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Our Ref:

Dr Tom Parry
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Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office
NSW 1230

By email: ipart@ipart.nsw.gov.au

3/2/04

Dear Dr Parry

Re : Regulated Retail Tariffs for Electricity and Gas

Please find attached a submission from the Public Interest Advocacy Centre (PIAC) in response to the Tribunal's *Issues Paper* for the review of regulated tariffs. We trust this will prove of value to the Tribunal in its deliberations. PIAC would be glad to provide any further information or clarification which may be required.

Yours sincerely
Public Interest Advocacy Centre

Jim Wellsmore
Senior Policy Officer

(enc)

1. Introduction

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit legal centre based in Sydney. PIAC has established the Utility Consumers' Advocacy Program (UCAP) with funding from the NSW Government. Its aims include the development of policy and advocacy in the interests of residential consumers, particularly low-income consumers, in the NSW energy and water industries.

A community-based Reference Group supports the development of policy by UCAP. The Reference Group is comprised of representatives from:

- Council of Social Service of NSW (NCOSS)
- NSW Council on the Ageing (COTA)
- Combined Pensioners and Superannuants Association of NSW (CPSA)
- Australian Consumers' Association (ACA)
- Park and Village Service based at the CPSA
- rural and remote consumers
- Institute of Sustainable Futures, University of Technology.

This submission has been reviewed by the Reference Group.

2. The case for regulated tariffs

The fixing of regulated tariffs for low volume users of energy is the flipside of the creation of a framework for full retail competition in this sector. Without competition and its outcome of 'winners and losers' there would be no need for the safe haven of 'standard' tariffs..

In the course of this review, a number of retailers have sought to assert a different relationship between competition and regulated tariffs. Arguments have been made which portray competition and 'market' tariffs as the normative mode. Regulated prices, then, are cast as the exception or, worse, as detracting from competition as a prior goal.

ActewAGL claims that 'it is widely accepted by regulators, policy makers and industry that competition is preferred over price regulation'. Unfortunately it appears ActewAGL have neglected to take account of what is preferred by the end-users of electricity and gas.

A number of retailers have cited NSW Government policy as the basis of their claims that the Tribunal should use this review of regulated tariffs to drive greater levels of retail competition. Integral Energy, for example, argues that, given Government policy of support for a competitive retail energy market, it follows that 'the regulatory framework should support the ongoing development of the market'. Unfortunately, it often appears that the benefits of competition must be paid for by higher prices on 'default' or standard energy customers.

Integral Energy goes on to claim that competition is the best way to manage pricing outcomes for all customers. Yet, the data presented by Integral to the public forum last November demonstrated that competition cannot in fact be relied upon to deliver superior outcomes for all end-users. The fact is that over the last decade the best price outcomes for electricity consumers in NSW have been achieved under price regulation and not open competition[1].

In any event, it is not valid to argue that the Tribunal, in making decisions about regulated tariffs, should be reliant on NSW Government policy about retail competition. Firstly, the Tribunal is not bound to follow the dictates of such policy[2]. More importantly, those retailers seizing on full retail competition as the justification for their respective proposals appear to have mis-read or misrepresented the actual content of that policy.

The terms of reference given to the Tribunal for the review of the standard electricity tariff make clear the Government's 'commitment to retain the offer of regulated retail tariffs'. The reason for this is clear enough - the Government itself points out that:

> '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 contracts which include regulated retail tariffs and charges'[3].

Our view is that the same circumstances and the same arguments are in evidence in the retail gas industry.

Howver important customer choice may be, the Tribunal has obligations other than the promotion of retail competition. Country Energy argues that the aim of Tribunal in setting the level of regulated tariffs should be to encourage customers to enter the market. However, the Tribunal firstly must have regard to its statutory responsibility to protect consumers from price exploitation and to take account of the social impact of its decisions or recommendations[4].

In its *Issues Paper* produced for this review, the Tribunal has expressed the view that as retail competition becomes more effective regulation of prices should become more light-handed. Several retailers have seized on this to urge that the Tribunal implement such a light-handed approach to the setting prices for the period up to June 2007.

In response, PIAC asks the question as to how much more light-handed can the setting of regulated prices be and still be regarded as regulation - let alone a framework for protecting the majority of low-volume end-users.

PIAC accepts that, by comparison with the period immediately before full retail competition commenced, there are fewer customers in the NSW market at present who require price protection. However, this cannot be taken to mean there is reduced need for price protection.

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[1] IPART (2002), 'Index of real household electricity prices 1992/93 – 2001/02' in *IPART 10 Year Review*, 2002
[2] *Independent Pricing and Regulatory Tribunal Act 1992* s.7
[3] Terms of Reference in IPART (2003), *Review of gas and electricity regulated retail tariffs – Issues Paper*, October 2003, Appendix 1
[4] *IPART Act 1992* s.15

To rely on competition and the retail energy market to provide protection for the great bulk of NSW consumers would contradict the stated policy of the NSW Government. Indeed, it would fly in the face of the very reasons for which the Government has referred the question of regulated tariffs to the Tribunal.

The standard tariff for electricity has been described as a safety net. However, PIAC does not believe it is valid to see regulated energy tariffs for low-volume consumers as a last resort which should be available only to the most marginal of retail customers. Prior to FRC we had argued for the retention for residential consumers of the choice not to enter the competitive retail energy market. If a competitive retail energy market is to be seen as successful then it must be made to work for the benefit of all consumers. Until that can be achieved it is important that there be retained the option for individual small consumers to remain outside the competitive market. The current design of the energy retail industry in NSW reflects the intent of the Government not only to stimulate competition but also to provide a framework which recognises that some households are unlikely to benefit from full retail competition

By contrast, the submissions made by some retailers to this review appear to suggest that a competitive retail energy sector is of such importance that, in effect, consumers should be given competition whether or not they like it. Unfortunately, the larger argument being presented to the Tribunal and the community is that in order to achieve a more active and robust competitive energy market it is necessary to raise costs for those who remain outside the market. This is why we argue that low-income and small-volume users must be the chief concern of the Tribunal in determining the appropriate structure and level of regulated energy tariffs.

It is not acceptable for households to be penalised for choosing to remain outside the market. Both the *Electricity Supply Act 1995* and the *Gas Supply Act 1996* make this choice available to small customers.

The market-based view of price behaviour is that discrimination between customers tends to reflect the range of values on a particular product held by different customers. In many markets customers have the fundamental ability to exercise control over pricing behaviour by choosing to exit the market altogether. Clearly, in the case of essential services such as household energy consumers do not have resort to such measures. Nor is price discrimination capable appropriate in determining the relative needs of consumers for domestic energy.

This point is especially pertinent in the case of customers of exempt netowrks. Long-term residents of caravan parks and boarding houses have their electricity bills determined by reference to regulated prices. Yet the choice of supplier for these consumers rests with the owner or operator of the park or boarding house.

Nor is it correct for retailers to assert, as some have done in this review, that customers in general continue to receive domestic energy supply under regulated tariffs because of their exercise of choice. PIAC is well aware that all second-tier retailers (including the incumbents in their role of providing market-based retail contracts) are exercising their capacity to refuse to provide negotiated retail contracts to certain groups of small-volume users. This practice is consistent with the behaviour of energy retailers in Victoria and which has been commented on publicly by the Essential Services Commission (ESC)[5].

[5] ESC (2002) *Special Investigation: Review of the Effectiveness of Full Retail Competition for Electricity - Final Report*, ESC Spetember 2002 p.46

In effect, then, a significant number of households remain in a situation of monopoly supply. PIAC simply cannot agree that the NSW retail energy market is in a state of 'workable competition'. The reality for most consumers flatly contradicts the assertion by NECG, in their consultancy for Integral Energy, that retailers 'are effectively limited in their price setting behaviour by the possibility that a buyer would choose another (retailer) in response to that behaviour[6].

The narrow targetting of small-volume customers by energy retailers in part explains the current relatively low level of customer churn in the NSW market. For example, in the case of electricity, to the end of December 2003 there had been 168,798 completed transfers of small customers between retailers[7]. This compares with the total number of small (below 160 MWh per year) customers in the State - around 2.5 million.

Yet, these numbers tell us very little about the particular situation of households in a competitive retail energy market. NEMMCO statistics do not include those customers who have changed to a 'market' tariff while remaining with their incumbent retailer. On the other hand, PIAC is sceptical about the extent to which the term 'competition' could be applied to a scenario where retailers are cherry picking their own customer base and signing people onto retail contracts with terms as long as three years. Many consumers would question why the benefits of lower prices offered by the incumbent retailers have not been made available to all households.

The further problem is that the category of 'small customers' is extremely wide. The overwhelming majority of households would consume no more than perhaps 10MWh of electricity each year. Based on our understanding of the nature of the electricity industry, and given the behaviour of the energy retailers, PIAC believes that the actual rate of switching amongst households is likely to be well below that of 'small' customers in aggregate.

We believe this scenario holds true also of low-volume consumers in the gas sector of the retail energy industry.

The incumbent retailers would assist our understanding of the workings of retail competition if they would reveal the numbers of their household customers to who they have offered a 'market' energy contract. However, it appears that in focussing on price as a driver of churn the retailers may themselves not fully understand the nature of retail energy competition.

A study of household electricity users in the United Kingdom, for example, has shown that price is not the key determining factor in choices to switch between retailers[8]. This experience might be reflected in the extent to which energy retailers in NSW currently are tending to bundle energy and other services or 'rewards' in their competitive contract offers. It also contradicts the assertion that the level of the regulated tariff in NSW has been limiting the extent of retail competition.

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[6] Network Economics Consuting Group (NECG) (2003), *Applying workable competition in the NSW electricity retail sector*, November 2003 p.7

[7] National Electricity Market Management Company (NEMMCO), *MSATS Transfers for NSW 2003* www.nemmco.com.au/data/retail.htm

[8] Brigham, B. and Waterson, M. (2003) *Strategic change in the market for domesic electricity in the UK*, University of Warwick, February 2003 p.11

The view of PIAC is that price is a much more important issue for those households unwilling or unable to enter into a 'market' energy contract. A second study has demonstrated that in the UK gas market retailers can raise their prices to a threshold of 33% above a competitive level before they suffer a net reduction in revenue[9]. That is, only above that point does the loss of customers begin to outweigh the added revenue from higher prices. It must be stressed that even at this level of price increase only some of the customers of the original retailer will be in a position to move to an alternative supplier.

This is not to suggest that customers who are able to churn can avoid price rises. Retailers can shadow the 'headroom' price, lifting their own charges above the level of what is 'competitive' or efficient and still offer a relative benefit to those consumers who are commercially attractive. Those households who are not commercially attractive to a second-tier retailer presumably can expect price hikes of greater than 33%.

Accordingly, PIAC rejects the view of NECG that the Tribunal should be prepared to allow the regulated price to rise above competitive or efficient levels in order to stimulate churn[10].

Our view is that in the current circumstances it is not appropriate for the Tribunal to reduce the level of regulatory protection for low-volume energy consumers in NSW.

In arguing for the retention of a strong regime of price protection for NSW households PIAC does not wish to downplay the efforts made by the retailers to address some of the social and financial needs of their customers. Indeed, PIAC in the past has attempted to give public support and recognition to the programs introduced or under development by the retailers. However, the concern for PIAC is that neither we as consumer advocates or the wider community can expect these initiatives fully to address the needs of individual customers nor to mitigate fully the impact of a rise in the price of household energy. It is important to acknowledge also that the Tribunal has little control over the content or implementation of these programs. On the other hand, regulation of a default price has universal application to all households throughout the State. It is for these reasons that PIAC has focussed on regulated tariffs rather than the respective social programs of the retailers.

3. Appropriate form of regulation

PIAC is pleased that the Tribunal has expressed a preference for keeping the arrangements for regulated retail energy tariffs as simple as possible. This has strong implications for proposals for the structure of regulated tariffs. We will discuss these below. However, it also impacts on a discussion of the appropriate form of regulation of default prices.

The Tribunal has pointed out that some customers currently being supplied under regulated tariffs are paying less than the cost of that supply. Other customers are paying a price higher than their costs of supply. PIAC understands that this issue underpinned the previous decision of the Tribunal to establish target tariffs for standard customers of electricity served by each incumbent retailer. Target tariffs were intended also, in our understanding, to permit some rationalisation of the total number of tariffs in the electricity sector. This has been supported by PIAC.

[9] Giuletti, M, Wddams Price, C. and Waterson, M. (2001) *Consumer Choice and Industrial Policy: A Study of UK Energy Markets*, Centre for Competition and Regulation, University of East Anglia, October 2001 p.21
[10] NECG (2003) ibid. pp. 14-15

However, identifying cost-reflectivity as the key goal of target tariffs gives rise to other concerns. For example, the element of price protection inherent in regulated tariffs is undermined when there is too great an emphasis on having all tariffs fully recovering all their associated costs. The decision about which costs are to be recovered also creates difficulty for customers in understanding the reasons for different prices applying to comparable households in different areas. This is an issue of horizontal equity and has been remarked on, for example, by Country Energy which echoed the concerns of their customers with variations in price between geographical areas.

It appears, then, that target tariffs might not be an appropriate mechanism to achieve both cost reflectivity and rationalisation of tariffs.

PIAC understand the issues facing the energy retailers and the Tribunal with respect to the recovery of costs. We point out, however, that there exists a tension between these requirements and the need to provide appropriate price protection for residential energy consumers. The view of PIAC is that the primary emphasis must go to protection of vulnerable consumers ahead of current economic orthodoxy against cross-subsidies.

After all, PIAC understands that the publicly-owned incumbent retailers are profitable and will continue to be so throughout the 2004-07 period. While public reporting of the financial performance of these state-owned corporations is hardly transparent we note that neither the incumbent electricity retailers or the NSW Government have made a claim to the contrary.

Furthermore, as we have argued elsewhere, there is a much wider range of cross-subsidies intrinsic to energy supply (including in the retail industry) than just among households receiving a default supply of energy. A glaring example is the inclusion in regulated tariffs of an allowance for FRC-related costs incurred by the incumbent retailers.

It should be noted also that household consumers of gas already have seen a significant restructuring of their prices which were supposed to have addressed cross-subsidies from business customers to domestic users. These changes resulted in the Tribunal lifting AGL's domestic tariff by 54% between 1994 and 2002[11].

The Tribunal's *Issues Paper* sets out a number of options for the form of regulated energy tariffs. PIAC supports consideration being given to the third of these options. This suggests the replacement of the current side constraints with a single CPI-X constraint.

PIAC wishes to stress that, from the viewpoint of residential consumers, the key point about side constraints is not the degree of flexibility they provide to retailers nor the extent to which they facilitate a transition to greater competition. Rather, it is providing certainty to 'default' customers that in a situation of what is, effectively, monopoly supply they will continue to be supplied with these essential services at an appropriate price and not be used to subsidise competitive benefits for other consumers.

The third option is of particular interest since, notwithstanding the claims of the retailers for higher prices to meet their costs, this option holds out the possibility that default customers could share in some of the benefits of retail competition. This would, of course, depend on a decision by the Tribunal about the value of the X-factor. We note that a positive value for X would result in price

[11] See IPART (2002) 'Index of real household gas prices 1994/5 – 2001/02'

increases for default customers and, under this model, higher than average increases for some households.

PIAC is opposed to the changes proposed for the gas voluntary pricing principles (VPPs) which would see regulatory approval needed only for price increases in excess of CPI.

A CPI-X constraint would require further development if the Tribunal is to continue to set target tariffs and address under-recovering tariffs. On the other hand, this option has the benefit of being more consistent with price protection with respect to water in the Sydney metropolitan water. It also returns an element of incentive for the incumbent retailers which has been, at best, diminished since the commencement of FRC. A CPI-X approach would have the further advantage of being simpler and easier for residential consumers to understand.

In general, we do not support any proposal which would see the Tribunal reviewing price changes and side constraints for each of a wide range of individual tariffs. Clearly, such a process would be onerous and costly, not least for consumers and community organisations who advocate on their behalf. However, PIAC is interested to discuss with the incumbent retailers and the Tribunal options for addressing those tariffs which are under-recovering to a significant extent - particularly where this under-recovery has been occurring for a prolonged period of time.

PIAC also is aware of the chronic problem faced by Australian Inland in recovering their overall costs of supply to customers. We note, furthermore, that this not a recent problem. Substantial price rises do not appear to be the answer to this problem. The suggestion made by AIEW that the cost of supply equation will only worsen as sections of its area of operation continue to experience negative economic growth (and, we presume, population decline as a result) indicates that raising prices for end-users now will only be followed by further price rises in the foreseeable future. By reason of these same factors we reject any attempt to reform the regulated price allowed to AIEW as part of a transition to a more market-based supply in the future. It is most unlikely that other than a tiny proportion of AIEW energy customers will ever be offered competitive market supply contracts. Our view is that the issues faced by AIEW in terms of cost reflectivity are more appropriately addressed by the NSW Government.

4. Structure of regulated tariffs

The structure of regulated retail energy tariffs must reflect their essential characteristic - the protection of vulnerable consumers and providing low-volume end-users with the choice of whether or not to enter the competitive retail energy market. As noted above, in this respect the regulated tariffs for electricity and gas consumers are a regulatory expression of NSW Government policy.

Accordingly, PIAC holds a strong view that the Tribunal must retain for itself the capacity to determine the appropriate structure for tariffs in relation to ‘default’ customers. That is, PIAC believes the Tribunal should state that it will continue to exercise a discretion in approving tariff models such as inclining block tariffs (IBTs) or time-of-use tariffs for default or standard customers. This approval must extend to the structure of tariffs including consumption thresholds and price differentials.

We reject the arguments in favour of inclining block tariffs and time-of-use pricing for standard electricity customers. In our view these tariff innovations more properly belong in the competitive segment of small customer market. It is difficult to understand the enthusiasm for tariff reform with respect to small-use customers when the retail businesses appear unwilling to offer competitive supply options to the majority of these same customers.

The proposed introduction of IBTs for the retail component of customer bills is especially troubling given that at least two of the NSW distribution businesses have indicated they intend to introduce this tariff structure for low-volume customers. We note that residential customers of EnergyAustralia already have their retail prices determined according to an inclining block tariff. The Corporation has stated publicly its intent to introduce a further block structure for the network prices of these same customers from July of this year. This illustrates that many standard customers (low-income households among them) will suffer a significant price risk with retail IBTs. Indeed, given that the shape of much household consumption of energy is relatively fixed, many households can expect rises in energy costs more akin to a price shock.

There is no doubt that permitting retailers to introduce inclining block tariffs would undermine social equity and the affordability of residential energy. The role of a regulated tariff in providing price protection (or a safety net as some have described it) would not be consistent with IBTs - the less so were the Tribunal to approve the proposal by some retailers to omit price constraints from prices for second and subsequent consumption blocks. Neither would such a model for IBTs be consistent with the Tribunal's expressed preference for prices which are cost reflective.

The proponents of inclining block tariffs have claimed variously that they are needed to address cost reflectivity and to drive demand management on the part of low-volume consumers of electricity. We doubt very much that both goals could be achieved simultaneously. Indeed, while PIAC might be doubtful about the cost reflective nature of IBTs we are certain that they cannot deliver with respect to demand management.

The Tribunal is well aware of the criticisms made by PIAC of the proposals by the electricity distributors for IBTs and, in particular, of the claims for their DM benefits. Notwithstanding those concerns, however, consumers at least have accepted that benfits can be derived in terms of deferral of investmentin distribution systems. To put it bluntly, however, these arguments simply are not applicable in the case of the incumbent retailers.

PIAC notes that all electricity retailers operating in NSW now face mandatory targets for greenhouse gas emissions related to the volume of energy they sell. However, we point out that these targets were mandated on the basis of modelling which showed that compliance would be achieved not through changes in the consumption behaviour of consumers but through more efficient consumption - that is, physical demand management such as facilitating the use of more efficient appliances and household retrofitting. Networks have an interest in demand management which shifts the timing of consumption away from peak periods. For the retailers the mandatory targets are applicable to the total usage of customers rather than the shape of their consumption profile.

Proposals to use price to alter consumption of essential utility services such as energy and water continue to be based on crude assumptions about supply and demand. PIAC long has challenged assertions about the price elasticity of household usage of these services. No compelling evidence has been produced to demonstrate that customers would respond to the introduction of IBTs by

making a significant reduction in their use of energy. The absence of such a response would be consistent with the experience of residential consumers internationally.

Integral Energy points to IBTs providing equitable outcomes for customers because their design permits a small price decrease to low-volume users. However, as PIAC argued in the case of proposals for IBTs by the electricity distributors, this is more a case of equity measured in economic terms than social outcomes designed around 'fairness' or need. The supposed benefit of IBTs, trading higher bills in some households for lower bills in others, is targetted not by social characteristics or per capita household income. Rather, they are delivered by the size of consumption - meaning that IBTs are likely to reward small but high-income households while penalising larger families with smaller total incomes.

Since, in the case of retailers, inclining block tariffs deliver neither cost-reflectivity nor demand management, consumers are left to wonder what benefits would accrue to the businesses from this type of tariff structure. Or, to put the question in another way, we are left to wonder how the incumbent retailers are disadvantaged by the current structure of target tariffs.

EnergyAustralia has proposed that the regulated tariffs in electricity be structured similar to the weighted average price cap (WAPC) the Tribunal is to introduce for distribution businesses. PIAC believes this model also is inconsistent with the price protection character of the regulated tariff. This is based largely on the amount of freedom for movement in prices available under a WAPC structure. In particular, it is uncertain whether, for example, a retailer would seek to vary the prices offered to its standard customers on the basis of whether of whether or not individuals or certain groups are liable to move to 'market' supply contracts. A WAPC approach might facilitate the very price discrimination against vulnerable customers which the regulated tariff is intended to prevent.

We understand such price discrimination would contradict the view of EnergyAustralia that a WAPC approach would facilitate the reduction of cross-subsidies between groups of standard customers. However, this serves to highlight issues with the definition of cross-subsidies. The extent to which cross-subsidisation can be identified accurately depends entirely on the retailer's cost allocation model and how coarse it is in treating the various elements of supply to individual customers. The question of which cross-subsidies are identified as needing to be addressed is based to a significant extent on subjective policy decisions. It is not reasonable to portray a certain level of cost recovery as *a priori* the 'correct' amount.

Finally, PIAC cannot support a WAPC model such as that proposed by EnergyAustralia since it treats so many of the components of end-use prices as merely pass-through items outside the scrutiny of the Tribunal or consumers.

The case for time-of-use tariffs (TOU) presented by Country Energy concentrates on the reduction of average electricity prices and improvement in the reliability of supply. Despite the status of Country Energy as a 'stapled' retailer and distributor PIAC is dubious about the strength of such arguments. Further information would be needed before consumers could feel confident that time-of-use tariffs would deliver these benefits rather than higher total bills.

This information also would need to address the additional problem of the complexity of TOU pricing. Based on the experience of consumers in other industries, PIAC and a number of its community stakeholders have concerns at the ability of households fully to comprehend the operation of time-of-use tariffs. It cannot be assumed that all households, especially those facing some form of hardship or disadvantage, will be in a position to manipulate their consumption in order to take advantage of the purported price benefits of such tariffs.

5. Cost of energy

The Tribunal has asked for opinions as to whether an allowance for energy purchase costs should be based on benchmarking of industry prices or a calculation of the long-run average cost (LRMC) of supply. This is a difficult question for low-volume end-users. For example, the derivation of LRMC for electricity is a complex process apparently combining guesswork and an 'economic blackbox'. On the other hand, it is by no means clear that benchmarking of contract prices for the gas industry is any more transparent, particularly given the demands for confidentiality from the quasi-monopoly incumbent retailers.

On balance, PIAC believes there is value in the Tribunal retaining consistency in the method it uses to calculate the allowance for costs in the regulated electricity tariff. We support the continued use of LRMC as the basis for this calculation. However, PIAC does not support the model discussed by Integral Energy in its submission to the Tribunal. In our understanding this would increase the complexity of the LRMC derivation and reduce transparency.

An important reason for PIAC supporting retention of the LRMC approach is our belief that the range calculated by the Tribunal for its 2001 decision[12] will remain valid for the 2004-2007 period. In our view there remains sufficient room within this original range to enable the retailers to adjust to likely movements in wholesale prices. While noting some upward pressure on wholesale electricity prices PIAC is not convinced that this will have a significant impact before June 2007.

PIAC notes the estimate of LRMC given recently by AGL in evidence to the Federal Court. Their claim was that LRMC for electricity remains within a band of $35 to $45 per MWh[13].

In making this argument we point also to the recent experience in South Australia of the strength of community expectation that recent reforms to the energy industry should be producing lower prices - and that outcomes with respect to wholesale prices should be shared with all end-users.

It appears that currently wholesale gas prices for regulated gas customers are being determined by a process more akin to benchmarking. AGL had their regulated tariff prices for low-volume customers in NSW adjusted in 2003 to take account of movements in long-term contract prices.

Once again, we find it necessary to make the point that this contradicts the expectations held by household customers of the outcome of competition reform. Perhaps more importantly, we note that the decision of the Tribunal with respect to AGL may have the appearance of establishing a precedent for the other incumbent retailers. Certainly in this review of regulated tariffs the other incumbent gas retailers have mimicked AGL in claiming that their respective contract prices should be treated by the Tribunal on a 'commercial-in-confidence' basis. This must lead to the view that

[12] IPART (2000), *Regulated Retail Prices for Electricity to 2004*, December 2000
[13] *Australian Gas Light Company v Australian Competition and Consumer Commission* (2003) FCA 1525, para 289

some form of industry benchmarking is appropriate to test the assertions of the retailers about movements in contract prices.

Origin Energy have argued against the use of benchmarking on the basis that they are a unique entity among the incumbent gas retailers. In our view, an individual retailer so different from the rest of the industry could hardly need the protection of confidentiality of information about their wholesale contracts.

Without a form of treatment such as industry benchmarking being applied to wholesale contracts the process of determining regulated gas prices will continue to lack transparency and the critical element of community confidence.

6. Network charges

PIAC has argued repeatedly to the Tribunal that the notion of cost reflectivity in prices paid by households is almost without real meaning. The structure of end-user prices, particularly for electricity, has entrenched some forms of cross-subsidies. This is most obvious in the distribution component in the creation of a band of pricing between marginal and stand-alone costs. In retail costs the cross-subsidies have included the allowance made in regulated tariffs for 'FRC-related' costs.

The concern with allowing a full pass-through of network costs into regulated tariffs largely is focussed on the cumulative impact on households of rises in both the distribution and retail components. We recognise that industry reforms over recent years have created a separation of retail and network functions within the industry. Unfortunately, this means that regulators now find it more difficult to consider separately the overall social impacts of price movements in each of these industry sectors.

Given these circumstances consumers hardly can expect that movements in retail prices will be limited in order to take account of the impact of network charges on end-use customers. Since network costs are regulated separately by the Tribunal it appears inappropriate to insist on side-constraints on retail prices which apply to network costs. Thus we find ourselves somewhat in agreement that regulated tariffs should provide for a full pass-through of network charges. We trust that the incumbent businesses in NSW will understand why PIAC has been so adamant on the issue of side constraints for network tariffs.

However, PIAC is disappointed that the retailers have not made use of their position in the market place and as customers of the networks to intervene in distribution revenue determinations undertaken by the Tribunal or separately to put pressure on the networks to reduce their costs.

7. Retail operating costs

PIAC states once again its view that the regulated retail energy tariffs should not include an allowance for the FRC-related activities of the incumbent businesses. As we have stated above, this allowance represents a cross-subsidy - in this case one which operates to the advantage of a narrow group of small-volume customers who are already commercially attractive to the retailers. Previously, the Tribunal has argued that all customers receive some benefit from retail competition and, thus, that it is appropriate for the costs of FRC-related activities to be recovered partly through the regulated tariffs. We submit that the general evidence of retailer behaviour, in particular their policy of ignoring low-volume and low-income households in the offering of 'market' tariffs, contradicts this position. Similarly, those customers being shut-out of the competitive market find little to benefit them in repeated demands by the incumbent and second-tier retailers for large price rises designed to create retail price 'headroom'.

It is difficult for PIAC or household customers in general to comment on the proposals from the incumbent retailers when some have chosen not to reveal their operating costs nor even to fully disclose the details of what they are requesting from the Tribunal. A notable case is that of Origin Energy who state publicly their willingness to accept CPI-based rises in the allowance for operating costs yet have made a separate confidential bid to the Tribunal. We can assume only that this is seeking a higher price outcome.

In general PIAC looks forward to the retailers substantiating their claims about retail costs. The arguments put forward by a number of retailers appear to be less about actual costs than opportunistic attempts to repeat the price outcomes achieved by retailers in other jurisdictions. This is not consistent with the role of regulated tariffs.

Some incumbent retailers have argued for higher costs to be included in the regulated tariffs as a consequence of churn - more commercially lucrative customers moving to 'market' contracts and leaving a fixed set of costs to be shared among a smaller pool of 'default' customers. We note Integral Energy has stated explicitly that the costs they have presented to the Tribunal have separated standard customers from those on 'negotiated' contracts. Nonetheless, we remain unclear about the extent to which 'default' and 'market' customers are separated within the business systems of the incumbent retailers. Unless a retailer has established two separate customer billing systems it seems to us that the level of churn to date (that is, customers moving to a new retailer rather then being cherry-picked) can hardly be the cause of higher costs per customer for the incumbent businesses. It is a major concern that 'default' consumers may be expected to subsidise the benefits of 'competition' enjoyed by a minority of their counterparts who are more commercially desirable.

It is clear that the majority of those customers who have switched have been 'cherry-picked' by their incumbent business. As noted above, the categories of 'small' customer are very broad. It is a concern that, for example, small businesses may be moving to 'negotiated' retail contracts and leaving household customers to pick up the tab in the form of higher priced regulated tariffs.

Integral Energy also has proposed that the Tribunal permit an automatic pass-through of certain 'other specified costs'. It appears that these costs are of the kind PIAC believes should be considered merely as part of the cost of 'doing business'. That is to say, the costs identified by Integral in this new category ought already to be recovered through the cost components that make up the regulated tariffs. It is appropriate that variations in these costs or new components in these

costs be borne by the retailers as part of the normal and accepted risks associated with any major business (and especially retail) activity. In our view, this approach would preserve important disciplines for businesses which claim to wish to operate as fully commercial entities.

PIAC cannot accept the notion advanced by Integral Energy that the Tribunal should seek a light-handed approach to operating costs such that it does not derive a fixed level for each individual component of the regulated tariffs. Again, this is counter to the nature of the regulated tariffs.

The argument is advanced that too tight regulation of these costs will discourage entry to the market by efficient retailers and have the potential to suppress competition. It is certain that this approach will not discourage inefficient retailers either. In our view, this proposal is simply a re-hash of arguments for retail price 'headroom' - in short, that prices for 'default' customers must rise in pursuit of the goal of greater activity in the competitive segment of the retail energy market. Integral suggests that seeking accurate forecasts of operating costs represents a 'theoretical ideal'. Yet, the other view of this argument is that low-income consumers should endure higher prices for essential services in pursuit of the theoretical benefits of a more competitive energy market.

We are concerned also with the proposal by Integral Energy to recover as much as 90% of retail operating costs through the fixed system access charge. In general, PIAC opposes this weighting of tariffs since it makes it more difficult for consumers to reduce their electricity bills through greater efficiency or reduced consumption. We note also that this proposal appears to run counter to the argument advanced by some retailers (including Integral) about the need to give greater signalling for customer driven demand management.

Claims also have been made that the incumbent electricity retailers ought to be compensated through the regulated tariff for higher costs associated with 'green compliance'. PIAC does not accept these claims. Compliance with the mandatory retail NSW Greenhouse Gas Abatement Certificate scheme (NGAC) scheme is not a product of a business operating as a standard retailer. The scheme applies to all electricity retailers in NSW.

It is accepted that there may be some increase in final prices if compliance with the mandatory benchmarks is to be achieved. PIAC previously has indicated to the NSW Government our view that it is appropriate for residential consumers to bear some reasonable increase in prices as a result of the new scheme. We point out, however, that modelling of the scheme by the then Ministry of Energy and Utilities indicated that NGAC compliance costs would remain within the range of 'green energy' costs granted by the Tribunal in the December 2000 decision on the regulated electricity tariff.

Furthermore, our understanding, based on modelling by the Ministry, was that compliance with the targets would be achieved not through the use of price but an increased effort in demand management at the level of individual customers. The contribution of demand management to NGAC compliance was expected to be strongest in 2004-2006. For reasons of both customer benefit and environmental outcomes PIAC would rather that the standard retailers pursued physical demand management programs rather than relying on pricing to achieve compliance. In this respect it is especially pleasing that EnergyAustralia Retail has made a commitment to expanding the REFIT scheme originally trialed in the Hunter region in collaboration with PIAC, the Sustainable Energy Development Authority (SEDA) and the Newcastle City Council.

Finally, PIAC rejects the proposal that the retail margin allowed in the regulated tariff be adjusted to take account of costs associated with the retailer of last resort (ROLR) scheme. Firstly, we do not accept that there is a significant likelihood of a major ROLR incident during the next regulatory period such that the businesses are can expect to face these costs. Secondly, separate provision for such costs already has been made through the introduction of a ROLR fee in the *Electricity Supply (General) Regulation 2001*. The level of this fee was the subject of advice to the Minister for Energy from the Tribunal which followed wide-ranging stakeholder consultation.

8. Retail margin

As noted above, PIAC is concerned that a number of the incumbent retailers have sought to use outcomes in other jurisdictions as a precedent for regulated tariffs in NSW. This is done with no comparison of costs or the relative position of retailers in other markets. It remains an open question as to whether the allowances for costs and margins granted in these other markets are appropriate to conditions in NSW.

The Tribunal has a responsibility to ensure the incumbent businesses remain commercially viable. However, several of the retailers have attempted to conflate the recovery of the underlying costs of supply with the issue of increasing profitability and return on assets. We view the claims for a re-set of prices (particularly for the gas retailers) as addressing the issue of overall viability of the businesses.

Beyond the imperatives of commercial viability, PIAC does not have a view as to the appropriate retail margin. However, we continue to argue strongly that the regulated tariffs must primarily be aimed at protecting vulnerable consumers. Within this framework the allowance granted by the Tribunal for a retail margin for the incumbent businesses must be related to actual costs rather than the headline profitability of retailers in other jurisdictions. At the same time, in determining the appropriate level of returns the Tribunal should take into account the low level of risk associated with the regulated retail supply of household energy. This low risk includes the likelihood of the incumbent retailers continuing to hold the overwhelming share of the market as a result of low rates of churn and the inertia of 'default' customers.

PIAC notes the claim of Integral Energy for a greater retail margin based on 'shape' risk. We do not necessarily acknowledge that the incumbent businesses face such a risk. In any event, the view of PIAC is that this issue is best addressed not by retail margins but in connection with the cost of energy and LRMC calculations.

9. Miscellaneous charges

PIAC concurs with the view expressed by several retailers that these 'non-tariff' charges should be set so as to recover costs actual costs faced by the businesses. Unfortunately, we note that yet again the businesses have made little effort to substantiate their claims as to the costs these charges are supposed to recover.

PIAC and its community stakeholders simply cannot agree with the assertions of AGLRE and ActewAGL that these charges are, in all cases, 'completely avoidable'. Accordingly, we reject their argument that it is appropriate for these charges not to be regulated by the Tribunal. PIAC is aware that these charges, being fixed irrespective of the level of consumption, are both regressive and in some cases have the effect of increasing hardship for low-income and disadvantaged consumers. As discussed above, we welcome social programs instituted by the retailers such as AGL's *Staying Connected* initiative. Nonetheless, PIAC believes that it is in keeping with the nature of regulated tariffs that miscellaneous charges continue to be regulated by the Tribunal. Without this approach consumers can have no confidence that the retailers will remain accountable for the level of charges they impose.

The question of whether costs are verifiable is raised by the proposal from EnergyAustralia to increase the late payment fee to $10. PIAC is less interested in what Telstra may be able to charge in relation to late payments than it is in the actual costs incurred by EnergyAustralia as a result of tardy payments.

Integral Energy is pursuing a smaller increase but also has failed to submit data to suggest that this increase is in line with actual costs. We note that Integral have pointed to an increase in the rate of late payment by its customers. However, in the absence of actual figures we are left to surmise that this change might reflect other social factors impacting on the capacity of some customers to pay rather than the result of deliberate delinquency. It would be appropriate to allow a trialing of the social program Integral Energy intends to introduce before the Tribunal approved an increase in such costs for customers.

PIAC opposes the further proposal by Integral Energy to widen the period during which a security deposit can be demanded from a customer. We always have opposed the use of security deposits, primarily due to their impact on low-income households. To the extent that security deposits are a tactic for dealing with non-payment of bills PIAC remains of the view that the retailers have other options available to them for dealing with this issue. Costs associated with non-payment are encountered in many retail industries and, as such, represent as legitimate cost of business.

Furthermore , the current arrangements for security deposits in NSW largely mirror those in force in Victoria. PIAC is not aware of complaints from Victorian retailers arising from these rules. Nor do the remaining incumbent retailers in NSW appear to share the concerns of Integral Energy.

With respect to account establishment fees, it is the firm view of PIAC that the same arguments which applied to these charges in the case of the distribution businesses apply in the case of the incumbent retailers. Given the regressive nature of these charges, and the fact that in many cases households are not able to avoid changing their residence, recovery of any costs shown to be incurred in account establishment should be recovered within the regulated tariffs.

Two retailers have proposed that the 'dishonoured bank fee' be expanded to include a failure of payment through direct debits and credit cards. It is not clear whether failed payments by these methods impose a similar level of costs on the retailers as do dishonoured cheques. The major concern for PIAC is the way in which these charges might be incurred by customers. We are aware of instances from outside the NSW energy industry where individuals relying on social welfare payments to fund direct debit transactions have incurred multiple charges for failure in relation to payment for a single bill. This appears to have been the result of a merchant making repeated attempts to secure payment for a single bill at a time when insufficient funds were available in that account.

Country Energy have asked the Tribunal to approve a pass-through of the credit card surcharge in line with the new rules approved by the Reserve Bank. We note this additional cost for household energy consumption will not be welcomed by customers. Moreover, the willingness of energy retailers so quickly to introduce this new charge would seem to support our contention that the low-volume customer segment of the NSW energy market is not characterised by full or 'workable' competition.

Finally, PIAC wishes to take this opportunity to signal that we intend to oppose the proposals from Origin Energy for the treatment of non-tariff charges in its next voluntary pricing principles (VPP) regime. Of particular concern are proposals related to security deposits and the account establishment fee.