



Review of Regulated Retail Tariffs and Charges for Electricity 2007 to 2010

Issues Paper

Electricity - Issues Paper
July 2006

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Submissions in response to this paper are due on **8 September 2006** for standard retailers and **6 October 2006** for other stakeholders.

Submissions should be sent to: **Review of Regulated Retail Tariffs and Charges for Electricity 2007-2010**
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1 INTRODUCTION

The Independent Pricing and Regulatory Tribunal of NSW (the Tribunal) is responsible for setting the regulated retail electricity prices charged by Country Energy, Energy Australia and Integral Energy to small retail customers on standard form customer contracts. The current determination on these prices will expire on 30 June 2007. The Minister for Energy has asked the Tribunal to review and determine the regulated retail electricity tariffs and charges that will apply from 1 July 2007 to 30 June 2010.

The Tribunal's terms of reference for this review specify the matters it must consider in making its determination. The Tribunal is now seeking comment from interested parties to inform its decision making.

1.1 Terms of reference for the review

The terms of reference for this review require the Tribunal to investigate and report on the regulated retail tariffs and charges to apply from 1 July 2007, and to consider and report on the basis for regulating miscellaneous charges, including security deposits. The review applies to the three standard retailers, Country Energy, Energy Australia and Integral Energy, and covers the regulated prices and charges which apply under standard form contracts to small retail customers.

The Tribunal must consider the NSW Government's policy aim of reducing customers' reliance on regulated prices, and the likely effect of its determination on competition in the retail electricity market. The Government's position on new generation is also relevant. Demand for electricity in NSW is increasing and in the Government's Energy Directions Green Paper it stated that additional generation capacity or demand management is likely to be needed by the end of the decade.¹ NEMMCO has identified that there will be generation reserve deficits in NSW from 2008/09.²

The terms of reference require the Tribunal's determination to ensure that:

- regulated retail tariffs and charges for all small retail customers are at cost reflective levels by 30 June 2010 (taking into account all the matters listed below)
- any 'price constraints' allow for the further rationalisation of regulated retail tariffs and movement to full cost recovery over the determination period.

In addition, the Tribunal must consider the following matters, many of which relate to the costs that retail tariffs are to recover:

- an allowance for electricity purchase costs, based on an assessment of the long run marginal cost of electricity generation from a portfolio of new entrant generation to supply the load profile of customers remaining on regulated retail tariffs
- mass market new entrant retail costs and margin
- an allowance based on the long run marginal cost of retailer compliance with any Commonwealth mandatory renewable energy target (MRET) requirements and the

¹ NSW Government, *Energy Directions, Green Paper*, December 2004, p 3.

² NEMMCO, *National Electricity Market - Statement of Opportunities 2005*, Executive Briefing, p 7.

- licence requirements relating to the NSW Greenhouse Gas Benchmark Scheme, and which takes into account price and volume
- energy losses as published by the National Electricity Market Management Company (NEMMCO)
 - a mechanism to ensure network charges as determined by the Tribunal and the Australian Competition and Consumer Commission (ACCC) and the Australian Energy Regulator (AER) are fully recovered
 - fees (including charges for ancillary services) as imposed by NEMMCO under the National Electricity Code
 - an allowance for expected movements in regulated components and NEMMCO fees
 - a mechanism to address any new, compulsory scheme that imposes material costs on the retailer (such as an inter-jurisdictional emission trading scheme)
 - the fact that the Electricity Tariff Equalisation Fund (ETEF) will cease to operate within the determination period
 - the hedging, risk management and transaction costs that retailers will face in the absence of the ETEF
 - the forecasting risks that retailers will face in the absence of the ETEF
 - the Net System Load Profiles (NSLPs) of each standard retailer, as well as projected future changes in those NSLPs
 - the requirement in the NSW Greenhouse Plan to require energy retailers to offer a 10 per cent Green Power component to all new (or moving) residential customers
 - the potential to simplify regulated tariff structures, including the potential to remove obsolete tariffs
 - the impact of the determination on demand management.

Arguably, the most significant differences between the terms of reference for the 2007 review and those for the 2004 review are that:

- They require the Tribunal to recognise retailers' hedging, risk management and transaction costs. The Tribunal notes that there may be some tension between this requirement and the requirement to include an allowance for electricity purchase costs based on an estimate of the long run marginal cost of generation, rather than the forecast pool price.
- They require the Tribunal to consider retail operating costs and margin based on those of a mass market new entrant, rather than those of the standard retailers as in previous reviews. As a mass market new entrant's retail operating costs are likely to include market and customer acquisition costs, plus costs for billing and IT systems and call centres, this requirement may lead to a higher overall cost than is included in the 2004-2007 determination.
- There is no requirement for the Tribunal to have regard to the impact of its determination on customers. If the Tribunal does decide to set price constraints, it must ensure that these constraints allow tariff rationalisation and cost reflectivity.
- There is a stronger focus on ensuring that tariffs are cost reflective by the end of the regulatory period.

The probable impact of these changes to the Tribunal's terms of reference will be to increase the level of cost reflective tariffs. (A copy of the full terms of reference is contained in Appendix 1.)

The terms of reference require the Tribunal to consider costs of a mass market new entrant retailer while requiring it to consider issues specific to standard retailers (for example, recognising that ETEF will cease operation within the determination period). The Tribunal will need to consider the basis for considering cost reflectivity – whether all costs should be considered based on a mass market new entrant retailer or on a standard retailer or both.

1.2 Review process and expected timing

The Tribunal has been asked to provide its determination and report to the Minister by 14 June 2007.

This issues paper is the first stage in the Tribunal's consultation and review process. Submissions in response to this paper are due on 8 September 2006 for standard retailers and 6 October 2006 for other stakeholders. Details on how to make a submission can be found at the front of this paper, on the page facing the Table of Contents.

The Tribunal intends to engage consultants to develop cost allowances for two significant cost areas:

1. The energy cost to be factored into the regulated retail tariff, which includes allowances for:
 - the long run marginal cost of electricity generation from a portfolio of new entrant generation
 - the long run marginal cost for retailer compliance with mandatory renewable energy targets and the NSW Greenhouse Gas Benchmark Scheme
 - hedging, risk management and transaction costs
 - NEMMCO fees, including charges for ancillary services.
2. The mass market new entrant retail operating costs and retail margin.

The consultants will be required to consult on their draft methodologies prior to preparing the draft reports. The draft reports will be publicly released and consulted on through a public workshop and submissions. The Tribunal will use the consultants' final reports in its draft determination.

The Tribunal will release a draft determination in April 2007, calling for submissions, before releasing a final determination by 14 June 2007 with effect from 1 July 2007.

Table 1 sets out the indicative timetable for the review. An updated timetable will be kept on the IPART website.

Table 1 Indicative timetable for the review

Event	Responsibility	Date
Call for tenders for consultancies (energy cost and retail operating cost and margin)	Tribunal	14 July 2006
Information request distributed	Tribunal	1 September 2006
Standard retailers submissions on Issues Paper due	Standard retail suppliers	7 September 2006
Standard retailers to present submissions publicly	Standard retail suppliers	8 September 2006
Release of consultants' draft methodologies	Consultant/Tribunal	22 September 2006
Workshop on consultants' draft methodologies	Consultant/Tribunal	29 September 2006
Submissions due on Issues Paper from non-standard retailers	Stakeholders (non-standard retailers)	6 October 2006
Information request due	Stakeholders	6 October 2006
Release of consultants draft reports	Tribunal	24 November 2006
Public forum on consultants draft reports	Consultant/Tribunal	1 December 2006
Submissions on consultants draft reports due	Stakeholders	22 December 2006
Release draft decision	Tribunal	early April 2007
Public forum	Tribunal	April 2007
Submissions on draft report due	Stakeholders	early May 2007
Release final decision	Tribunal	14 June 2007

1.3 Structure of this paper

This issues paper has been prepared to help stakeholders to provide meaningful input into the review. The paper is structured as follows:

- Chapter 2 explains the recent policy changes that affect the regulation of retail tariffs
- Chapter 3 discusses possible alternatives for the forms of regulation that could be used for setting regulated retail tariffs, and the price limits that could be applied under each of these options. It also discusses how the Tribunal will assess the different options against the objectives for the review established in the terms of reference
- Chapter 4 looks at the matters the terms of reference requires the Tribunal to consider in setting regulated retail tariffs, highlighting how these costs differ from those the Tribunal considered in making the current determination
- Chapter 5 discusses the basis for regulating retail charges (miscellaneous charges) and the level of those charges and compares them to those in other jurisdictions.

2 POLICY CHANGES THAT AFFECT THIS REVIEW

Full retail contestability was introduced in the NSW electricity market on 1 January 2002. Since that time, small retail customers³ have been able to choose their retail electricity supplier and negotiate a retail supply contract. However, the Government has asked the Tribunal to continue to set regulated retail prices for small retail customers to facilitate the smooth transition to a competitive retail market in NSW.

Since the Tribunal's 2004 review, several changes have occurred in government policy that will affect the regulation of retail tariffs. In particular:

- the NSW Government has announced that it will phase out the Electricity Tariff Equalisation Fund (EETF) between September 2008 and June 2010
- the Council of Australian Governments (COAG) endorsed the Ministerial Council on Energy (MCE) reform agenda, in particular, to phase out the regulation of retail prices where effective competition can be demonstrated⁴
- the Council of Australian Governments (COAG) has agreed to the progressive national roll out of 'smart' electricity meters from 2007 to allow the introduction of time-of-day pricing.

Each of these changes and its implications for the Tribunal's review are outlined below.

2.1 NSW Government's decision to phase out the EETF

The EETF was put in place to allow the Government to regulate retail prices without undermining competition or exposing retailers or the Government to unacceptable financial risk.⁵ Retailers contribute to and/or withdraw from the fund based on differences between the actual price they pay for electricity and the cost of electricity assumed in setting regulated retail tariffs. Government-owned generators are also required to contribute to the fund when it falls below a certain level.

Under the existing legislation, the EETF is due to expire on 30 June 2007. However, to allow adequate time for adjustments to occur in the energy trading market, the Government has announced that the EETF will be phased out gradually between September 2008 and June 2010. The payment rules specify the following phase out of EETF:⁶

³ Small retail customer means a customer that consumes electricity at less than 160 MWh per year as prescribed in clause 7 of the *Electricity Supply (General) Regulation 2001*. A small retail customer is eligible for supply under a standard form customer supply contract.

⁴ Council of Australian Governments' Meeting, *Communique*, 10 February 2006, Appendix A to Attachment B, p 8.

⁵ Office of Financial Management *Electricity Tariff Equalisation Fund – Information Paper*, December 2000, p 1.

⁶ Office of Financial Management, *Payment rules for the Electricity Tariff Equalisation Fund*, April 2006, p 3.

Table 2 Timetable for phasing out ETEF

Date	Percentage of NSW regulated retail load supported by ETEF
Until September 2008	100
From September 2008 to March 2009	80
From March 2009 to September 2009	60
From September 2009 to March 2010	40
From March 2010 to June 2010	20
From June 2010	0

As ETEF is phased out, standard retailers will be responsible for managing the exposure to pool price risk for an increasing portion of the load associated with regulated retail customers. The Tribunal's terms of reference for this review require it to consider a number of matters related to the phasing out of the ETEF in making its determination on retail electricity tariffs. The matters include:

- An allowance for electricity purchase costs based on an assessment of the long run marginal cost of electricity generation from a portfolio of new entrant generation to supply the load profile of customers remaining on regulated retail tariffs – that is, not based on forecast market based prices. (This issue is discussed in detail in section 4.1.)
- The hedging, risk management and transactions costs that retailers will face in the absence of the ETEF.
- The forecasting risks that retailers will face in the absence of the ETEF.

The Tribunal seeks comment on:

- *Whether, for the purposes of establishing cost reflective tariff levels, it should consider the phasing out of the ETEF over a period of time or assume that the ETEF immediately ceases.*
- *How the phasing out of the ETEF will affect retailers' hedging, risk management and transactions costs over the course of the determination and whether these costs are different between a standard retailer and a mass market new entrant retailer.*
- *How it should recognise the forecasting risks that retailers will face in the absence of the ETEF and whether these risks are different between a standard retailer and a mass market new entrant retailer.*

2.2 COAG endorsement of Ministerial Council on Energy's agenda to phase out retail price regulation

At the COAG meeting of 10 February 2006, Australian governments agreed to the MCE reform agenda, in particular, to phase out energy retail price regulation where effective competition can be demonstrated, with reviews to commence on 1 January 2007.⁷ The Amended Australian Energy Market Agreement specifies that the Australian Energy Market Commission (AEMC) will undertake regular assessments on the effectiveness of competition in retail energy markets and conduct a review every two years until all retail energy price controls are phased out. States and Territories retain the right to maintain reserve price regulation powers, obligation to supply arrangements and price monitoring to protect consumer interests provided these do not materially impede competition.⁸

As part of this review, the Tribunal will examine the current competitiveness of the NSW retail electricity market. It will form its view on what form of regulation is most appropriate, having regard to the terms of reference.

The terms of reference require the Tribunal to consider the effect of its determination on competition in the retail electricity market.

The Tribunal seeks comment on:

- *the extent of competition in the NSW retail electricity market*
- *the appropriate form of regulation given Governments' aim to phase out energy retail price regulation.*

2.3 COAG's agreement to roll out time-of-use meters

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

... the progressive national roll out of 'smart' electricity meters from 2007 to allow the introduction of time of day pricing and to allow users to better manage their demand for peak power where benefits outweigh costs for residential users and in accordance with an implementation plan that has regard to costs and benefits and takes account of different market circumstances in each State and Territory.⁹

Electricity network service providers in NSW have already begun introducing time-of-use meters for small retail customers. For example, EnergyAustralia is currently rolling out 'smart' meters that are able to record consumption in half-hour periods. It intends to implement time-of-use metering and pricing progressively over the next decade, as part of a long-term plan to help reduce the increasing peaks in electricity demand by spreading electricity consumption more evenly across the day.¹⁰

⁷ Council of Australian Governments' Meeting, *Communique*, 10 February 2006, Appendix A to Attachment B, p 8.

⁸ Ministerial Council of Energy, *Energy Market Reform Bulletin No. 64*, 7 June 2006.

⁹ Council of Australian Governments (COAG) *Communiqué* of 10 February 2006, p 5.

¹⁰ EnergyAustralia website, www.energy.com.au.

The Tribunal notes that the terms of reference for this review require it to consider the impact of its determination on demand management. It also notes that under the current determination, retailers have experienced some practical difficulties in restructuring tariffs, including establishing time-of-use tariffs. The Tribunal will consider how best to resolve these difficulties as part of its review (see section 3.1.1).

The Tribunal seeks views on:

- *What problems have arisen during the current determination as a result of network roll out of time-of-use meters*
- *How the new determination could be used to facilitate the transition to time-of-use tariffs*
- *How the Tribunal should consider the impact of its determination on demand management.*

3 FORM OF REGULATION AND PRICE CONSTRAINTS

The form of regulation in the current retail electricity determination requires the Tribunal to set target tariffs, and a set of rules which govern how retailers move regulated tariffs to the target tariffs. In addition, the Tribunal has sets limits on the annual percentage increase in the retail component of a tariff and in the annual customer bill.

As part of this review, the Tribunal needs to decide what form of regulation it should use to regulate retail electricity tariffs and what price limits it should apply, if any. The terms of reference imply a range of objectives for the review, many of which are relevant to setting the form of regulation. These include:

- reducing customers' reliance on regulated prices and encouraging competition in the retail market
- ensuring that regulated retail tariffs and charges are at cost reflective levels for all small retail customers by 30 June 2010
- ensuring that any price constraints allow the further rationalisation of regulated retail tariffs and movement to full cost recovery over the determination period
- encouraging demand management
- ensuring that regulated network charges are fully recovered
- allowing for movements in regulated charges and fees and for any new compulsory scheme that imposes material costs on retailers
- simplifying regulated tariff structures, including removing obsolete tariffs.

The following sections identify several different options for the form of regulation, and the price limits that could be applied under each of these approaches. The final section discusses how the Tribunal will assess the options against the objectives implied in the terms of reference.

3.1 Broad options for the form of regulation

The Tribunal has identified four broad options for regulating retail tariffs:

- setting target or maximum tariffs based on a build up of the network and retail (N + R) cost components; this options cover the specific approach applied in the current determination
- applying a weighted average price cap
- establishing a new 'safety net' tariff that customers will need to choose to be on
- monitoring prices for some types of tariffs or classes of customer.

These options are outlined below. However, there may be other options or combinations of options that would be appropriate.

The Tribunal seeks comment from stakeholders on the regulatory approach that best meets the objectives for the review, the pros and cons of the options, and whether there are additional broad options or variations within the options that the Tribunal should consider.

3.1.1 Setting target or maximum tariffs based on N+R

The Tribunal could adopt a similar form of regulation to that adopted in the current determination, by setting target tariffs, or maximum tariffs, calculated as the sum of two components: the network tariff component (N), and the retail costs component (R).

At its simplest, under this approach, the value of N would be a direct pass-through of the relevant network charge. The value of R would be set as part of the retail determination. For each regulated retail tariff, the relevant target tariff would be calculated by adding the applicable network tariff (which may have fixed and variable elements) and the relevant R values.

There are various ways to express the R and N components and to calculate the target tariff. In the current determination, the R component is split into subcomponents and the following R values may apply:

- Fixed R (\$ per customer, per year) – one value applies to all retailers.
- Standard variable R (c/kWh) – one value each for EnergyAustralia and Integral Energy, separate rural and urban values for Country Energy and Australian Inland.
- Off-peak variable R (c/kWh) – one value each for EnergyAustralia and Integral Energy, separate rural and urban values for Country Energy and Australian Inland.
- Extended off-peak variable R (c/kWh) – one value each for EnergyAustralia and Integral Energy, separate rural and urban values for Country Energy and Australian Inland.

To calculate the target tariff, retailers must use the fixed R and one variable R value from the above list. The determination requires that the standard variable R value be used for all single rate tariffs, the off-peak variable R be used for off-peak (controlled load A) tariffs, and the extended off-peak variable R be used for extended off-peak (controlled load B) tariffs. For time-of-use tariffs, the determination requires that the standard variable R value be used for the peak and shoulder periods, and the off-peak variable R be used for the off-peak period.

The total revenue that the retailer receives from customers on each regulated retail tariff is then compared to the total revenue it would have received if the charges to the customers were equal to the target tariff. If the actual revenue exceeds or equals the target revenue, then the retailer may not increase that tariff. If the actual revenue is less than the target revenue, then the retailer must increase the tariff subject to the price limits. However, retailers are not required to ensure that the structure of their regulated retail tariffs reflects the structure of the target tariff.

The benefits of the N+R target tariff approach are that it allows retailers to transition their existing tariffs to cost reflective levels, and it allows direct pass-through of network charges. Target tariffs allow retailers to retain over-recovering tariffs and transition under-recovering tariffs towards cost reflectivity.

Continuing to use an N+R approach will allow full cost reflectivity over the determination period, subject to price limits. It will also ensure that network charges are fully recovered, as required by the terms of reference. However, the benefit of retaining a direct pass-through of network charges needs to be weighed against the limitations that this approach can place

on the scope for tariff rationalisation and innovation. There are currently more than 300 regulated retail tariffs in NSW, most of which belong to Country Energy.

The current N+R approach, combined with price constraints, has raised a number of issues such as the difficulty in introducing new time-of-use tariffs and accommodating other tariff reform being undertaken by networks. The Tribunal will review problems retailers have experienced with application of the current N+R approach to and consider variations within this overall option.

The Tribunal seeks stakeholder views on:

- *Whether the N+R approach should be retained.*
- *Whether there are variations within the N+R approach which should be considered.*
- *What modifications could be made to the current N+R framework an/or incorporated in a revised N+R approach to meet the objectives implied in the terms of reference.*
- *How the N+R approach could be designed and implemented to better accommodate network tariff reform.*

3.1.2 Applying a weighted average price cap

The Tribunal could establish a limit for the amount by which prices can increase in each year of the determination by setting a weighted average price cap. Provided it can be implemented under the current regulatory framework, the advantages of a weighted average price cap approach are that it would reduce the Tribunal's involvement at an individual tariff level, and would provide retailers with more flexibility to restructure tariffs.

Under this approach, the Tribunal would specify an annual limit to average price rises, based on assumed levels of consumption for each tariff and/or tariff component. Retailers would be able to choose how to vary each tariff, provided that their weighted average price increase stays within the limit and they meet any other requirements imposed by the Tribunal.

To set an appropriate limit on the weighted average price increase, the Tribunal would need to consider the costs involved in supplying customers, and the increase to current revenue required to recover these costs. It would then set annual price limits that allow retailers to move their current regulated tariffs to levels that, on average, will recover these costs by the end of the determination period, assuming the actual consumption and load profiles are as forecast.

Under a weighted average price cap, a standard retailer could potentially reduce one tariff in order to achieve a greater increase in another tariff, which could mean that the first tariff becomes less cost reflective. Given that the terms of reference ask the Tribunal to ensure that tariffs are set at cost reflective levels, it could consider placing a requirement on the standard retailers to ensure that they move tariffs towards cost reflective levels within the weighted average price cap.

A variation on this approach would be to apply a weighted average price cap to increases in the retail (R) component of tariffs only, rather than to the published regulated retail tariffs. The advantage of this is that it would allow retailers to directly pass through all increases in network tariffs, and thus ensure that these increases do not erode the cost reflectivity of retail

tariffs. It is also consistent with the objective of ensuring that regulated network charges are fully recovered.

However, a weighted average price cap may allow retailers to maintain some tariffs above the cost of supply reflective level and others below this level. While the scope for retailers to do this should reduce as competition increases, a weighted average price cap alone may not provide sufficient protection for customers whose needs cannot be met through the competitive market. In addition, an overall price limit approach restricts the Tribunal's ability to take into account demand management objectives, as it gives retailers themselves greater discretion over tariffs and tariff structure.

The Tribunal seeks views on:

- *Any implementation issues associated with introducing a weighted average price cap.*
- *How the framework can be used to promote cost reflectivity and demand management objectives.*
- *Whether a weighted average price cap should be applied to the retail component of tariffs only, and any issues associated with this approach.*

3.1.3 Establishing new opt-in regulated tariffs

The Tribunal is also considering whether it could establish a limited number of 'basic' regulated retail tariffs that are determined at cost reflective levels from the outset of the new determination period. Under this approach, all current retail tariffs would become unregulated (that is, retailers would have discretion over whether they continue to offer the current tariffs and at what level). Customers would then be required to actively choose (or 'opt-in') to move on to the new 'basic' regulated tariff.

This approach would simplify the range of regulated tariffs and ensure that these tariffs are cost reflective. However, requiring customers to actively choose to be on a regulated retail tariff would not protect those who are not aware of their options in the competitive market. It would also be a significant departure from past practice, and may have implications for the broader regulatory framework, including the ETEF, standard retail suppliers licences and the use of standard form customer contracts. In addition, it is likely to raise concerns about customer protection. To some extent, these concerns may be overcome by provision of information to customers.

The Tribunal seeks input from stakeholders on:

- *Whether it is appropriate to apply a regulatory approach that requires customers to 'choose' to be supplied on a regulated tariff and the implications of doing this.*
- *What measures could be taken to resolve the customer protection issues associated with such an approach, and who should take responsibility for taking them.*
- *Whether customers could continue to be supplied on a standard form contract if they do not choose to be supplied on the new regulated tariff.*

3.1.4 Monitoring prices where competition is considered 'effective'

The Tribunal considers that effective competition exists where no company has sufficient market power to allow it, in the absence of cost increases, to raise prices, to lower service quality and to restrict services, and still maintain profitability. Where competition is effective, regulation can be more light-handed; competition will provide customer choices and limit prices to efficient levels.

As part of the 2007 review process, the Tribunal will assess the current effectiveness of competition. To do this, it will seek information from standard retailers and other stakeholders, including second tier retailers.

The Tribunal notes that in the Australian Capital Territory (ACT), the independent regulator has recommended that it discontinues setting regulated tariffs and instead monitors the default prices set by the standard supplier. It recommended that the government retains the option to refer a review of prices to the regulator.¹¹

Under section 43EA of the *Electricity Supply Act 1995* the Minister has referred to the Tribunal, for investigation and report, the determination of regulated retail tariffs or regulated retail charges, or both. Given that the Tribunal is required to determine regulated retail tariffs and charges, price monitoring is not considered an option for the 2007-2010 regulatory period.

3.2 Price constraints

Under the current determination, retailers must move under-recovering tariffs towards the target level. However, they must also keep price increases within certain limits. The determination specifies maximum increases in revenue from the retail (R) component for each retailer, and maximum increases to any customers' bill.¹² The aim of these price constraints is to ensure customers are protected from unacceptable price increases.

The Tribunal will consider whether it should set similar price constraints as part of this determination. However, the terms of reference for this review require the Tribunal to ensure that all regulated tariffs and charges for small customers are at cost reflective levels by the end of the determination, and that any price constraints it sets allow further rationalisation of regulated retail tariffs and movement to full cost recovery over the determination. The terms of reference do not ask the Tribunal to consider the impact of price increases on customers.

The Tribunal will also consider whether different price constraints should be applied in different circumstances. For example, many of the current regulated retail tariffs are now 'obsolete' (that is, retailers are not offering these tariffs to new customers). There may be a case for removing price limits on obsolete tariffs, on the basis that all customers have the option of moving to an alternative tariff, albeit at a higher price.¹³

¹¹ Independent Competition and Regulatory Commission, *Retail Prices for Non-contestable Electricity Customers: Final Decision*, April 2006, p 3.

¹² The limit excludes miscellaneous charges and assumes an unchanged volume and pattern of consumption.

¹³ IPART, *Regulated retail prices for electricity to 2004*, December 2000, p 12.

There are two approaches to price constraints that may be applied alongside the regulatory approaches discussed in section 3.1 – these are:

- limiting increases to individual customers' bills
- limiting increases to individual tariffs.

These approaches are discussed below. Each approach could be applied as the form of regulation or in addition to the other forms of regulation discussed. For example, the Tribunal currently applies an N+R approach with limits on increases to individual tariffs.

The Tribunal seeks views on whether and at what level it should set price limits, how price limits interact with the form of regulation, and whether it is appropriate to remove price limits on obsolete tariffs.

3.2.1 Limiting increases to customers' bills

Previously, the Tribunal has set limits on allowable increases to customers' bills to ensure that customers do not experience unacceptable price increases.¹⁴ This form of price limit ensures that customers are protected from unacceptable price increases and is relatively simple to administer.

The Tribunal seeks comment on:

- *Whether it should impose limits on increases to customers' bills.*
- *Whether there are alternative approaches that the Tribunal should consider.*
- *Experiences with the customer bill price limit in the current determination.*
- *Whether different limits should be applied to different customer classes, and why.*

3.2.2 Limiting increases to individual tariffs

Limits on tariff increases could be in the form of a single limit applied to all tariffs, or be based on different price limits for different tranches of tariffs, depending on how far they are from cost reflective levels. Any single limit would need to be high enough to ensure that all tariffs reach cost reflective levels by the end of the determination period. However, this may allow retailers to increase tariffs that are already above the cost reflective levels. Setting different price limits for tranches of tariffs would ensure that retailers can increase tariffs to cost reflective levels as soon as possible while containing annual price increases for customers. For example, the Tribunal could allow:

- tariffs "close to" cost reflectivity (for example, within 5 per cent) to move to the cost reflective level immediately by applying no price limits
- tariffs that are "modestly below" cost reflectivity (for example, 5 to 10 per cent from cost reflectivity) to transition to the cost reflective level over two years with a maximum price increase specified for the first two years of the determination only

¹⁴ The Tribunal would assess whether the bill of an individual customer rose by more than the specified amount over a one-year period, assuming the same volume and pattern of consumption. Typically, this form of price limit would be specified as 'the greater of X% or \$Y per annum', to facilitate restructuring within the components of that tariff. For example, see IPART, *NSW Electricity Regulated Retail Tariffs 2004/05 to 2006/07, Final Report and Determination*, June 2004, p 18.

- tariffs that are “well below” cost reflective levels (for example, greater than 10 per cent from cost reflectivity) to transition to the cost reflective level over three years with maximum price increases specified in each year of the determination.

The Tribunal seeks comment on:

- *Whether it should impose limits on increases to individual tariffs.*
- *Whether there are alternative forms of price limits it should consider.*
- *Whether different limits should be applied to different tariffs or tranches of tariffs, and why.*

3.3 Assessing the options

There are inherent tensions between some of the objectives implied by the terms of reference, and it is likely that there will be trade-offs in how well any form of regulation can meet these various objectives. For example, it will be difficult to develop a simple form of regulation with a small number of retail tariffs while also achieving cost reflectivity because of the number of network tariffs.

The Tribunal’s decision on the form of regulation, including any price constraints, will be informed by its view of how well each option meets the objectives within the terms of reference, and how the tensions between these objectives should be reconciled and the current regulatory framework established under section 43EB of the *Electricity Supply Act 1995*. One of the factors likely to influence this decision is the effectiveness of competition in the market. Where competition is effective, regulation can be more light-handed as competition will provide customer choices and limit prices to efficient levels.

The Tribunal seeks comment on the most appropriate form of regulation, having regard to the terms of reference.

4 COSTS TO BE RECOVERED

The terms of reference require the Tribunal to ensure that regulated retail tariffs reflect the full costs of supply by the end of the determination period. The terms of reference also list a range of matters related to costs that the Tribunal must consider in determining regulated retail tariffs.

As noted in Chapter 1, there are a number of differences between the cost matters the Tribunal must consider for this review and those it considered in past reviews. For example, the terms of reference require the Tribunal to consider mass market new entrant retailer costs and margins, and the hedging, risk management and transaction costs and forecasting risks that retailers will face in the absence of the ETEF.

The terms of reference also note that international and national experience shows that the level of regulated retail tariffs relative to market based prices is the key determinant of how many eligible customers remain on regulated arrangements. In addition, they note that setting regulated tariffs below the cost of supply will inhibit investment in the new generation that will be required as demand increases, as investors will not be able to recover their costs.

The sections below discuss each of the cost matters specified in the terms of reference, including how the relevant cost might firstly be determined and secondly considered in determining regulated retail tariffs.

The Tribunal seeks views on the appropriate level for each of the relevant costs and on how the Tribunal should directly or indirectly consider that cost in determining regulated tariffs.

4.1 Long run marginal cost of electricity generation

The terms of reference require the Tribunal to consider an allowance for electricity purchase costs based on an assessment of the long run marginal cost (LRMC) of electricity generation for a portfolio of new entrant generation to supply the load profile of customers remaining on regulated retail tariffs. The Tribunal notes that setting regulated prices on the basis of this LRMC raises issues in the context of a competitive market, where, at any point in time, competing firms source energy from this market at prices that are likely to diverge from the LRMC.

The current determination incorporates a LRMC based on new entry generation of \$47 per MWh (in 2004/05 dollars).¹⁵ The Tribunal adopted this estimate of the LRMC, based on the medium cost scenario presented by Intelligent Energy Services (IES), one of its consultants for the 2004 review. The LRMC includes an allowance of \$0.10 for generator National Electricity Market (NEM) fees, as these fees are unavoidable costs incurred by generators in the process of selling electricity in the NEM.

¹⁵ The Tribunal allowed energy purchase costs of \$50/MWh, which included \$3/MWh green energy costs, IPART, *NSW Electricity Regulated Retail Tariffs 2004/05 to 2006/07 – Final Report and Determination*, pp 9 and 36.

In South Australia and the ACT, the current regulated retail tariffs include an allowance for electricity purchase costs that is not based on an assessment of the LRMC of electricity generation. Rather, this allowance is based on the expected forward cost of purchasing energy at pool prices in the NEM and the costs of contracts with generators and other parties to cover quantity and pool price variations.^{16 17} In South Australia, this allowance is \$68 - 76 per MWh.^{18 19}

In Victoria, the Department of Infrastructure engaged Charles River Associates (CRA) to carry out a review of the costs that Victorian electricity retailers may be expected to face in supplying customers on standard contracts. CRA recommended an allowance for electricity purchase costs of \$53 - 84 per MWh.²⁰ This recommendation was based on an expected forward cost of purchasing energy at pool prices in the NEM and the costs of contracts with generators and other parties to cover quantity and pool price variations.²¹ The Tribunal notes that both this range and the South Australian allowance discussed above are higher than the allowance for energy purchase costs in the Tribunal's current determination.

For the 2007 review, the Tribunal intends to engage a consultant to make recommendations on the appropriate long run marginal cost of electricity generation and on how this cost is affected by the other matters being considered by the Tribunal. Stakeholders will be given the opportunity to comment on the consultant's proposed methodology and draft recommendations before its report is finalised.

The scope of work to be undertaken by the consultant includes developing a model to calculate the LRMC of new entrant electricity generation to supply the load profile of customers remaining on regulated retail tariffs in NSW. In line with the terms of reference for this review, the consultant will be required to recognise the Net System Load Profiles (NSLPs) for each standard retailer, as well as projected future changes in those NSLPs, in calculating the LRMC (See Appendix 3 for more information on the NSLPs).

The same consultant will also be required to provide advice on an allowance based on LRMC for retailer compliance with any Commonwealth mandatory renewable energy target (MRET) requirements and the licence requirements relating to the NSW Greenhouse Gas Benchmark Scheme, which takes into account price and volume (see section 4.6 below).

¹⁶ The Terms of Reference required ESCOSA to have regard to AGL SA's actual costs of wholesale energy, as well as the costs incurred by a prudent retailer. ESCOSA, *Inquiry into Retail Electricity Price Path: Final Report*, March 2005, p 48.

¹⁷ ICRC, *Investigation into Retail Prices for Non-Contestable Electricity Customers in the ACT: Final Determination*, May 2003, p 24.

¹⁸ ESCOSA, *Inquiry into Retail Electricity Price Path: Final Report*, March 2005, p 48.

¹⁹ The ICRC did not provide detail in its final report on the amount that was included in retail prices for electricity purchase costs on the basis that ActewAGL provided the Commission with confidential information. ICRC, *Investigation into Retail Prices for Non-Contestable Electricity Customers in the ACT: Final Determination*, May 2003, p 24.

²⁰ CRA provided the Victorian Government with a plausible range of wholesale energy purchase costs between 2005-07 to assist the Government in developing a price path agreement with the incumbent Victorian electricity retailers. Charles River Associates (2003) *Electricity and Gas Standing Offers and Deemed Contracts (2004-2007)*. Report for the Department of Infrastructure, December 2003, p 33.

²¹ Charles River Associates (2003) *Electricity and Gas Standing Offers and Deemed Contracts (2004-2007)*. Report for the Department of Infrastructure, December 2003, p 32.

The Tribunal seeks views on:

- *The appropriate level of LRMC to be included in regulated retail tariffs.*
- *How and whether the Tribunal should recognise projected future changes in net system load profiles and what these profiles are likely to look like in 2010.*

4.2 Hedging, risk management and transaction costs

As Chapter 2 discussed, the NSW Government announced that it will gradually phase out the ETEF between September 2008 and June 2010. The terms of reference for this review require the Tribunal to recognise the hedging, risk management and transaction costs that retailers will face in the absence of the ETEF. These terms also require the Tribunal to recognise the forecasting risks that retailers will face in the absence of the ETEF.

In operating within the wholesale market for electricity without the ETEF, standard and new mass market retailers could legitimately face:

- costs associated with hedging electricity purchases
- costs arising from inefficiencies in the wholesale electricity market, such as information asymmetries
- risks associated with unavoidable errors in forecasting load
- risks associated with being unable to obtain hedging that perfectly follows load shape.

The Tribunal did not include an allowance for hedging, risk management and transaction cost in its 2000 or 2004 determinations, when it used an estimate of the LRMC of electricity generation as a proxy for energy purchase costs. In its report on the 2004 determination, the Tribunal noted that during consultations, the retailers had stated that hedging costs should be included in energy costs to encourage retail competition. However, the Tribunal's terms of reference for that review required it to estimate the LRMC of electricity generation and not a market price for electricity, and it considered that hedging costs should not be included in the LRMC. In addition, the terms of reference for the 2000 and 2004 reviews did not explicitly require the Tribunal to consider hedging, risk management and transaction costs.

In its 1999 determination, the Tribunal did make an allowance for energy prices based on the price of vesting contracts²² (prior to the introduction of ETEF), and included an allowance for managing the volatility of the pool price for the franchise load for Type 2 vesting contacts and the residual load (that not covered by vesting contracts and subject to the pool price). The Tribunal stated:²³

Franchise retailers may enter into contracts with generators and other parties in order to hedge against pool price risks. The cost of hedging is an appropriate cost to be included in the benchmark.

²² Vesting contracts were contracts arranged by state jurisdictions between their local generators and retailers. They covered that portion of the electricity load still governed by regulated tariffs.

²³ IPART, *Pricing for the retail supply of electricity to franchise customers*, December 1999, p 25.

For the 2007 review, the Tribunal will need to consider the relationship between hedging, risk management and transaction costs and the LRMC of electricity generation. The Tribunal could:

- include an allowance for energy purchase costs based on the LRMC of electricity generation and not include hedging costs (as it did in the 2000 and 2004 reviews)
- include an allowance for energy purchase costs based on an estimate of the pool price and include hedging, risk management and transaction costs, although this approach may not be consistent with the terms of reference or
- include an allowance for energy purchase costs based on the LRMC of electricity generation and include hedging, risk management and transaction costs.

The Tribunal intends to engage a consultant to help it determine how best to recognise hedging, risk management and transaction costs and how these costs relate to the LRMC of electricity generation. Stakeholders will be given the opportunity to comment on the consultant's proposed approach and draft recommendations before its report is finalised.

The Tribunal intends to ensure that any recognition of hedging, risk management and transaction costs is explicit, and recognises the relationship between these costs, the electricity purchase costs and the appropriate retail costs and margin.

The Tribunal seeks comments on:

- *The appropriate level of hedging, risk management and transaction costs for inclusion in regulated retail tariffs.*
- *Whether the concepts of LRMC and hedging are compatible and how any relationships should be considered.*
- *Whether the Tribunal should consider hedging costs against the pool price or only allow costs for hedging above the LRMC estimate.*
- *Retailers' experience in hedging load for customers less than 160MWh per annum in NSW and hedging in other relevant markets.*
- *What impact the phasing out of the ETEF is likely to have on hedging and risk management costs over the determination period.*

4.3 Mass market new entrant retail operating costs

In the 2004 review, the Tribunal determined retail operating costs based on its view of the standard retailers' efficient costs in supplying customers on regulated retail tariffs. However, the terms of reference for this require the Tribunal to consider new entrant retail costs in the mass market.²⁴

All retailers incur retail operating costs in supplying and acquiring electricity customers, which include the costs associated with customer service (e.g., operating call centres, billing and collecting revenue), finance, IT systems, and regulation (eg, licence fees).

²⁴ The terms of reference defines 'mass market new entrant' as a new market entrant that is of sufficient size to achieve economies of scale.

The current determination incorporates an allowance for retail operating costs of \$70 per customer (in 2004/05 dollars) based on the efficient costs incurred by the NSW standard retailers.²⁵ The Tribunal calculated these costs as a benchmark retail cost that applied to all of the standard retailers, taking into account the actual costs of the standard retailers in NSW and other available information on efficient operating costs for such retailers.

In South Australia and the ACT, the current regulated retail tariffs include an allowance for retail operating costs incurred in supplying customers on regulated retail tariffs of \$84 and \$85 per customer respectively.^{26 27} In Victoria, the Department of Infrastructure engaged CRA to carry out a review of the costs that Victorian electricity retailers may be expected to face in supplying customers on standard contracts. CRA recommended an allowance for retail operating costs of \$92 per customer.²⁸ The Tribunal notes that all these allowances are higher than the allowance for retail operating costs included in the Tribunal's 2004 determination.

The Tribunal intends to engage a consultant to estimate appropriate mass market new entrant costs (and the mass market new entrant retail margin, discussed below) for the purposes of determining regulated retail tariffs.

The Tribunal will also seek information from retailers on new entrant retail operating costs. Stakeholders will be given the opportunity to comment on the consultant's approach and draft recommendations before the consultant's report is finalised.

The Tribunal seeks comments on:

- *The appropriate level of mass market new entrant retail operating costs for inclusion in regulated retail tariffs.*
- *The experience of mass market new entrant retailers, both in NSW and other relevant markets.*

4.4 Mass market new entrant retail margin

The retail margin (or profit margin) represents the reward to investors for committing capital to a business. For electricity retailers, the margin is influenced by a range of factors, including the level of risk associated with energy purchasing costs, customer default and bad debt, and competition from electricity substitutes.

For the 2004 determination, the Tribunal used a retail margin of 2 per cent, based on its view of an appropriate margin for the standard retailers in relation to supplying customers on regulated retail tariffs. However, the terms of reference for the 2007 review require the Tribunal to consider the retail margin for a mass market new entrant.

²⁵ IPART NSW *Electricity Regulated Retail Tariffs 2004/05 to 2006/07 – Final Report and Determination*, June 2004, p 10.

²⁶ ESCOSA decided to increase the allowance for retail operating costs in future years by CPI + 2%. ESCOSA (2005) *Inquiry into Retail Electricity Price Path: Final Report*. March 2005, p 53.

²⁷ ICRC (2003) *Investigation into Retail Prices for Non-Contestable Electricity Customers in the ACT: Draft Determination*, April 2003, p 22.

²⁸ For 2004 Charles River Associates recommended using the 2003 figure of \$90 adjusted for inflation and a 1 per cent productivity factor, which equates to approximately \$92. Charles River Associates (2003) *Electricity and Gas Standing Offers and Deemed Contracts (2004-2007)*. Report for the Department of Infrastructure, December 2003, p 25.

In making its 2004 determination, the Tribunal took into account that standard retailers currently purchase electricity through the ETEF, which eliminates energy purchase price risk. It also noted that full retail competition would increase the riskiness of the customer base, but that there had been limited uptake of retail competition.²⁹ But as section 4.2 discussed, the ETEF will be phased out during the 2007 - 10 determination period, and the Tribunal is required to consider the hedging, risk management and transactions costs and the forecasting risks that retailers will face in the absence of the ETEF.

In South Australia and the ACT, the current regulated retail tariffs include an allowance for a retail margin of 5 per cent and 3 per cent respectively.^{30 31} In Victoria, the Department of Infrastructure engaged CRA to carry out a review of the costs that Victorian electricity retailers may be expected to face supplying customers on standard contracts. CRA recommended a retail margin of 5 - 8 per cent.³²

The Tribunal intends to engage a consultant to recommend an appropriate allowance for a new entrant retail margin for a competitive mass market retailer (as well as an allowance for new entrant retail operating costs, as discussed above). Stakeholders will be given the opportunity to comment on the consultant's approach and draft recommendations before the consultant's report is finalised.

The Tribunal seeks views on the appropriate mass market new entrant retail margin to be included in regulated retail tariffs.

4.5 Network charges

The terms of reference require the Tribunal to consider providing a mechanism to ensure that network charges are fully recovered, such as would occur under an automatic pass through of network charges into regulated retail tariffs.

The network charges incurred by retailers include transmission use of system charges and distribution use of system charges. Most transmission and distribution charges are subject to economic regulation. In June 2004, the Tribunal released its distribution pricing determination to apply to NSW distribution network service providers from 1 July 2004 to 30 June 2009.³³ Similarly, in April 2005 the ACCC released decisions determining the maximum annual revenues for NSW transmission network service providers between 1 July 2004 and 30 June 2009.³⁴

²⁹ IPART NSW *Electricity Regulated Retail Tariffs 2004/05 to 2006/07 - Final Report and Determination*, June 2004, Appendix 3.

³⁰ ESCOSA provided a retail margin of 10 percent of the combined wholesale electricity costs and retailer operating costs. Assuming network charges represent 50 per cent of total costs a comparable figure is 5 per cent. ESCOSA, *Inquiry into Retail Electricity Price Path: Final Report*, March 2005, p 57.

³¹ ICRC, *Investigation into Retail Prices for Non-Contestable Electricity Customers in the ACT: Draft Determination*, April 2003, p 23.

³² Charles River Associates, *Electricity and Gas Standing Offers and Deemed Contracts (2004-2007)*. Report for the Department of Infrastructure, December 2003, p 43.

³³ IPART, *NSW Electricity Distribution Pricing 2004/05 to 2008/09 - Final Report*, June 2004.

³⁴ TNSPs must notify customers of the transmission use of system prices that are to apply for the following financial year by 15 May each year. ACCC (2005), *NSW and ACT transmission network revenue cap: EnergyAustralia 2004-05 to 2008-09: Decision and NSW and ACT transmission network revenue cap: TransGrid 2004-05 to 2008-09: Decision*.

Under the current determination and approach to regulation, electricity retailers can pass network charges through to customers on regulated tariffs as the N component in the N+R framework, subject to overall increases staying within the price limits.³⁵ For the 2007 determination, the form of regulation adopted will influence the choice of a mechanism for the pass-through of network charges.

The Tribunal seeks views on how best to ensure that network charges are fully recovered by retailers.

4.6 Cost of compliance with green energy obligations

The terms of reference require the Tribunal to consider an allowance based on the LRMC of retailer compliance with any Commonwealth Mandatory Renewable Energy Target (MRET) and the NSW Greenhouse Gas Abatement Scheme (GGAS) that takes into account price and volume.

Retailers incur costs associated with complying with these current 'green' schemes. The costs associated with complying with MRET are a mandated cost of selling electricity in NSW. This scheme currently requires retailers to purchase 2 per cent of the energy from renewable resources such as wind, solar or landfill gas. The GGAS establishes annual statewide greenhouse gas reduction targets, and then requires individual electricity retailers and certain other parties who buy or sell electricity in NSW to meet mandatory benchmarks based on the size of their share of the electricity market.

The current determination includes an allowance for the costs of these schemes of \$3 per MWh (MRET costs of \$1 per MWh and GGAS costs of \$2 per MWh, in 2003/04 dollars). As discussed in Section 4.1, the Tribunal will require the consultant that provides advice on the estimated LRMC of electricity generation to also consider the LRMC of compliance with MRET and GGAS requirements.

The Tribunal seeks comment from stakeholders on the appropriate allowance for such costs and how they might change during the course of the determination.

4.7 Retailer NEM fees

The terms of reference require the Tribunal to consider an allowance for the fees (including charges for ancillary services) imposed by the National Electricity Market Management Company (NEMMCO) under the National Electricity Rules. These terms also require the Tribunal to consider an allowance for expected movements in regulated components and NEMMCO fees.

NEMMCO is the independent market and system operator for the national electricity market. It is responsible for the administration and operation of the market in accordance with the National Electricity Rules. It levies fees directly on market participants, including retailers, generators and network service providers, to cover its costs. Electricity retailers' annual NEM fees are calculated on a per MWh basis, according to their electricity purchases. Retailers must also pay ancillary charges to cover the costs associated with the physical safety and coordination of the National Grid as distinct from the trading market. Ancillary charges are levied as the costs are incurred, and are also charged on a per MWh basis.

³⁵ IPART, *Regulated retail prices for electricity to 2004*, December 2000, p 8.

The current determination provides an allowance for NEMMCO fees and ancillary charges of \$1 per MWh – NEMMCO fees of \$0.41 per MWh and ancillary charges of \$0.58 per MWh (2005/05 dollars).³⁶

The Tribunal seeks comment from stakeholders on the appropriate allowance for retailer NEM fees, and on whether these fees are expected to change significantly from their current levels.

4.8 Energy losses

The terms of reference require the Tribunal to consider an allowance for energy losses as published by NEMMCO. Energy losses result from the nature of energy flows through networks, which leads to some energy being lost during transportation (transmission and distribution). Because of these energy losses, retailers must purchase more electricity than they are able to sell to customers, based on their metered electricity consumption. To reflect the true cost of purchasing the energy used by end customers, purchase costs need to be adjusted to reflect these losses.

NEMMCO calculates transmission loss factors, while the electricity distributors calculate distribution loss factors (subject to the Tribunal's approval). Both approved transmission and distribution loss factors are published on NEMMCO's website by April each year.

The current determination incorporates a loss factor for each retailer into the R component of regulated retail tariffs. For Country Energy, separate urban and rural loss factors are incorporated.

The Tribunal seeks comment on the appropriate allowances to account for energy losses in supplying electricity.

4.9 Optional Green Power component to all new (or moving) residential tariffs

The NSW Greenhouse Plan, released in November 2005, commits the Government to require energy retailers to offer a 10 per cent Green Power component to all new (or moving) residential customers. The Greenhouse Plan states:

Currently, electricity customers can choose a Green Power scheme in which they pay a premium to have the equivalent to all or part of their electricity usage sourced from accredited renewable energy sources. This initiative would replace the current opt-in scheme with an opt-out scheme. All customers would be offered 10% Green Power, with the option to refuse, accept, increase or decrease the Green Power component.³⁷

The terms of reference require the Tribunal to consider the costs of meeting this requirement in setting regulated retail tariffs.

³⁶ IPART, *NSW Electricity Regulated Retail Tariffs 2004/05 to 2006/07*, June 2004, p 10 and p 40.

³⁷ New South Wales Greenhouse Office, *NSW Greenhouse Plan*, November 2005, p 46.

Under the current determination, customers on regulated retail tariffs can voluntarily elect a green premium component that is added to the regulated tariff. The Tribunal did not regulate the premium component. The Tribunal stated that it believed that these arrangements provide standard retail suppliers with the flexibility to introduce appropriate green premiums.

Because the customers are not required to accept a Green Power component, the Tribunal could:

- continue its current approach of not regulating the Green Power component, or
- establish an additional regulated tariff that includes the Green Power component, if the customer does not opt-out.

The Tribunal seeks comment on the most appropriate way to account for the requirement of energy retailers to offer a 10 per cent Green Power component to all new (or moving) residential tariffs.

4.10 Mechanism to capture costs of new schemes

The terms of reference require the Tribunal to consider a mechanism that would address any new compulsory scheme that imposes material costs on retailers, such as an inter-jurisdictional emissions trading scheme.

The Tribunal will consider what is an appropriate mechanism to allow retailers to recover costs they have incurred that were not included in the cost of supply initially determined by the Tribunal, in the event that a new compulsory scheme is introduced that imposes material costs on them. The mechanism needs to be compatible with the form of regulation adopted and should:

- provide a clear definition of eligible costs
- keep administrative costs to a manageable level
- balance the interests of customers and retailers in terms of incentives for efficiency (it should not undermine incentives to minimise costs)
- allow the change in costs to be readily distinguished from costs already incorporated.

The inclusion of a pass through mechanism transfers some of the risk associated with cost-changing events from retailers to end customers. How much risk is transferred depends on the specific formulation of the mechanism.

The Tribunal seeks views on:

- *The appropriate form of the mechanism that should be included.*
- *Whether 'material' should be defined in terms of a particular threshold.*

5 MISCELLANEOUS CHARGES

The terms of reference require the Tribunal to consider and report on the basis for regulating regulated retail charges (miscellaneous charges). These charges are fees that energy retailers charge as a result of a request from a customer, or when a customer takes (or fails to take) certain actions. Thus miscellaneous charges are not a routine part of retail supply services, but arise from particular events associated with the supply of energy to customers. However, they have the potential to affect every retail customer.

The *Electricity Supply Act 1995* (ESA) defines regulated retail charges as a security deposit, late payment fee or a dishonoured bank cheque fee, of an amount specified in a determination that is in force.³⁸ Therefore, the Tribunal will limit its review of miscellaneous charges to these three charges.³⁹ The sections below provide an overview of each of these charges, including the level of the charge under the current determination and equivalent charges in other jurisdictions.

5.1 Security deposits

Under the current determination, a standard retail supplier may require a security deposit at the levels and under the circumstances set out in Table 5.1.⁴⁰

³⁸ Part 1, section 4, reference the Dictionary to the *Electricity Supply Act 1995*.

³⁹ In addition to the regulated retail charges, there are a number of distribution network miscellaneous services, including meter testing, special meter reading, disconnection visit disconnection at meter box, disconnection at pole top/pillar box, rectification of illegal connection, off-peak conversion, reconnection outside business hours and supply of conveyancing information. These network charges can be passed through to retail customers, but are not subject to this review.

⁴⁰ IPART, *NSW Electricity Regulated Retail Tariffs 2004/05 to 2006/07 Final Report and Determination*, June 2004, Schedule 3 and p.25 of the report.

Table 5.1 Security deposits under the current determination

	Residential customers	Business customers
When a security deposit can be charged	<ul style="list-style-type: none"> • Customer left a previous address without settling an electricity bill, the debt remains outstanding and the customer refuses to make an arrangement to pay the debt, or • Customer was responsible for the illegal use of electricity within the past two years, or • Customer cannot demonstrate a satisfactory credit history, and has refused to agree to an instalment plan or other payment option 	<ul style="list-style-type: none"> • Customer was responsible for the illegal use of electricity within the past two years, or • Customer cannot demonstrate a satisfactory credit history, or • Customer is a new business
Maximum that can be charged	<ul style="list-style-type: none"> • 1.5 times the average quarterly account, or • 1.75 times the average 2-monthly account, or • 2.5 times the average monthly account 	<ul style="list-style-type: none"> • 1.5 times the average quarterly account, or • 1.75 times the average 2-monthly account, or • 2.5 times the average monthly account
Form of security	<ul style="list-style-type: none"> • Cash, cheque, credit card or guarantee 	<ul style="list-style-type: none"> • Cash, cheque, credit card, guarantee or annual security levies.
When the security must be returned	After on-time payment for one year	After on-time payment for two years and maintenance of a satisfactory credit rating

These arrangements are similar to the arrangements for security deposits for regulated gas charges in NSW. For example, AGL Retail Energy may require residential customers to pay a security deposit of 1.5 times the average quarterly account (standard charge \$150), and must refund this deposit when the customer has paid bills on time for one year. For business customers, AGL Retail Energy may require a security deposit of 2.5 times the average monthly account, and must refund this amount when the customer has paid bills on time for two years.⁴¹ Origin Energy's residential security deposit is \$150, while its business security deposit is \$420 in Albury and the Murray Valley region and \$65 in the Central West region.⁴² Country Energy's residential security deposit is \$180, and its business security deposit is 2.5 times the average monthly account (and is refunded after bills are paid on time for two years).⁴³

In Victoria, security deposits (called refundable advances) for supply of electricity (or gas) cannot exceed 37.5 per cent of the amount billed to the customer over the previous four quarters or, if consumption is unknown, the average amount billed to domestic customers over those four quarters.⁴⁴ Retailers are required to refund security deposits, plus interest, after payments have been made on time for one year for residential customers or two years for business customers.

⁴¹ AGL website - www.agl.com.au.

⁴² Origin Energy website - www.originenergy.com.au.

⁴³ Country Energy website - www.countryenergy.com.au.

⁴⁴ Essential Services Commission (Victoria,) *Energy Retail Code*, February 2006, pp 15-16.

In South Australia, security deposits from residential customers may not exceed 1.5 times the average quarterly bill, while those from business customers may not exceed 2.5 times the average monthly bill.⁴⁵ Retailers must pay interest on security deposits held and must refund them to customers after one year of on-time payments.

The Tribunal invites views on the appropriate level for security deposits, and on the circumstances in which a security deposit may be collected and refunded.

5.2 Late payment fees

The current determination allows retailers to charge customers a late payment fee if the customer has not paid a bill five business days after its due date, and has been notified in advance that the fee will be charged if the account is not paid or an alternative arrangement entered into within five business days of the due date. Late payment fees are set at a maximum of \$5.00 (exclusive of GST) and are limited to a maximum of one per bill.

The current determination also specifies certain circumstances in which late payment fees cannot be levied, for example, where a customer has been granted an extension of time or is paying by an agreed instalment arrangement, or makes a billing-related complaint to the Energy and Water Ombudsman. The determination also sets out the circumstances in which late payment fees must be waived, generally in cases of hardship or financial difficulty.

Gas retailers in NSW are permitted to charge late payment fees and these fees may be increased annually by up to the change in CPI, under the Voluntary Transitional Pricing Arrangements agreed between the Tribunal and each standard supplier. AGL Retail Energy currently charges a late payment fee of \$11.44 (including GST),⁴⁶ Origin Energy charges a late payment fee of \$8.80 (including GST)⁴⁷ and Country Energy charges \$5.50 (including GST).⁴⁸

In Victoria, electricity and gas retailers may charge a late payment fee that is fair and reasonable having regard to the cost incurred by the retailer.⁴⁹ In South Australia, late payment fees applying to standing and default contracts for electricity can be charged to cover reasonable costs of recovering the amount due; business customers may also be charged interest on the outstanding amount.⁵⁰

The Tribunal invites views on the appropriate level for the late payment fee and information on the costs incurred by retailers where a customer does not pay a bill by the due date.

⁴⁵ Essential Services Commission of South Australia, *Energy Retail Code*, March 2004, pp A-37 – A-39.

⁴⁶ AGL website, www.agl.com.au.

⁴⁷ Origin website, www.originenergy.com.au.

⁴⁸ Country Energy website, www.countryenergy.com.au.

⁴⁹ Essential Services Commission (Victoria) *Energy Retail Code*, August 2004, p 12,

⁵⁰ Essential Services Commission of South Australia, *Energy Retail Code*, March 2004, p B-14,

5.3 Dishonoured bank cheque fees

A standard retail supplier may impose a regulated retail charge on a customer for a dishonoured cheque, but only if it actually incurs a bank or other financial institution fee for that dishonoured cheque.

Under the current determination, the maximum amount that a retailer can charge a customer for a dishonoured cheque is twice the regular GST-exclusive fee charged by the bank or other financial institution to which the cheque is presented.⁵¹

In the NSW gas industry, standard suppliers also charge dishonoured payment fees. AGL Retail Energy currently charges \$24.20 (including GST),⁵² Origin Energy charges around \$22 (including GST)⁵³ and Country Energy charges twice the bank fee plus GST.⁵⁴ Gas retailers may increase these charges annually by up to the change in CPI. These charges relate to dishonoured payments and are not restricted to dishonoured cheques.

In Victoria, retailers of gas and electricity may recover any fee they incur as a result of a customer payment being dishonoured, and may charge an additional amount under an 'agreed damages term'.⁵⁵ In South Australia, electricity retailers may recover the amount of any fee incurred as a result of a dishonoured payment made by cheque, direct debit or credit card.⁵⁶

The Tribunal invites views on the level of the dishonoured bank cheque fee.

⁵¹ IPART, *NSW Electricity Regulated Retail Tariffs 2004/05 to 2006/07 - Final Report and Determination*, June 2004, clause 8.3.

⁵² AGL website, www.agl.com.au.

⁵³ Origin website, www.originenergy.com.au.

⁵⁴ Country Energy website, www.countryenergy.com.au.

⁵⁵ Essential Services Commission (Victoria), *Energy Retail Code*, August 2004, p 13.

⁵⁶ Essential Services Commission of South Australia, *Energy Retail Code*, March 2004, p A-36.

APPENDIX 1 TERMS OF REFERENCE

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

A1.1 Reference to the Tribunal under section 43EA

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

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

A1.1.1 Background

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

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

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

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

A1.1.2 Matters for consideration

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

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

For the purposes of section 43EB (2)(b) of the *Electricity Supply Act 1995*, the Tribunal must consider the Government's policy aim of reducing customers' reliance on regulated prices and the effect of its determination on competition in the retail electricity market. The level of regulated prices for small retail customers is a crucial factor in encouraging new entry in the retail sector. If the level is set too low, it is not possible for new retailers to attract small retail customers away from the regulated price. This can reduce scale economies for new entrants, increasing their costs and making it more difficult for them to compete. More specifically, the Tribunal is to take account of the following matters in undertaking its review:

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

The determination should ensure that:

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

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

A1.1.3 Consultation

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

A1.1.4 Timing

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

A1.1.5 Definitions

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

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

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

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

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

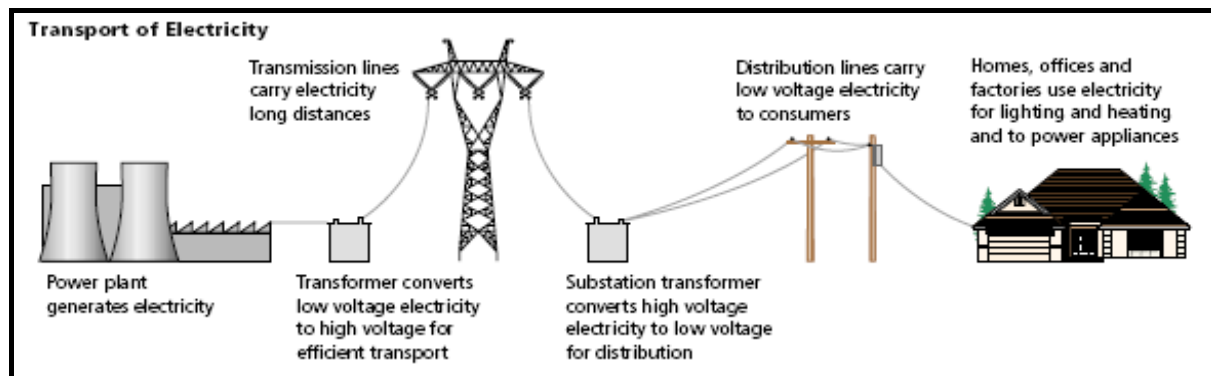
APPENDIX 2 COMPETITION AND REGULATION OF ELECTRICITY

The energy reform process introduced in the 1990s by the Council of Australian Governments involved restructuring the traditionally vertically integrated energy industry so that consumers could benefit from competition where possible. Although the National Competition Policy (NCP) established a national framework for many elements of the supply chain, the NCP has been progressively implemented by State governments that have also pursued their own reform policies and regulatory arrangements in retail energy markets. This chapter provides background on the national electricity industry, the specific reforms undertaken in NSW and outlines the relevant regulatory and legislative framework.

A2.1 Structure of the electricity industry

Traditionally the electricity industry in NSW was made up of large vertically integrated companies that controlled most parts of the supply chain, including generation, transportation and retail of electricity (see Figure 2.1).

Figure 2.1 The Electricity Supply Chain



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

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

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

A2.2 Regulation of retail prices in NSW

The Tribunal has been asked to continue to regulate retail prices for small retail customers (defined as customers that use less than 160MWh of electricity per year, equivalent to an annual bill of approximately \$20,000) who do not choose to enter into a negotiated contract.

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

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

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

The determination that applies to current regulated retail tariffs and charges was released by the Tribunal in June 2004 and applies until 30 June 2007.⁵⁷ Copies of the current determination are available on the Tribunal's website (www.ipart.nsw.gov.au).

Other regulatory arrangements

There are a number of other regulatory arrangements in NSW that relate to the electricity retail market but that are not determined by the Tribunal as part of its review of regulated retail tariffs and charges. These include:

- The Electricity Tariff Equalisation Fund (ETEF).
- Greenhouse scheme and Green Power obligations.
- Licensing and customer protection requirements.

The Tribunal will need to consider the impact of each of these arrangements on its determination and ensure that its determination is able to operate within the current regulatory environment. The Tribunal will also need to consider the possibility of new regulations introduced during the determination period that could impose material costs on the retailer.

⁵⁷ IPART, *NSW Electricity Regulated Retail Tariffs 2004/05 to 2006/07 – Final Report and Determination*, June 2004.

APPENDIX 3 NET SYSTEM LOAD PROFILE

There are approximately 3 million small retail customers in NSW.⁵⁸ Most of these customers have accumulation meters. Accumulation meters measure the total amount of electricity consumed during a period of around two to three months; they do not provide information on when in that period the electricity is used. However, the national electricity market (NEM) operates on trading intervals of half an hour and consumption information for each interval is required in order to settle the market.

The National Electricity Market Management Company (NEMMCO) uses an assumed pattern of consumption (or load profile) called a 'net system load profile' to convert the accumulation meter data provided to it by each retailer into half hourly intervals. It then uses this converted data to allocate electricity usage for each half hourly interval to the various retailers in the market.

In NSW, a net system load profile and a controlled load profile are derived for each local network service provider's distribution area (there are three: EnergyAustralia, Integral Energy and Country Energy's network areas).⁵⁹ The net system load profile for each area is derived by subtracting the controlled load profile,⁶⁰ interval metered and unmetered consumption in each half hourly interval from the total electricity inflow to the profile area⁶¹. The net system load profile therefore, represents the pattern of usage of all accumulation metered consumption in a given profile area. The use of net system load profile to estimate half hourly usage for each retailer assumes that the customers of each retailer in the profile area follow this pattern.⁶²

Currently in NSW, the Tribunal is the metrology coordinator under the National Electricity Rules and determined the metrology procedure, including load profiling, in January 2003. This metrology procedure requires the calculation of a net system load profile and controlled load profile for each network area in NSW. However, on 3 February 2006 the National Electricity Market Management Company (NEMMCO) submitted to the Australian Energy Market Commission (AEMC) a request to make a series of changes to the National Electricity Rules relating to the metering arrangements in the National Electricity Market (NEM).⁶³ The proposed Rule change assigns the relevant responsibilities of metrology coordinator to NEMMCO. The AEMC will not finalise the rule change process until the second half of 2006.

The current retail determination sets a single wholesale electricity cost based on long run marginal cost. Different energy costs were not included for each standard retailer. The Tribunal noted that practical problems prevented it from using a retailer specific long run marginal cost (the consultant undertaking the long run marginal cost study had experienced data issues). However, establishing retailer specific long run marginal costs was something the Tribunal noted may be worth further consideration in future reviews. The terms of

⁵⁸ According to the IPART licensing database there were 3,009,569 small retail customers at 30 June 2005.

⁵⁹ IPART *NSW Electricity Supply Industry Metrology Procedure, Types 5, 6 and 7 Metering Installations*, v2.0, 24 January 2003.

⁶⁰ NEMMCO estimate the controlled load profile for each profile area using a sample of interval energy data. In NSW, the DNSPs can choose to introduce a second controlled load profile in their profile areas.

⁶¹ Inflows are measured at Transmission Node Identifiers (the unique identifier assigned by NEMMCO to each node in the transmission system).

⁶² Where second tier retailers supply only customers with time of use (not accumulation) meters, there is no need to determine a net system load profile because all residual consumption once half hourly measured consumption is removed is attributable to the incumbent retailer.

⁶³ AEMC website, 10 May 2006.

reference for this review require the Tribunal to recognise the net system load profile *for each standard retailer*, as well as projected future changes in those net system load profiles.

The Tribunal will need to have regard to the load profile of customers remaining on regulated tariffs in making an allowance for the energy purchase costs. As set out in section 1.2, the Tribunal intends to engage a consultant to undertake a study of the long run marginal cost of electricity generation. The Tribunal will require that consultant to consider the projected future changes in the net system load profiles.

