariffs that are not in a fixed and variable structure, the average cents per kilowatt hour should be applied; if the existing structure of the tariff means we can achieve transition in a component approach, that should be the preferred approach, but we don't think to make one rule will be appropriate.

MR COX: Thank you. PIAC?

MR WELLSMORE: There may well be an argument to treat things like off-peak differently in the setting of the targets and the setting of side constraints. I don't think we baulk at that idea at all. We still have the debate about what was going to be the appropriate treatment for OP1, off-peak, but certainly you could treat them in different ways.

The question I am still unclear about is when off-peak was being discussed in the retail submissions, how it is that off-peak apparently is so far below where it is supposed to be or needs to be? I am not sure how we got to the situation where off-peak is so damned cheap. I assume there is some historical explanation for that. I don't know what it is, I wasn't around at the time, but that is a historical factor that has to be borne in mind when talking about side constraints and target tariffs and transitions.

We see a side constraint being a social policy issue. Obviously the debate here - side constraints has been raised in relation to the speed of the transition to the target tariffs. We think it is crazy to have different tariffs, people on one side of the street paying different to the people on the other side. However, from our situation, there are 400 or 500 different tariffs out there. Where did they come from? They came from the situation of making a decision about what the tariff is. Now people are saying, customers have to see reason and



they have to accept all manner of individual negotiated rises in their prices, and how are customers, households or groups of households or classes of customers, really supposed to be able to debate the appropriate rate of transition for them towards the target tariff? You are asking a lot of the community really.

That is where you come back to the idea about side constraints being a form of regulation that actually comes from the view of saying, let's have some social policy at work here. The thing about the target tariffs from our perspective is really whether or not over the long term the businesses are earning the right or the reasonable or appropriate or earning some amount of money from their customers to allow them to do the things they need to do, so in other words the target tariffs should not be set at a level where a business will go bust or not pay their dividends to Treasury - because everyone likes dividends to Treasury going to houses and schools and those sorts of things - so if you take that as a given, we have not heard the argument that that is not occurring, that target tariffs will force people out of business, so we are back to the argument of Trish before, there is always going to be some cross-subsidy, you can't unpick them, some level of smearing between people.

Essentially that is what the target tariffs are supposed to be doing over time, I guess taking that smearing is a given and saying, instead of having lots of small groups of customers with smearing within them, let's have a smaller number of groups and have smearing in there. Either the total costs are being recovered or they are not. Some customers may be returning more, some may be returning less, but that is always the case it seems to us in any event.

So, lastly, the issue of new entrants. I am sorry, you won't get much joy from us on that. We said two years ago, look, it astounds us I suppose that people could suggest that incumbent or regulated customers who are probably never going to move to a negotiated contract, whether because of choice or they are just not attracted to the second tier retailers or whatever, that those people ought to be somehow carrying costs or carrying a burden in order that the second tier retailer can operate and that it looks a lot more pleasurable for those people that will change. I can't think of another market where that argument would get up. Anyway, that is us for side constraints.

MR RAY: I guess from our point of view side constraints are a major problem as well. The issues of asymmetry between the network and retailers have been discussed but it is a bit wider than that. The retail limit also includes GST so there is a narrowing of the margin between the $30 for the network and the $21.70 or whatever it is for retail. We are at a time now where there is a cessation of derogations on insurance pricing which will allow us to approach the tribunal for possibly increasing greater than CPI for network price increases. Obviously if that occurs that will put further pressure on the retailer in not being able to move their tariffs so we are at a point of time where we need to increase network prices to recover increased costs, but at the same time the retail side of the business also needs to make a profit, service customers and pay dividends, and we are an integrated business so that is an issue.

Certainly if the overall limit is what the retailer sets out on the bill then they will get further squeezed as the networks recover the cost. Certainly from our point of view the immediate problem is side constraints and trying to recover adequate revenue.

In analysing our tariffs, we've looked at a number of these. Some are below the target level, some are above and some have got a cross-over point in between. The question is how do you determine it? Do you shift your block arrangement so that the under-portions don't get up to the target level? Do you, as has been suggested, increase it and then do a rebate system? It depends on the flexibility of your CIS systems in doing a rebate determination, whether you do it on a monthly calculation, on a rolling 12 months, or on a 12 month block. There are a number of ways of doing it provided your billing system has that capability.

Side constraints is certainly an issue we're grappling with and it's going to become more of an issue. I would certainly agree with the points made before by Country Energy about the definition of target tariffs and whether target tariffs hinder competition. Retailers have to be able to provide a service and a product to customers and they need a return to be able to do it. I think target tariffs need to be at an appropriate level.

THE CHAIRMAN: Are there any further comments from members of the panel?

MR LEES: Jim was saying that in the past businesses made mistakes and didn't increase tariffs when they could have and that's maybe why some of the off-peak tariffs with some of the businesses are not what they should be. Yes, we've done that but we're not embarrassed by that. Companies don't necessarily make the right decisions but that is no reason to



not redress that situation until the end of time. That is really all we need to say about that. It doesn't matter what the reason was. These cost reflective aspects need to be addressed.

THE CHAIRMAN: Are there any further comments at this stage? As I see it, everyone seems to be agreeing that side constraints are needed. Everyone seems to agree that there's a balance between getting the tariffs in a reasonable time and protecting the customers. The essence is that that balance should be shifted towards faster recovery and that there should be more flexibility in how the side constraints are applied to tariffs.

As I understand it, that seems to be the crux of what people are saying. Are there any comments on those questions?

MS TRISH BENSON: Can I say something?

THE CHAIRMAN: Yes.

MS TRISH BENSON: I haven't read all the submissions in detail but it might be worthwhile hearing from retailers. The complaint about the tariffs is that they're not going to recover costs or those that are under-recovering aren't going to recover costs during this determination. My assumption is that they'll get there eventually. I would like to make that point.

What I would like to know is the proportion of tariffs compared to those that are over-recovering that won't meet the target by the end of this determination, which is two years' time. The social policy stuff is really important. Maybe we should just keep cross-subsidies. I think we should debate that point.

THE CHAIRMAN: Does anyone want to respond to that? The main points are how much under-recovery tariffs are likely to be and how important they are likely to be in the period. There is the factual issue and there's the balancing issue of social policy so as to get to the recovery level in a reasonable time. Maybe people don't want to speak in specifics about that. Maybe someone would like to speak about that.

MR LEES: I said at the start I thought we had to progress in the context that we accept the targets have to be reset and then you can talk about what side constraints you need to get. Even in that context for EnergyAustralia it's only the off-peak ones that we have to increase by more than the side constraints to get to the target tariff by the end of the determination. If you don't reset the target tariffs, heaven forbid, we're talking about a one-off peak 1. The other ones are above target anyway; they won't increase at all. I don't mind saying that. That is the only comment we have.

MS WALDMAN: I am happy to reply in a general sense. We go back to our original principle and the principle is that we're here to provide competition and customer choice and therefore, you have to look at how this target tariff issue is hindering that from a customer, an individual business and an industry perspective.

From a customer perspective we're saying there's really not sufficient head room to encourage competition and so they are going to be limited in their choices. Where that impacts on the price and issues of price shocks, we're happy to work with the Tribunal to minimise the impact of that and to consider that.

EA referred to the sorts of CPI increases that you're looking at to go up in this area. In relation to the individual businesses themselves, there's only so long that you can supply electricity below cost and remain viable for survival in the industry.

From an industry perspective, if we are about competition then there has to be a mechanism by which you can encourage entrants to enter the market. If you look at the full stakeholder perspective, it is a balancing act. You can't continue to supply a low cost product.

MS TERRI BENSON: From Country Energy's perspective, our modelling shows that transitioning tariffs will probably be 60 to 70 per cent still below target at the end. That is with the current side constraint, which is one reason why we've been trying to look at other options of transitioning those tariffs.

In our submission we have alluded to this rebating system at the customer level, but it does depend on CIS and that's trying to stop the existing side constraint which applies at customer level, stopping tariff level adjustments occurring, but that's so we can work within the current side constraint where flexibility on that current side constraint would save us a bit of money on changing the CIS.

MR RAY: I think our off-peak tariffs are the ones that are probably undercovered. There would have to be significant price increases to achieve the target by the determination. Similarly, because you can't have an off-peak tariff in isolation, it is part of your total package of having a primary tariff as well.



At the end of the day you're still limited to the annual increase, if you decide not to move your primary tariffs, as to how far you move the other one. Your off-peak tariffs are not your main consumption. It is going to be very dramatic across all the customer bases.

THE CHAIRMAN: Are there any further comments or suggestions from the back of the room? It seems to me that you have left us with a balancing act: that's kind of you. We might move on to session 3 on regulated retail tariffs. I think Michael has some comments to make on that .

MR SEERY: Thank you, Jim. As I referred to earlier, the third block of terms of reference related to whether there should be any new regulated retail tariffs and secondly, it looked at the issue of off-peak tariffs, including the merits of a shoulder tariff.

As I said in my opening comments, a regulated retail tariff is led to be a plain, manila, non-fancy tariff. That raises the question of how many regulated retail tariffs there should be. As Country Energy noted, they currently have over 300 regulated retail tariffs, which is in part or largely due to the fact that Country Energy is an organisation that has been created out of a large number of smaller distributors, as they were called in those days, and these distributors haven't been able to get those tariffs to a common scale, even when they are still three separate businesses. It has become harder for them now that they are one business.

Ideally, there should only be a few regulated retail tariffs. Also, choice should be an issue for negotiating contracts, not for the regulated retail tariff area. The issue we need to look at here is why should there be new regulated retail tariffs? Is it because of changes in the network tariff structures? For example, the time of year structure may change or something similar. Maybe there's an issue in that case.

Is it a green issue? Is it trying to pick up the green environmental-type structure? Green premiums have for a long time not been regulated by IPART. Is it to provide choice? It is my view that regulated retail tariffs are not the place for choice: that is for the negotiated environment. Is there some other reason that I haven't thought of yet?

The question, of course, is under the Electricity Supply Act the Tribunal determines regulated retail tariffs in a determination. We will be going through a new determination phase in the next month or so. What if someone wants to have a new regulated retail tariff outside that determination? How can that be achieved under the current framework? I don't think it is possible. That means that people, if they have to have new tariffs for some reason, need to fit them within the framework that we have at the moment.

The other issue relates to the variable R and whether and where off-peak fits into that. Currently we have a variable R for peak and for controlled flow but off-peak too. A controlled flow product is sold in the off-peak period and in the peak period and there are questions about whether the current variable R applied to off-peak 2 is the appropriate level and that is the standard off-peak usage price; that is certainly an issue.

The other issue relates to timing these tariffs and, as I said, in the terms of reference it requires us to think whether there should be a separate shoulder tariff.

The question probably is should the current control load R, variable R, be used in the final use tariff or should all of the R components in the time and use tariffs be the one value, that is, the peak value? They are some of the issues that relate to this particular session.

THE CHAIRMAN: Thank you. I might open it up for discussion. Perhaps we could ask Country Energy to lead off.

MS BANICEVIC: My name is Natalie Banicevic and I am from Country Energy. I will start with what is a regulated retail tariff? Country Energy believes that the current transitional existing prices should reflect the price of supply and eventually they should mirror the target tariff. It is also a safety net for consumers who choose not to compete or are not in a position to compete or opt back from the competitive market.

Should new regulated tariffs be introduced? We believe they should, particularly if a new network tariff is introduced, because effectively you'll have a new target with no retail tariff to match it.

The creation of new products outside your plain manila product, as Michael alluded to previously, should be left to the competitive market where there is scope for innovation and new ideas.

In relation to new R components, off-peak 2 is



different to off-peak 1 in many ways and really is not representative of the current controlled load tariff. Some of the off-peak 2 tariffs in our area can actually run up to 20 hours and compared to off-peak 1, which is only 7 hours, we've got a big mismatch there between the peak and off-peak price you pay under ETEF.

This ultimately sends incorrect price signals to customers and eventually off-peak 1 and 2 will come closer together, with really the only differential being the network price, which is slightly more but it is not enough compared to what you pay with your peak and off-peak prices in ETEF.

The introduction of a shoulder target we feel is not really representative of the cost of supply because the targets should be representative of the costs of supply. Because there isn't a shoulder period in the ETEF is not really a reason to introduce the shoulder target. Again, the differential in the shoulder period of a retail price is driven by the network price, not the ETEF.

If the ETEF were to change my peak shoulder off-peak type approach, then there's room, I suppose, for the target to reflect that, but at the moment we are in a peak and off-peak type environment and really there's not a lot of scope for a shoulder component. I think that is pretty much all I wish to say.

THE CHAIRMAN: Thank you. I will move on to PIAC.

MS TRISH BENSON: I don't know if we've actually got much to say about this section. I suppose a couple of points should be made. It was always our impression that in this process we would try to rationalise the number of tariffs and now we're talking about having new tariffs.

It sometimes worries me a bit. That was obviously one of the original objectives of the determination. It would seem to me that the price rises people are talking about around off-peak hot water systems may not actually achieve the objectives of switching to another fuel source. That is my comment, particularly when and indeed EA's price increase might be larger than $17 a year. I am not sure, Jim, whether you would switch to gas or solar because you're charged $17 a year more.

MR LEES: We should be charging more, shouldn't we?

MS TRISH BENSON: That is a point we often make, that price signals are a pretty blunt instrument and they have to be actually very, very large to change people's behaviour. We would like to make those points.

THE CHAIRMAN: Thank you. Adrian?

MR RAY: Jim, I think there should be scope to introduce new tariffs, even if it is purely to obsolete or simplify an existing range of tariffs. I don't believe that a determination should lock in a particular set of tariffs over a long period. The obvious other thing is to provide greater customer choice or a range of products to customers.

One of the points that should be brought out in relation to off-peak tariffs is that they are used in both residential and business. There are different both in urban and rural. We often tend to focus on the low income residential customers but off-peak 1 and off-peak 2 tariffs are available to both classes of customers, business as well, and there are different side constraints applying to those.

Again, we have asymmetry there between what we might be able to do with an off-peak tariff that was purely targeted to business, versus one that is purely targeted towards residential. They are both coming from generation and obviously from the same marginal costs.

In terms of whether there should be a shoulder tariff or separate Rs, I'm not quite sure whether by saying that we introduce a shoulder tariff you're implying that we've got to be able to measure it, which implies time and use metering or profiling or some other method. In a lot of cases - I would have thought in most times - we're probably looking at trying to operate the market, at this point in time, with basic metering and all of the vagaries and problems with profiling.

I am sure as time goes on and we get the availability of more cost effective and time use metering, we could do a whole range of things and offer a greater range of product to customers at the right price, but I don't necessarily agree that we should be sort of running out to introduce shoulder tariffs.

There may be good opportunities if the technology is there and the market retailers have a particular package to offer, but I mean it can create some problems as well.

THE CHAIRMAN: Thank you. Graeme?

MR LEES: Should new regulators be introduced? I can see all the arguments why you wouldn't when you have a huge amounts of tariffs. I don't want to say I



don't think we should close the door and say definitely no. I think anything should be looked at on its own merits: for instance, network time of use tariffs and a passing on of retail time of use tariffs. I don't know how that would work. I don't know how the networks would impose a retail cost, whether it is tier 1 or tier 2.

I think we should keep the option open that any of these things should be looked at going forward, because there might be some fantastic management initiatives that come forward over the next couple of years. We don't want to close the door and say we can't go ahead with that.

Green, yes, sure, if something like pure energy or any products like that are our premium on existing tariffs, that that's how we go forward, we really don't have an issue.

I have already spoke out of cont ext about off-peak. It is a matter dear to our hearts. I have really gone through all that –

THE CHAIRMAN: You can say it again if you wish.

MR LEES: No-one is going to change their behaviour just for $17 or $40, if you're a 9 megawatt customer. That is just one string to our bow. We are installing solar hot water systems at below cost because we're getting the benefits of those. We are in negotiations with the Government with respect to compliance on jurisdictional matters.

With respect to green, it's tough to get our compliance factored in so that we actually get more benefit from these demand management initiatives. It is very costly to offset our abatement gap. We are looking at new interest loan schemes to shorten the payback on a solar hot water system from five years to less than half that time. That is one of several things but it doesn't help if it doesn't move.

THE CHAIRMAN: TXU?

MR EGAN: We have just a couple of points really. First of all, I think we're best off leaving the technicalities of off-peak and shoulder, et cetera, to the locals. Our general thrust would be that choice is best provided through competitive products, through special products that are outside the regulatory umbrella. There is perhaps a minor system's point there. I assume a new regulated tariff would at least be immediately at the target level and therefore immediately cost reflective: that would be good.

THE CHAIRMAN: Thank you very much. Integral?

MS WALDMAN: On the new regulated target tariffs, I guess what we'd like to see is that you have a basic suite of regulated target tariffs developed and formalised so that it is as simple as possible, as was mentioned earlier. Then you'd look at the scope for the retailer to introduce different products based on a contractual basis and if they want a specific green tariff, then that should be lower market offering rather than a regulated tariff.

However, there is an argument for a regulated tariff to recover the cost of greenhouse abatement targets; for instance, when these costs go across the entire base rather thanthose that have just chosen to enter the market. We believe that while it was and it is important to have regulated tariffs to provide customer protection at market start, it should be recognised that over time, and assuming the market developed appropriately, there shouldn't be a need for regulated tariffs in the longer term.

We would support anything that goes to fewer rather than more regulated tariffs. In what circumstances you should introduce new ones, however, given what we're saying is about a basic suite, we think there does need to be some mechanism whereby there has to be a direct pass-through of any new network tariffs that impact on the regulated tariffs, so retailers don't have to bear the additional risk purely because the network has decided to introduce a new tariff. That wasn't contemplated when regulated tariffs were set.

In so far as the separate R for shoulder or off-peak, we have stated that a separate variable R factor should be determined for the off-peak 2 tariff and it should incorporate the cost of supplying the energy in the shoulder period as well as the off-peak periods.

We would support anything that allows more appropriate pricing signals, as subtle as they may be, but going in the right direction and from a demand side management and energy efficiency viewpoint it is important for customers in every way possible to understand the cost impacts of using energy actively at times during the day.

MR WELFARE: My points are basically the last two points just made and that was that if there is a possibility of swinging customers, a better type of usage, more cost reflective - and that is possible - then we would be wholly supportive of that.

MR KELLY: Our position is that we would like to see no regulated tariffs but, putting that aside, I think



one of the points to recognise in regulated tariffs is that customers do have a short span, when talking about innovative products, that should be in the negotiated contract. What a customer does is compare it to the regulated tariff they are currently on, so the control and constraints and the way that those regulated tariffs are changed does have an impact into the negotiated contract market.

Another aspect that probably needs to be considered is if you do introduce new regulated tariffs, what is the option for the customer? Is that imposed on the customer or does the customer have a choice of moving to that new regulated tariff?

MR COX: Further comments?

MS TRISH BENSON: I think I may have given the impression we do not support EnergyAustralia's demand management strategies. We do.

MR COX: I get the impression that most people have a view that there should not be new regulated tariffs or only in very exceptional circumstances; is that correct? Does anybody strongly disagree with that?

MS TERRI BENSON: We think that there should be the ability to but there should be a framework for it to happen. I am not saying there should be a blanket rule you can't do it. If it is appropriate for transition tariffs or to match network change or to cope with demand management issues not thought of, there needs to be a framework.

MR COX: The presumption should be no, but there might be exceptions; is that right?

MR WELLSMORE: If I can just comment, the current determination has two years left to run. At best if somebody comes out in the next 12 months with a fantastic idea that everybody thinks is the way to go, yes. We are not that far off anyway.

MS WALDMAN: What we said is, you can't write it off completely, that there should be some mechanism if something unforeseen happens.

MR COX: Something unusual, it could happen, there would have to be a strong case?

MS WALDMAN: Yes.

MS TRISH BENSON: Reasonable.

MS TRISH BENSON: That will bring out the lawyers.

MR COX: Yes, "reasonable" is a difficult word. I am not sure where we ended up on the peak shoulder issue. My impression is that most people are not strongly supportive of a separate shoulder component but there should be consideration of the off-peak costs is where we came out.

MR LEES: We are very strong on what we consider, what we call the off-peak 1 and off-peak 2 because of the cost components. We don't think there is anything wrong with having as many targets as you have major towns. We have 95 per cent of our customers on four tariffs. We don't think four targets is unreasonable for that. We don't have the issues of Country Energy, but certainly the cost make-up is different.

MS BANICEVIC: At the moment we have a significant number of targets. Even if we fix up the problems with the tariffs, we will still have a number of tariffs.

MS TERRI BENSON: There is the control load R. At the moment the control load is supplied, not all of our technically controlled load tariffs are off-peak 1. The wa y the control load R is constructed to be off-peak 1 only does not apply to our controlled load tariffs.

MR COX: So it is a miss-match between reality and what is in the R?

MS TERRI BENSON: Yes.

MR COX: Any comments from people at the back?

PROF PARRY: Should there be regulated tariffs? I remind people that New South Wales is now compliant with the National Electricity Law and the Electricity Code. As a jurisdictional regulator we don't under the code regulate retail tariffs. Our role has been given to us by the Minister, who asked us to set for the period 2004 default tariffs, which we have done, and he has asked us to review those tariffs, which we are now doing.

I don't believe, even if it was argued, that it is open to us to set a category of any other tariff that DNSP or a retailer might think is appropriate at some point in time. I don't think that is possible. If there is a change in circumstances, I pick up Jim Wellsmore's point about we have only got two years to go anyway, so if there are certain circumstances that arise presumably it is open to the Minister to refer to us the question of whether there should be some other category or specific type of regulated default tariff which he is presumably able to set. I don't think it is open for us to do anything to give us flexibility because I don't



think the power is there - subject, of course, to legal advice as always, the standing caveat.

MR NICK SAPHIN: Does that cover an old tariff introduced last year?

PROF PARRY: I don't know the answer to that, but I keep on being told, maybe Michael remembers what the advice is, that some of the sorts of things that EA raised I think they told me could have been accommodated in a way like that, but maybe Michael has the answer.

The question was, is it possible to resurrect or reintroduce or bring back to life a tariff that is extinguished in some form and use that under the current regulative arrangements, because I know there has been a conversation between the EA and us on some of the specifics and I can't remember where that ended up in terms of what mechanisms. Michael, you don't know the answer?

MR SEERY: No.

MR COX: The answer may not be easy. That does tend to reinforce the point that new tariffs are difficult.

MR SAPHIN: I think we are trying to have too many different ways here. I know it is a balancing act but IPART did a report on demand management this week for retail and there are things in there about smart metering and doing things with the customers, and at the same time we are talking here about issues as to whether tariffs are cost reflective and monitor what the market prices are. Unless we actually address the first one, you will never get the second one to drive changes in behaviour.

I know it is difficult to balance the two out but if we don't address the first one in terms of making the tariffs cost reflective in terms of what the market costs are, this would not be open to negotiation. If you close off completely new tariffs for those customers, you will never get any change in behaviour if you are trying to address the demand management issues in the discussion paper.

MR COX: I sympathise with your comments. Anything else anybody else wants to add at this stage? If not, we will close off the session now. Thank you very much for your comments. I believe the next stage is that we are willing to consider further submissions on the issues arising from today up to 10 May, so we would obviously like to hear from you if you have more to add. Thank you very much for your attendance and your contribution.

(At 12.05pm the forum concluded)