

**Regulated retail prices for electricity
to 2004**

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

Regulated retail prices for electricity
to 2004

FOREWORD

Over the next two years the New South Wales Government plans to fully open to competition the retail market for electricity supply. This means that every electricity customer in New South Wales will be able to choose which company supplies their electricity.

In December 2000, the Electricity Supply Amendment Act was passed by Parliament. This Act allows customers to switch from one retail supplier to another and provides a consumer protection framework. The Act provides for the Recommendation on the system of regulated retail tariffs that accompanies this report to become a determination of retail prices under the *Electricity Supply Amendment Act, 2000*.

In developing the Recommendation the Tribunal has had regard to the current regulated retail tariffs in New South Wales. This was a significant task as there are over 500 tariffs, each with varying levels of profitability. The Tribunal believes that a significant degree of tariff consolidation can occur within the limits established in the Recommendation.

In the Recommendation the Tribunal has established appropriate levels for regulated retail tariffs that reflect the cost of supply ('target levels'). Because these levels are in some cases significantly different from current regulated retail tariff levels, the Tribunal has established transition paths that move regulated retail tariffs towards the target levels. As a result, the highest increase that residential small retail customers will face is the increase in the CPI or \$25 per annum, assuming they have the same consumption level and patterns as the previous year. The highest increase that business small retail customers will face is the increase in the CPI plus 5 per cent or \$50 per annum – again, assuming the same consumption level and patterns. These increases will be faced by only a small numbers of business customers that are typically on specific end use tariffs that are substantially below the cost of supply. Many small retail customers will see no price change for some years. The differences in the transition paths depend on where the current regulated retail tariff is compared to the target level.

This review has not been an easy task. The Tribunal hopes that its decision will facilitate a smooth transition to competition while protecting customers. However, the electricity market will change considerably as it is opened to competition. Therefore, the Tribunal proposes that it reviews its decision in late 2002 to ensure that the framework established remains robust.

Thomas G Parry
Chairman
December 2000

Recommendation

**Recommendation in a final report of the Tribunal under an arrangement
entered into between the Premier and the Tribunal
on 14 July 2000**



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

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1 PREAMBLE

- 1.1 The NSW government is progressively opening its electricity retail industry to competition in accordance with its obligations under the National Electricity Code.
- 1.2 It is intended that all customers be able to choose their retail supplier for electricity by 1 January 2002.

2 DEFINITIONS AND INTERPRETATION

2.1 Transitional provision

[**Note:** This sub-clause is required as a transitional measure consequent upon the passage of the Amending regulation.]

- 2.1.1 In this sub-clause:

Amending regulation means the *Electricity Supply (General) Amendment Regulation, 2000*;

transition period has the meaning set out in Part 10 of the Amending regulation.

[**Note:** The Amending Regulation currently provides that the transition period is the period commencing on 1 January 2001 and ending on the date of commencement of Schedule 1, item 10 of the *Electricity Supply Amendment Act, 2000* or 1 June 2001, whichever is the earlier.]

- 2.1.2 In this Recommendation, during the transition period, a reference to:

- (a) a distribution network service provider is taken to be a reference to an electricity distributor
- (b) a standard retail supplier is taken to be a reference to an electricity distributor; and
- (c) a small retail customer is taken to be a reference to a franchise customer or a person who in accordance with clause 58(4) of the Amending regulation elects to be supplied with electricity by the electricity distributor for that persons supply district.

2.2 Definitions

Amending Act means the *Electricity Supply Amendment Act, 2000*

business includes rural business

business day means a day other than a Saturday, Sunday or public holiday

Commencement Date means the date that this Recommendation commences, namely the date that Schedule 1, item 65, clause 37 of the Amending Act commences

CPI^{-GST} has the meaning set out in Schedule 1

CPI₁^{-GST} means the percentage derived from the application of the formula described in Schedule 1

CPI₂^{-GST} means the percentage derived from the application of the formula described in Schedule 1

CPI₃^{-GST} means the percentage derived from the application of the formula described in Schedule 1

ESA means the *Electricity Supply Act 1995* as amended by the Amending Act

GST is defined in Schedule 1

Miscellaneous transaction is a transaction listed in clause 7.4

network component means the charge levied by a distribution network service provider on a standard retail supplier for network services provided by a distribution network service provider in relation to a relevant small retail customer

nominal terms means amounts expressed in dollars of the day

Price change date is defined in clause 5.2(a)

Recommendation has the meaning set out in clause 3.1

residential includes rural residential

Target level is the level of a standard retail tariff determined by the application of clause 6.4

Termination date means the date that this Recommendation ends, namely 30 June 2004 or such earlier or later date as may lawfully be provided

Tribunal means the Independent Pricing and Regulatory Tribunal of New South Wales established under the *Independent Pricing and Regulatory Tribunal Act 1992*

2.3 Interpretation

- 2.3.1 Words and phrases used in this Recommendation that are defined in the ESA or the Amending Act have the same meaning as in the ESA or the Amending Act.
- 2.3.2 In the interpretation of this Recommendation a construction that would promote the purpose or object expressly or impliedly underlying the Amending Act and ESA is to be preferred to a construction that would not promote that purpose or object.
- 2.3.3 The reference to an Act, Code, legislation or law includes regulations and other instruments under it and consolidations, amendments, re-enactments or replacements of them.
- 2.3.4 A schedule means a schedule to this Recommendation.
- 2.3.5 Words importing the singular include the plural and vice versa. For instance, the reference to a tariff (or regulated retail tariff) includes tariffs (or regulated retail tariffs) and vice versa.
- 2.3.6 Where a word is defined in this Recommendation (including because of the operation of clause 2.3.1), other grammatical forms of that word have a corresponding meaning.
- 2.3.7 The explanatory notes and footnotes do not form part of this Recommendation, but in cases of uncertainty may be relied on for interpretation purposes.

3 APPLICATION OF RECOMMENDATION

- 3.1 This Recommendation is made under an arrangement entered into between the Premier and the Tribunal on 14 July 2000. This Recommendation is intended to operate as the initial determination of regulated retail tariffs and regulated retail charges under s43EB ESA, by virtue of Schedule 1, item 65, clause 37 of the Amending Act.
- 3.2 This Recommendation commences on the Commencement Date and ends on the Termination Date.
- 3.3 This Recommendation sets the regulated retail tariffs and regulated retail charges that standard retail suppliers can charge small retail customers whose:
 - (a) premises are in a standard retail supplier's supply district; and
 - (b) are supplied electricity at those premises by a standard retail supplier under a standard form customer supply contract.

[**Note:** From 1 January 2002 all small retail customers are scheduled to be able to choose to be supplied electricity under either:

 - (a) agreed negotiated customer supply contract with retail suppliers; or
 - (b) standard form customer supply contract with standard retail suppliers.]

4 INITIAL REGULATED RETAIL TARIFFS

Retail tariffs developed by each of the standard retail suppliers, EnergyAustralia, Integral Energy, NorthPower, Great Southern Energy, Advance Energy and Australian Inland Energy under the *Pricing for the Retail Supply of Electricity to Franchise Customers: Determination No 5, 1999* issued by the Tribunal in December 1999:

- (a) in place as at 31 December 2000
- (b) in accordance with the licence held by the standard retail supplier, immediately before the Commencement Date; and
- (c) for the supply district of the standard retail supplier immediately before the Commencement Date

will be taken to be the regulated retail tariffs for each of them in the relevant supply district for the purpose of this Recommendation and the Amending Act, from the Commencement Date.

[**Note:** Upon commencement of Schedule 1, item 10 of the Amending Act, a retail supplier's licence held by a distribution network service provider, will because of Schedule 1, clause 24(1) of the Amending Act, be taken to be a licence held by a standard retail supplier. Under clause 24(2), Schedule 1 of the Amending Act, the supply district of a standard retail supplier is, until altered by the ESA Act, taken to be the distribution district of the distribution network supplier immediately before the commencement of Schedule 1 of the Amending Act. A regulated retail tariff applies to a small retail customer who elects to be supplied with electricity by a standard retail supplier under a standard form customer supply contract.]

5 INITIAL REGULATED RETAIL TARIFFS TO MOVE TOWARD TARGET LEVEL

- 5.1 In this clause “Usage” means the same pattern and volume of electricity consumption as in the previous year for a small retail customer.
- 5.2 A standard retail supplier that amends a regulated retail tariff must do so, so as to commence that amended regulated retail tariff on:
- (a) 1 July 2001, 1 July 2002 and 1 July 2003, or if special circumstances exist, no later than 14 days after each of such dates (each commencement date being a 'Price change date'); and
 - (b) in accordance with this Recommendation.
- 5.3 A standard retail supplier whose regulated retail tariff at a Price change date is below the Target level (calculated under this Recommendation) may, and must if required by clauses 6.1 and 6.2, increase that regulated retail tariff up to, but not exceeding the Target level. However a standard retail supplier must not increase a regulated retail tariff by an amount that would have the following effect:
- (a) in the case of a small retail customer being supplied electricity as a residential customer - the total amount of the bills issued to the customer would exceed the greater of:
 - (i) for the period 1 July 2001 to 30 June 2002: \$25 above the total of the bills issued to the small retail customer for the corresponding period of the immediately preceding year for the same Usage; or
 - (ii) the amount of:
 - (A) in the case of bills issued for the period 1 July 2001 to 30 June 2002: (the total of the bills issued to the small retail customer for the corresponding period of the immediately preceding year, for the same Usage) $\times (1 + \text{CPI}_1^{\text{-GST}})$;
 - (B) in the case of bills issued for the period 1 July 2002 to 30 June 2003: (the total of the bills issued to the small retail customer for the corresponding period of the immediately preceding year, for the same Usage) $\times (1 + \text{CPI}_2^{\text{-GST}})$; or
 - (C) in the case of bills issued for the period 1 July 2003 to 30 June 2004: (the total of the bills issued to the small retail customer for the corresponding period of the immediately preceding year, for the same Usage) $\times (1 + \text{CPI}_3^{\text{-GST}})$.
 - (b) in the case of a small retail customer being supplied electricity as a business customer - the total amount of the bills issued to the customer would exceed the greater of:
 - (i) for the period 1 July 2001 to 30 June 2002: \$50 above the total of the bills issued to the small retail customer for the corresponding period of the immediately preceding year and for the same Usage; or

- (ii) the amount of:
 - (A) in the case of bills issued for the period 1 July 2001 to 30 June 2002: (the total of the bills issued to the small retail customer for the corresponding period of the immediately preceding year, for the same Usage) x (1 + CPI₁^{-GST} + 5%);
 - (B) in the case of bills issued for the period 1 July 2002 to 30 June 2003: (the total of the bills issued to the small retail customer for the corresponding period of the immediately preceding year, for the same Usage) x (1 + CPI₂^{-GST} + 5%);
 - (C) in the case of bills for the period 1 July 2003 to 30 June 2004: (the total of the bills issued to the small retail customer for the corresponding period of the immediately preceding year, for the same Usage) x (1 + CPI₃^{-GST} + 5%)

5.4 A bill in clause 5.3 means:

- (a) a bill inclusive of the applicable amount (if any) of GST payable in respect of the items to which the bill refers; and
- (b) a bill as if it contained no amounts for regulated retail charges for Miscellaneous transactions.

5.5 A standard retail supplier whose regulated retail tariff at a Price change date is above the Target level (calculated under this Recommendation) must not increase that regulated retail tariff in nominal terms.

6 TARGET LEVELS OF REGULATED RETAIL TARIFFS

6.1 A standard retail supplier must ensure that a regulated retail tariff that is below the Target level, must equal the Target level on or before the Termination Date.

6.2 A standard retail supplier will not be in breach of clause 6.1 if:

- (a) it has applied clauses 5.3(a) and 5.3(b) in such a manner, consistent with the flexibility which those clauses permit, (including by increasing the regulated retail tariff by the maximum amount permitted by those clauses where necessary), so as to comply with its obligation under clause 6.1; and
- (b) despite that application (and for no other reason) the regulated retail tariff nevertheless does not equal the Target level on or before the Termination Date.

6.3 A standard retail supplier must ensure that if a regulated retail tariff equals the Target level, that regulated retail tariff does not depart from that Target level before the Termination Date.

6.4 The Target level for a regulated retail tariff is determined by applying the formula:

$$\mathbf{N+R}$$

where:

- (a) **N** is the applicable network component for the relevant small retail customer; and

- (b) **R** is a retail component, comprising:
- (i) a fixed charge ('**Fixed R**') expressed in dollars per customer; and
 - (ii) a variable charge ('**Variable R**') expressed in c/kWh (cents per kilowatt hour).
- (c) **Fixed R** at the target level for each regulated retail tariff is:
- (i) for the period to 30 June 2001: \$37.50; and
 - (ii) for the period 1 July 2001 to 30 June 2002: $\$37.50 \times (1 + \text{CPI}_1^{\text{-GST}})$;
 - (iii) for the period 1 July 2002 to 30 June 2003: $\$37.50 \times (1 + \text{CPI}_1^{\text{-GST}}) \times (1 + \text{CPI}_2^{\text{-GST}})$; and
 - (iv) for the period 1 July 2003 to 30 June 2004: $\$37.50 \times (1 + \text{CPI}_1^{\text{-GST}}) \times (1 + \text{CPI}_2^{\text{-GST}}) \times (1 + \text{CPI}_3^{\text{-GST}})$.

Variable R at the target level for each regulated retail tariff of each standard retail supplier supplying the relevant supply district is:

- (i) for the period to 30 June 2001: the relevant amount set out in the following table (the 'Listed amount');
- (ii) for the period 1 July 2001 to 30 June 2002: $\text{Listed amount} \times (1 + \text{CPI}_1^{\text{-GST}})$;
- (iii) for the period 1 July 2002 to 30 June 2003: $\text{Listed amount} \times (1 + \text{CPI}_1^{\text{-GST}}) \times (1 + \text{CPI}_2^{\text{-GST}})$; and
- (iv) for the period 1 July 2003 to 30 June 2004: $\text{Listed amount} \times (1 + \text{CPI}_1^{\text{-GST}}) \times (1 + \text{CPI}_2^{\text{-GST}}) \times (1 + \text{CPI}_3^{\text{-GST}})$.

**Variable R including net margin (c/kWh) for a supply district for the period to
30 June 2001**

	Urban		Rural	
	standard	controlled load	standard	controlled load
For the supply district of EnergyAustralia under the licence held by it immediately before the Commencement Date.	5.16	3.55	5.16	3.55
For the supply district of Integral Energy under the licence held by it immediately before the Commencement Date.	5.41	3.61	5.42	3.70
For supply district of NorthPower under the licence held by it immediately before the Commencement Date.	5.78	3.76	6.08	4.00
For the supply district of Great Southern Energy under the licence held by it immediately before the Commencement Date.	5.53	3.64	6.04	3.96
For the supply district of Advance Energy under the licence held by it immediately before the Commencement Date.	5.82	3.74	6.07	3.88
For the supply district of Australian Inland Energy under the licence held by it immediately before the Commencement Date.	5.87	3.96	5.86	3.95

[**Note:** The target levels set out in this clause 6 apply to the relevant geographical areas, or supply districts, supplied by EnergyAustralia, Integral Energy, NorthPower, Great Southern Energy, Advance Energy and Australian Inland Energy as at 31 December 2000.

If the supply district of a standard retail supplier changes from that described in clause 6.4, the Tribunal intends to request that the Minister refer to it, for investigation and report, the determination of regulated retail tariffs under section 43EA of the ESA, based on the changed supply district.]

7 REGULATED RETAIL CHARGES

- 7.1 Regulated retail charges apply to all small retail customers who elect to be supplied with electricity by a standard retail supplier under a standard form customer supply contract.
- 7.2 Regulated retail charges are charges that standard retail suppliers may charge to small retail customers supplied electricity under clause 7.1.
- 7.3 Regulated retail charges are separate from and additional to the regulated retail tariffs.
- 7.4 The maximum that a standard retail supplier may charge under a standard form customer supply contract for a Miscellaneous transaction listed below, is the maximum regulated retail charge corresponding to the Miscellaneous transaction listed.

Regulated retail charges – Maximum charge

Miscellaneous transaction	Maximum regulated retail charge
Fee for a dishonoured bank cheque	2 times the regular fee charged by the Bank to which the cheque is presented.
Late payment fee	\$5.00
Security deposit	1.5 times average quarterly electricity account ¹ , or 1.75 times average 2-monthly electricity account, or 2.5 times the average monthly electricity account Interest may not be levied on a security deposit.

- 7.5 A standard retail supplier may not impose a charge or fee for a Miscellaneous transaction (whether the transaction is described as a Miscellaneous transaction or otherwise) except as permitted by this Recommendation.
- 7.6 A standard retail supplier may impose a regulated retail charge on a small retail customer for a dishonoured bank transaction only if the standard retail supplier actually incurs a bank fee for that dishonoured bank transaction.
- 7.7 A standard retail supplier may only impose a regulated retail charge on a small retail customer for a late payment transaction in accordance with Schedule 2.
- 7.8 A standard retail supplier:
- can only require a small retail customer to pay a security deposit where the requirements set out in Part A of Schedule 3 are met; and
 - must repay a security deposit to a small retail customer in accordance with Part B of Schedule 3 as soon as the relevant small retail customer meets the requirements in Part B of Schedule 3.

¹ The amount of the average account will vary between standard retail suppliers, depending on average tariff levels and average consumption. The amount of the average retail account should be calculated as part of the tariff setting process, and the amount of the required security deposits posted on the standard retail suppliers' tariff schedules.

SCHEDULE 1 DEFINITION OF CPI^{GST} (CLAUSE 2)

Definition of CPI^{GST}

1.1 Interpretation

CPI^{GST} means the CPI exclusive of the net cumulative impact since 1 July 2000 of:

- (a) the GST; and
- (b) changes to any other Commonwealth, State or Territory taxes or charges, consequent upon the introduction of the GST,
as calculated and published by the Australian Bureau of Statistics from time to time. If the Australian Bureau of Statistics does not, or ceases to, calculate and publish it then CPI^{GST} will mean:
 - (i) an index published by Commonwealth Treasury which is its best estimate of the CPI^{GST}; or
 - (ii) if Commonwealth Treasury does not, or ceases to, publish an index then an index published by the Reserve Bank of Australia which is its best estimate of CPI^{GST}; or
 - (iii) if the Reserve Bank of Australia does not, or ceases to, publish an index, then at the Tribunal's discretion, either:
 - (A) an index published by a person appointed by the Tribunal which is that person's best estimate of CPI^{GST}; or
 - (B) an index published by the Tribunal that is its best estimate of CPI^{GST}.

CPI means the consumer price index, All Groups index number for the weighted average of eight capital cities as published by the Australian Bureau of Statistics, or if the Australian Bureau of Statistics does not or ceases to publish the index, then CPI will mean an index determined by the Tribunal that is its best estimate of the index;

GST means the Goods and Services Tax as defined in *A New Tax System (Goods and Services Tax) Act, 1999*.

1.2 Application of the formula

CPI_1^{-GST} means the number derived from the application of the following formula:

$$CPI_1^{-GST} = \left(\frac{CPI_{Mar2000} + CPI_{June2000} + CPI_{Sep2000}^{-GST} + CPI_{Dec2000}^{-GST}}{CPI_{Mar1999} + CPI_{Jun1999} + CPI_{Sep1999} + CPI_{Dec1999}} - 1 \right) \times 100\%$$

CPI_2^{-GST} means the number derived from the application of the following formula:

$$CPI_2^{-GST} = \left(\frac{CPI_{Mar2001}^{-GST} + CPI_{Jun2001}^{-GST} + CPI_{Sep2001}^{-GST} + CPI_{Dec2001}^{-GST}}{CPI_{Mar2000} + CPI_{Jun2000} + CPI_{Sep2000}^{-GST} + CPI_{Dec2000}^{-GST}} - 1 \right) \times 100\%$$

CPI_3^{-GST} means the number derived from the application of the following formula:

$$CPI_3^{-GST} = \left(\frac{CPI_{Mar2002}^{-GST} + CPI_{Jun2002}^{-GST} + CPI_{Sep2002}^{-GST} + CPI_{Dec2002}^{-GST}}{CPI_{Mar2001}^{-GST} + CPI_{Jun2001}^{-GST} + CPI_{Sep2001}^{-GST} + CPI_{Dec2001}^{-GST}} - 1 \right) \times 100\%$$

where:

- CPI is as defined and where the corresponding subtext (for example $_{Jun2000}$) means the CPI for the quarter and of the year indicated (in the example the June quarter for the year 2000)
- CPI^{-GST} is as defined and where the corresponding subtext (for example $_{Jun2001}$) means the CPI for the quarter and of the year indicated (in the example, the June quarter for the year 2001).

SCHEDULE 2 LATE PAYMENT FEE (CLAUSE 7)

1. Late payment fees must not be levied:
 - (a) during the period of an extension of time the small retail customer has to pay the electricity retail bill, agreed between the standard retail supplier and the small retail customer; or
 - (b) where a small retail customer has made a billing related complaint in relation to the relevant electricity retail bill to the Energy Industry Ombudsman or another external dispute resolution body where that complaint is unresolved; or
 - (c) during the period of an instalment arrangement, where the small retail customer has entered into an instalment arrangement with the standard retail supplier to pay the electricity retail bill.
2. A late payment fee must be waived:
 - (a) where the small retail customer has contacted a welfare agency/support service for assistance; or
 - (b) where payment or part payment is by EAPA voucher²; or
 - (c) on a case by case basis as considered appropriate by the standard retail supplier or the electricity industry ombudsman under an approved electricity industry ombudsman scheme under the ESA.
3. A late payment fee may only be levied:
 - (a) on or after the date which is at least 5 business days after the due date shown on the electricity retail bill that is the subject of the late payment; and
 - (b) after the small retail customer has been notified in advance that the late payment fee will be charged if the account is not paid, or alternative payment arrangements entered into, within 5 business days of the due date.

² A voucher issued under the Energy Accounts Payments Assistance Scheme. This Scheme is administered by the NSW Department of Community Services.

SCHEDULE 3 SECURITY DEPOSITS (CLAUSE 7)

Part A

Residential small retail customers

A standard retail supplier may require a security deposit from a residential small retail customer prior to connection only if that small retail customer:

- (a) has left a previous supply address without settling an electricity retail bill (**debt**) owed to the standard retail supplier or any other standard retail supplier, the debt remains outstanding and the small retail customer has refused and refuses to make an arrangement to pay that debt; or
- (b) has been responsible for the illegal use of electricity within the previous two years; or
- (c) does not have a satisfactory credit history in the reasonable opinion of the standard retail supplier or cannot demonstrate satisfactory credit history with another retail supplier to the reasonable satisfaction of the small retail supplier, and the standard retail supplier has offered the small retail customer an instalment plan or other payment option (for example pay as you go by instalments, direct debit) and the small retail customer has refused, or failed to agree to the offer.

A standard retail supplier must not require a security deposit from a residential small retail customer after connection.

Business small retail customers

A standard retail supplier may require a security deposit from business small retail customers prior to connection only if the small retail customer:

- (a) does not have a satisfactory credit history in the reasonable opinion of the standard retail supplier or cannot demonstrate a satisfactory credit history with another retail supplier to the reasonable satisfaction of the small retail supplier; or
- (b) is a new business; or
- (c) has been responsible for the illegal use of electricity within the previous two years.

A standard retail supplier must not require a security deposit from a business small retail customer after connection.

Types of Security Deposit

A small retail customer must only choose from the following types of security deposits:

- (a) **cash, cheque or credit card** from residential or business small retail customers;
- (b) **annual security levy** from business small retail customers only;
- (c) **guarantees**, including **Department of Housing guarantees** from residential small retail customers, and **bankers' guarantees** from business small retail customers.

Part B

Return of security deposits paid by cash, cheque or credit card

A small retail customer who is required to pay a security deposit, and who pays in the form of cash, cheque or credit card, is eligible for that deposit to be refunded when they have completed:

- (a) for residential small retail customers - on time payment of bills for one year from the date of the first bill; or
- (b) for business small retail customer - on time payment on time of bills for two years from the date of the first bill and the maintenance of a satisfactory credit rating in the reasonable opinion of the standard retail supplier.

When this occurs, the standard retail supplier must inform the small retail customer, in writing, of the amount that is refundable, and credit that amount to the small retail customer's account within 10 business days.

Maximum duration of requirement for annual security levy or guarantee

A small retail customer who is required to pay a security deposit and does so in the form of an annual security levy or guarantee, is eligible for the levy to cease or the guarantee to be discharged when:

- (a) for residential small retail customers - on time payment of bills for one year from the date of the first bill; or
- (b) for business small retail customers - on time payment of bills for two years from the date of the first bill and the maintenance of a satisfactory credit rating in the reasonable opinion of the standard retail supplier.

A standard retail supplier must inform a small retail customer who meets the above requirements that an annual security levy or guarantee is no longer required. A small retail customer must be informed in writing, and within 10 business days, of the above requirements being met.

Cessation of supply

If a standard retail supplier requires a small retail customer to pay a security deposit, and the small retail customer requests that the standard retail supplier cease supplying electricity to the small retail customer's supply address, the standard retail supplier must:

- (a) inform the small retail customer in writing of the amount of the security deposit held; and
- (b) pay the amount either to the small retail customer or into the small retail customer's account.

This must occur within 10 business days of the small retail customer ceasing to take supply.

Report

**Regulated retail prices for electricity to 2004
Final report**



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

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1 INTRODUCTION

1.1 Background to this review

The NSW government is progressively opening the State's electricity retail industry to competition. By 1 January 2002 all customers are scheduled to be able to choose their retail supplier.

In July 2000, the Premier asked the Independent Pricing and Regulatory Tribunal (the Tribunal) to prepare a report under section 9 of the *Independent Pricing and Regulatory Tribunal Act, 1992*. The terms of reference require the Tribunal to investigate and report on a system of regulated retail tariffs and miscellaneous charges for regulated customers, for the period from 1 January 2001 to 30 June 2004.

The recommendation contained in this report is a determination under the *Electricity Supply Act, 1995* (the ESA) as amended by the *Electricity Supply Amendment Act, 2000* (the Amending Act). The Amending Act sets out the Government's framework for delivering customer choice and protection.¹ The Tribunal's role in setting regulated retail tariffs and regulated retail charges (also known as miscellaneous charges and security deposits) is only part of the Government's package of customer protection and market design policy.²

The Tribunal forwarded an interim report to the Premier on 24 November 2000. It was necessary to provide an interim report as well as this final report because of uncertainty surrounding the final form of the Amending Act. This final report is consistent with the ESA (as amended by the Amending Act).

1.2 Terms of reference

The Tribunal has undertaken its investigation and made its report with due regard to the terms of reference issued to it by the Premier on 14 July 2000 and its obligations under the *Independent Pricing and Regulatory Tribunal Act, 1992* (the IPART Act).

The terms of reference asked the Tribunal to conduct an investigation and report on a system of regulated retail tariffs for all 'franchise customers' and 'eligible default customers' in each distribution area of NSW:

- Franchise customers³ are customers not yet eligible to participate in the contestable market. Currently, this includes all customers consuming less than 160 MWh (or around \$16,000) of electricity each year. The threshold for participation in the contestable market will fall progressively, as outlined in Appendix 2.

¹ For more information on the Government's reform package, refer to the Market Implementation Group website at <http://www.treasury.nsw.gov.au/mig.htm>

² For an overview of the introduction of competition in the retail supply market, see Appendix 2.

³ Franchise customers are defined in the *Electricity Supply Act, 1995* as those customers ineligible to participate in the competitive electricity market, by virtue of an order in force under s92 of the Act.

- Eligible default customers⁴ are those that either have not entered (but are eligible to enter) the contestable market, or have entered the contestable market and decided to return to a regulated retail tariff. Customers that require a retailer of last resort also fall within this category.

The terms of reference ask the Tribunal to consider 'the Government's objective of promoting competition in the retail market for electricity'. The Tribunal was required to consider the following:

- facilitating a smooth transition to a contestable retail market
- keeping the arrangements as simple as possible
- having regard to the costs of supply.

The terms of reference also authorised the Tribunal to consider and report on the basis for regulating miscellaneous charges and security deposits.

The terms of reference are reproduced at Appendix 1.

1.3 Terminology

The terms of reference refer to franchise and eligible default customers. The ESA, however, uses different terminology to distinguish franchise and eligible default customers from other customers. Under the ESA, franchise or eligible default customers are, in essence, small retail customers who choose to be, or must be, supplied electricity by a standard retail supplier under a standard form customer supply contract.⁵

To ensure consistency in terminology between this report, the recommendation contained in this report and the ESA, this report refers to 'franchise' and 'eligible default customers' as small retail customers.

A retail supplier to whose licence is attached a standard retail supplier's endorsement is known as a standard retail supplier. At this time, the retail businesses of the New South Wales government-owned electricity businesses — EnergyAustralia, Integral Energy, NorthPower, Great Southern Energy, Advance Energy and Australian Inland Energy — carry out the role of supplying electricity to franchise and eligible default customers.

⁴ 'Eligible default customers' are defined as:

- (a) customers who are capable of becoming non-franchise customers by virtue of an order in force under s.92 of the *Electricity Supply Act, 1995* (who consume 160MWh of electricity or less per annum) including:
 - (i) customers who have been franchise customers at 31 December 2000 but who do not choose to enter into a negotiated contract (ie, do not elect to choose their retailer) after they have the right to choose their retailer from 1 January 2001;
 - (ii) any other customers that may be deemed to be eligible by the Minister for Energy (eg, customers who, after electing to choose their retailer, subsequently decide to return as a customer receiving a regulated tariff from a default retailer); and
- (b) customers supplied by a retailer of last resort (as defined in the National Electricity Code), being customers who consume 160MWh of electricity or less per annum, and that are supplied by another retailer in the event that their retailer of choice defaults supplying that customer.

⁵ See section 92 of the Bill for the definition of small retail customer.

The Electricity Supply (General) Amendment Regulation 2000 currently provides that the transition period is the period commencing on 1 January 2001 and ending on the date of commencement of Schedule 1 to the Electricity Supply Amendment Act 2000 or 1 June 2001, whichever is the earlier. In this report, during the transition period, a reference to:

- (a) a distribution network service provider is taken to be a reference to an electricity distributor;
- (b) a standard retail supplier is taken to be a reference to an electricity distributor; and
- (c) a reference to a small retail customer is taken to be a reference to a franchise customer⁶.

Finally, the terms of reference provided that the Tribunal may consider and report on the basis for regulating miscellaneous charges and security deposits. Regulated miscellaneous charges are late payment charges and dishonoured bank cheque charges. The ESA incorporates both miscellaneous charges and security deposits into its definition of regulated retail charges. Therefore, in the interest of ensuring consistency in terminology between this report, the recommendation contained in this report and the ESA, the term regulated retail charges is used in this report to include miscellaneous charges and security deposits.

1.3.1 Legal framework

Under the ESA, it is a condition of a licence held by a standard retail supplier that the standard retail supplier must prepare a standard form customer supply contract setting out the conditions on which it will supply electricity to small retail customers who elect to be supplied with electricity under standard form customer supply contracts.

The ESA also provides that the standard retail supplier, when imposing tariffs and charges for or in relation to the supply of electricity under a standard form customer supply contract, must impose them in accordance with a relevant determination of the Tribunal in force under Division 5 of the ESA.

Standard retail suppliers must give the Tribunal notice in writing of any new regulated retail tariffs as a condition of their licence. The Tribunal has set limits on the increases in prices, however, the ESA does not provide the Tribunal with the power to approve standard retail suppliers' regulated retail tariffs. The standard retail suppliers will be required to provide the Tribunal with information that the Minister for Energy determines for the purposes of demonstrating that the new tariffs and charges are in accordance with the recommendation.

The recommendation contained in this report is a determination under the ESA.⁷

⁶ Or eligible default customer

⁷ See section 37 and section 43EB.

It is important to note that regulated retail tariffs and regulated retail charges only apply to those small retail customers who are supplied electricity by a standard retail supplier under a standard form customer supply contract. Regulated retail tariffs and regulated retail charges do not apply to customers, including small retail customers, who agree negotiated customer supply contracts with retail suppliers, even when a retail supplier is a standard retail supplier for the purposes of the ESA. The terms of reference required the Tribunal to advise on regulatory protection for all customers consuming less than 160 MWh per annum (or around \$16,000 of electricity per annum). However, customers eligible for regulated retail tariffs will be established by regulation and is, therefore, a matter for Government.

1.4 Principles forming the basis of the Tribunal's considerations

In addition to the principles that the Tribunal was required to consider under the terms of reference, the Tribunal considered the impact of its decision on customers, on the financial sustainability of standard retail suppliers, and on the level of economic efficiency in the electricity retail market.

1.5 Developing the system of regulated retail tariffs

The Tribunal considered that during the period of transition to full retail competition in the New South Wales electricity market (the 'contestable market') regulated retail tariffs are still required in order to protect small retail customers that:

- **are not yet entitled to choose a retail supplier.** While the largest electricity consumers already choose which retail supplier supplies their power and pay unregulated, competitive tariffs, until 2002 there will be some small retail customers that will not be able to choose their electricity supplier⁸.
- **need time to make an informed choice about which retail supplier supplies their electricity.** It may take some small retail customers several months or years to select and arrange an alternative retail supplier, and they should have that time.
- **may not be in the best position to negotiate a competitive deal.** Some small retail customers may not be approached by other retail suppliers. These small retail customers may have a poor payment history or consume a relatively small amount of electricity. As a result, they have no choice but to remain with their standard retail supplier, and so they need a guaranteed supply of electricity at a regulated price.
- **no longer have a negotiated contract because their retail supplier has ceased to trade.** When a retail supplier is unable to supply electricity for any reason, including ceasing to trade or withdrawal of authorisation under the National Electricity Code, the small retail customers of that retail supplier will pass to the standard retail supplier as the 'retail supplier of last resort' for the purposes of the National Electricity Code. Where this occurs, small retail customers also need a guaranteed supply of electricity at a regulated rate until alternative supply arrangements can be made.

⁸ For an overview of the introduction of competition in the retail supply market, see Appendix 2.

In order to provide regulatory protection to these types of small retail customers⁹, the Tribunal believes that small retail customers should be able to remain with their standard retail supplier and pay the regulated retail tariff if they choose to do so. New small retail customers (including small retail customers who move premises) and small retail customers who enter the contestable market and subsequently return to a regulated retail tariff should be able to be supplied on the basis of the same regulated retail tariff as those who have remained on a regulated tariff. However, in most cases the level of regulated retail tariffs will change in accordance with the Tribunal's recommendation as they move toward the target levels.

The Tribunal's approach is based on the view that regulated retail tariffs should, where possible, adequately recover the efficient cost of supplying electricity to small retail customers. It includes a formula for setting a target level for each regulated retail tariff. The regulated retail tariff that the small retail customer is eligible for depends on their standard retail supplier, whether they are urban or rural, their network charge and whether they have standard or controlled load service. The Tribunal believes these target levels are sufficient to enable the standard retail supplier to recover the cost of supplying small retail customers with electricity and earn an appropriate profit margin.

However, at present there are more than 500 existing regulated retail tariffs in NSW and many of these are significantly lower or higher than the corresponding target level. Therefore, the Tribunal has established a process by which a small retail customer's regulated retail tariff will increase or decrease¹⁰ gradually until it aligns with the relevant target level. The Tribunal has imposed limits on the amounts that regulated retail tariffs may increase each year towards reaching the relevant target levels and some regulated retail tariffs will not be able to increase at all. To make this decision, it was necessary for the Tribunal to balance the interests of standard retail suppliers and small retail customers. The limits on price movements mean that some regulated retail tariffs will not align with the relevant target levels by 2004.

An important aspect of the Tribunal's recommendation is that at any given point in time, each small retail customer will only be eligible for one regulated retail tariff. This will be the small retail customer's regulated retail tariff while that tariff is in the process of moving to, or is at, the target level.

Those regulated retail tariffs that are moving toward the relevant target levels are referred to as 'transitional tariffs' in this report from time to time.

⁹ Small retail customers will be determined under government regulation.

¹⁰ Regulated retail tariffs that are above the relevant target levels will not be permitted to increase in nominal terms, which equates to a decrease in real terms.

1.6 Review of Tribunal's decision

The Tribunal is aware that introducing retail contestability in the electricity industry is a complex process. Jurisdictions that have already done so have achieved varied success. Therefore, the Tribunal considers that it may be appropriate for it to conduct a mid-term review to assess the robustness of the regulated retail tariffs and regulated retail charges in late 2002. If, as a result of the mid-term review, the Tribunal considers the regulated retail tariffs and/or regulated retail charges in place to be inadequate, the Tribunal will request the Minister to refer to it, for investigation and report, the determination of regulated retail tariffs or regulated retail charges, or both.¹¹

The Tribunal's recommendation is based on the understanding that the NSW Government will introduce a range of protection mechanisms, including the electricity tariffs equalisation fund.¹² The Tribunal will monitor the balance of the fund. If necessary, the Tribunal will seek the Minister's referral to review the recommendation so that the balance of the tariff equalisation fund remains at an appropriate level.

1.7 Structure of the report

This report explains the Tribunal's recommendation and the rationale behind it in more detail. It provides explanatory information on:

- the approach to setting regulated retail tariffs for small retail customers that is set out in the recommendation and
- the approach to setting regulated retail charges for small retail customers that is set out in the recommendation.

There are a number of appendices that provide information on matters that the Tribunal considered in its deliberations.

¹¹ Pursuant to section 43EA(2) of the ESA.

¹² For information on the electricity tariff equalisation fund, refer to the *Electricity Supply Amendment Bill, 2000* and New South Wales Treasury, *Position Paper: Replacement for NSW Vesting Contracts*, November 2000.

2 ESTABLISHING REGULATED RETAIL TARIFFS FOR SMALL RETAIL CUSTOMERS

The Tribunal believes regulated retail tariffs should, where possible, be set so that they adequately cover the cost of supply. If the target level is set below cost, competing retail suppliers may be unable to offer a more attractive service and competition may be hindered. The experience in other jurisdictions where competition has already been introduced supports this view. In California, for example, regulated tariffs were initially set relatively low and this led to significant problems when competition was implemented. If regulated tariffs are set significantly above the cost of supply (as occurred in Pennsylvania), this may promote competition but disadvantage customers who are less able to participate in the contestable market¹³. Such an outcome would also be in conflict with the Tribunal's requirement under the terms of reference to have regard to the "costs of supplying regulated [small retail] customers".¹⁴

Therefore, the Tribunal has developed a system for setting a target level for regulated retail tariffs that reflects the cost of supplying electricity to small retail customers and moves existing regulated tariffs towards that level. Competitive retail suppliers (including the competitive arms of standard retail suppliers) will have the opportunity to develop commercial packages that are more attractive than the regulated retail tariffs by introducing valued-added services and by reducing their costs below those incurred by standard retail suppliers in providing the regulated tariffs.

Under the Tribunal's system, a small retail customer will be able to remain on their regulated retail tariff, if they choose to do so. They will also be able to return to their regulated retail tariff if they move premises, or enter the contestable market and then decide to switch back to their standard retail supplier. (However, the level of the tariff may have moved in accordance with the Tribunal's recommendation.)

However, many regulated retail tariffs are either higher or lower than the level required to recover the cost of supply. Therefore, the Tribunal's system includes an approach for determining the cost recovery level, or 'target level' for each regulated retail tariff and a process for moving regulated retail tariffs towards that level over time. The rest of this chapter explains the various elements of this system of regulated retail tariffs and the Tribunal's rationale in more detail. It sets out:

- how target levels are set and their structure
- how existing regulated retail tariffs will move towards target levels
- the impact of this system on prices paid by small retail customers on regulated retail tariffs.

¹³ This could occur because, for example, the small retail customer has a poor credit history or low consumption and no retail supplier agrees to supply them.

¹⁴ As specified in the terms of reference.

2.1 Setting target levels, and their structure

Target levels for regulated retail tariffs will be determined according to the formula 'N+R', where 'N' is a network component and 'R' is a retail component.

Under the Tribunal's system, target levels for regulated retail tariffs will be determined according to the formula 'N+R', where 'N' is a network component (which is the local distribution company's network tariff) and 'R' is a retail component (derived from the cost of supply and set by the Tribunal).

In choosing this form of regulation, the Tribunal took into account a number of objectives in accordance with the terms of reference, including simplicity, economic efficiency, customer protection and promoting competition. The Tribunal believes its formula is easy to understand and consistent with economic efficiency as it ensures that the target levels of regulated retail tariffs are derived from the component costs of supply.

2.1.1 The level and structure of target regulated retail tariffs

The network ('N') component must be the applicable network charge for each customer. The retail ('R') component must be split into a fixed component (dollars per customer) and a variable component (c/kWh). The fixed 'R' per customer will be set at \$37.50 per annum (in 2001 dollars) for all target levels of regulated retail tariffs. The variable 'R' for each standard retail supplier will be as set out in Table 2.1.

Table 2.1 Variable 'R' (c/kWh, \$2001)

	Urban		Rural	
	standard	controlled load	standard	controlled load
For the district supplied by EnergyAustralia under the licence held by it immediately before the commencement date.	5.16	3.55	5.16	3.55
For the district supplied by Integral Energy under the licence held by it immediately before the commencement date.	5.41	3.61	5.42	3.70
For the district supplied by NorthPower under the licence held by it immediately before the commencement date.	5.78	3.76	6.08	4.00
For the district supplied by Great Southern Energy under the licence held by it immediately before the commencement date.	5.53	3.64	6.04	3.96
For the district supplied by Advance Energy under the licence held by it immediately before the commencement date.	5.82	3.74	6.07	3.88
For the district supplied by Australian Inland Energy under the licence held by it immediately before the commencement date.	5.87	3.96	5.86	3.95

Both the fixed R and variable R component of the target levels of regulated retail tariffs are set in 2001 dollars and will be inflated by CPI-GST annually. CPI-GST is defined in Schedule 1 of the recommendation.

The fixed R and variable R differentiate between the supply districts currently being supplied by the retail businesses of the existing franchise retail suppliers.¹⁵ If a different standard retail supplier becomes responsible for supplying small retail customers in a supply district, the fixed R and variable R set out in this recommendation will apply to customers in the supply district. However, if the boundaries of the supply districts change within the period of the recommendation, the Tribunal will request that the Minister refers an investigation to the Tribunal, with the object of making another determination.¹⁶

The network component of the target levels of regulated retail tariffs will be the network tariff that is charged by the distribution network service provider (the 'DNSP') to the standard retail supplier. Standard retail suppliers are required to incorporate the network tariff into their customer's bill, but they have no control over the level of network tariffs. Having a separate network component in the target levels formula allows regulated retail tariffs to move in accordance with variations in network tariffs.

The retail component of the target level of a regulated retail tariff has been set by the Tribunal to reflect the cost of supply. (The cost components taken into account are outlined in section 2.2.3, below.) The retail component is made up of a fixed amount of \$37.50 a year (in 2001 dollars), plus a variable R, which depends on which supply district the small retail customer is in, whether the small retail customer is urban or rural and has a standard or controlled load service. The Tribunal has kept the categories of target levels for regulated retail tariffs to a minimum in the interests of simplicity. A regulated retail tariff is intended to be a basic option without special features. The categories used by the Tribunal are required in order to reflect:

- the different loss factors that apply to urban and rural small retail customers¹⁷
- the lower energy costs of controlled load (or off-peak) consumption.

Although there are only four variations in the R component of the target levels for regulated retail tariffs (for each standard retail supplier), there are many more network tariffs and therefore many more N components. This means that there will still be many different target levels for regulated retail tariffs applicable in NSW.

¹⁵ Namely EnergyAustralia, Integral Energy, NorthPower, Great Southern Energy, Advance Energy and Australian Inland Energy. Differentiation is appropriate because different loss factors apply in each supply district (see Appendix 3).

¹⁶ Pursuant to section 43EA(2) of the ESA.

¹⁷ Loss factors represent the proportion of electricity that is "lost along the way" as it travels from the generator to the customer. Loss factors are higher for small retail customers in remote areas because electricity must travel further to reach such customers. Further, the low voltage distribution network (which is necessarily more heavily relied upon in rural areas) experiences higher loss factors than the high voltage network. For these reasons, the cost of supplying small retail customers in rural areas is higher.

2.1.2 The cost components reflected in the retail component

The retail component recovers the Tribunal’s estimates of electricity purchase costs (including green energy purchases), National Electricity Market (NEM) fees, energy losses and an allowance for retail operating costs (including a profit margin).

To set the retail component, the Tribunal undertook detailed analysis to assess the size of each component of the cost of supply (as set out in its terms of reference). Based on this analysis, the retail component includes allowances to recover the following costs:

- electricity purchases (based on the long run marginal cost of electricity generation), including green energy purchases (as required by the standard retail suppliers’ licence agreements)
- electricity losses during transportation
- fees (including charges for ancillary services) imposed on retail suppliers by the National Electricity Market Management Company (NEMMCO) under the National Electricity Code
- retail operating costs and a profit margin.

The terms of reference instructed the Tribunal to consider ‘recovery of some or all of retail under recovery balances remaining at 31 December 2000 over the full franchise period to 31 December 2001’. The Tribunal considered this matter and decided not to allow such recovery (see Appendix 3 for discussion).

Table 2.2 shows the values for each of the components that the Tribunal used to derive the retail component of the target levels for regulated retail tariff. The analysis used to assess these values is described in Appendix 3.

Table 2.2 Costs used to derive the retail component of target levels

Cost component	Costs used in the Tribunal’s calculations
Energy purchases (including green energy purchases)	<ul style="list-style-type: none"> • The Tribunal used a weighted average for the long run marginal cost of energy purchases in the range of \$36 to \$56 per MWh (in 2001 dollars).
NEM fees	<ul style="list-style-type: none"> • The Tribunal used NEM fees of \$1.37 per MWh in 2001 and \$1.30 per MWh in 2002 and 2003 (in 2001 dollars).
Energy losses	<ul style="list-style-type: none"> • The Tribunal used energy losses based on the distribution area specific, disaggregated loss factors published by NEMMCO.
Retail operating costs and a profit margin	<ul style="list-style-type: none"> • The Tribunal used retail operating costs¹⁸ that fell within the range of \$40-\$60 per customer per year (in 2001 dollars), plus a 1.5-2.5% net profit margin. Retail operating costs were split into a fixed and a variable component, resulting in the \$37.50 per year fixed charge set out in section 3.3.1. • The range of retail costs includes \$5 per customer per year allowance towards full retail contestability (FRC) costs.

¹⁸ When calculating retail operating costs the Tribunal treated a 'small retail customer' as a customer that consumes less than 160 MWh per annum. (This is consistent with the current definition of a small retail customer.) This could become important if the Government changes the definition of a small retail customer.

2.2 Moving regulated retail tariffs towards target levels

2.2.1 Customers will be able to remain on their regulated retail tariff

From 1 January 2001 all small retail customers may remain on the regulated retail tariff that they were levied on 31 December 2000.¹⁹ New small retail customers (including small retail customers who move premises) and small retail customers that enter the contestable market and subsequently return to a regulated retail tariff, will be able to purchase electricity at the regulated retail tariff that applies under the relevant standard form customer supply contract.

The terms of reference provide that the Tribunal may report on the nature and operation of any restrictions on price movements within the system of regulated retail tariffs.

The Tribunal considered requiring new and returning small retail customers to move to the target level immediately. However, it decided against this approach for a range of reasons:

- in some cases there are significant differences between regulated retail tariffs and target levels, so moving a regulated retail tariff straight to the target level would result in significant price shocks for some small retail customers
- it would make the system of regulated retail tariffs more complex
- it could discourage small retail customers from testing the contestable market, because they would not be able to move back to the same regulated retail tariff if they changed their mind.

Even though the Tribunal's approach requires new small retail customers to be put on regulated retail tariffs that are being phased out, the Tribunal considers that the benefits of its approach outweigh the costs in this instance.

2.2.2 Transitional tariffs

Subject to the limits on price increases set out in section 2.2.3, standard retail suppliers must move regulated retail tariffs towards the relevant target levels. A standard retail supplier must ensure that once a regulated retail tariff equals the target level, the regulated retail tariff does not depart from that target level.

There are currently more than 500 regulated retail tariffs in NSW. Some of these are significantly higher than the applicable target level (which is based on the cost of supply), while others are close to or lower than the applicable target level. The Tribunal believes that moving the regulated retail tariffs to target levels immediately could, in some instances, result in significant price increases for some small retail customers. It has, therefore, set out a process through which regulated retail tariffs move towards the relevant target levels gradually, in yearly increments.

¹⁹ The Tribunal's recommendation does not affect a customer's right to enter into a negotiated customer supply contract.

Standard retail suppliers will be able to increase regulated retail tariffs that are currently below their target level in line with CPI^{-GST20} until 2004. The definition of the CPI^{-GST} as used in this report can be found in Schedule 1 of the recommendation. They will not be able to increase regulated retail tariffs that are currently above the relevant target level, so that these tariffs will decrease in real terms. When setting transitional tariffs, standard retail suppliers must comply with the limits on price increases set out by the Tribunal (see section 3.2.3, below).

Target levels are 'end-points' for regulated retail tariffs. The duration of the transition period will depend on how cost-reflective the small retail customer's regulated retail tariff is when the transition commences. The regulated retail tariff of many small retail customers will reach the relevant target level at the first price change while others may only reach the relevant target levels after several years (which could be beyond 2004).

2.2.3 Limits on price increases applying to transitional tariffs

At each price change for the same pattern and volume of consumption as the previous year, tariffs must not increase in a manner that would result in a small retail customer's bill increasing:

- by more than the change in CPI^{-GST}, or \$25 (whichever is greater) for those residential²¹ regulated retail tariffs that are currently below the relevant target levels as set by the Tribunal.
- by more than the change in CPI^{-GST} plus 5%, or \$50 (whichever is greater) for those business²² regulated retail tariffs that are currently below the relevant target levels as set by the Tribunal.

Regulated retail tariffs that are above the applicable target levels must not increase in nominal terms. This will result in real price reductions for customers on those regulated retail tariffs.

The Tribunal has established rules governing the rate at which standard retail suppliers can move transitional tariffs towards target levels. It believes these rules achieve a reasonable balance between the financial requirements of the standard retail suppliers and the impact on small retail customers.

Under the Tribunal's recommendation, the majority of small retail customers' regulated retail tariffs will reach target levels by 2004. However, by 2004 there will be some small retail customers on regulated retail tariffs that are below the target level. Standard retail suppliers will need to fund the difference between the revenue derived from these 'uneconomic' regulated retail tariffs and the costs of supply. The Tribunal has allowed for this in its treatment of regulated retail tariffs that are above the relevant target level (see below).

²⁰ CPI^{-GST} is defined in Schedule 1 of the recommendation.

²¹ Note that residential is defined to include rural residential.

²² Note that business is defined to include rural business.

Where a regulated retail tariff is less than the relevant target level

As set out above, where a *residential* transitional tariff for *residential* small retail customers is below the relevant target level, the residential small retail customer's bill must not increase by more than CPI-GST or \$25 (whichever is greater) per annum.²³ The definition of the CPI-GST as used in this report can be found in Schedule 1 of the recommendation. This limit will apply largely to regulated retail tariffs for residential small retail customers with controlled loads (for example, off-peak hot water systems) which are below target levels.

Where a *business* transitional tariff for *business* small retail customers is below the relevant target level, standard retail suppliers can increase the bill of a business small retail customer by up to the CPI-GST plus 5 per cent or \$50 (whichever is greater) per annum.²⁴ In general, the regulated tariffs for business small retail customers that are currently priced below cost are for specific-end-uses, such as for irrigation, and specific times of use, some of which are substantially below the corresponding target level.

In making its decision, the Tribunal took into account the network tariff projections for the next four years (provided by the retail suppliers). These suggested that, in general, residential network tariffs for residential small retail customers are likely to either remain constant or reduce in real terms²⁵. These reductions will feed through to regulated retail tariffs.

Where a regulated retail tariff is more than the relevant target level

Regulated retail tariffs that are higher than the relevant target level must not increase in nominal terms although the standard retail suppliers may, if they wish, offer tariffs below this rate. As inflation occurs, small retail customers on such regulated retail tariffs will experience real price reductions. The Tribunal believes this gradual approach is fair to standard retail suppliers. Eliminating immediately those regulated retail tariffs that over recover would deny standard retail suppliers a source of revenue to fund tariffs currently earning less than the cost of supply. Small retail customers on regulated retail tariffs that are above the target levels are likely to be offered price reductions in the contestable market. Once eligible for contestability, they will be free to enter into a negotiated customer supply contract with a retail supplier.

²³ Assuming the same pattern of consumption as the corresponding period the year before.

²⁴ Assuming the same pattern of consumption as the corresponding period the year before.

²⁵ Some of the existing retail suppliers who supply to small retail customers in regional areas project a slight increase in network tariffs for the business small retail customers. On the other hand, EnergyAustralia and Integral Energy forecast a real reduction in the business network tariffs.

2.2.4 Timing of price changes

Regulated retail tariffs in force on 31 December 2000 must remain unchanged until 1 July 2001. Standard retail suppliers must not change their regulated retail tariffs more than once in a 12 month period.

The Tribunal considers it appropriate that standard retail suppliers change regulated retail tariffs only once a year, in a predictable, orderly manner. This approach will give regulatory certainty to small retail customers and industry.

Standard retail suppliers will be required to make price changes to regulated retail tariffs on 1 July²⁶ from 2001 to 2003.²⁷ This means that regulated retail tariffs as at 31 December 2000 will not change before 1 July 2001.²⁸

2.3 Effect of these changes on the level of regulated retail tariffs

The indicative average target levels²⁹ for the standard retail suppliers in NSW over the period from 1 January 2001 to 30 June 2004 are set out in Figure 2.3. The figures are based on the standard retail suppliers' projected network tariffs and the Tribunal's decisions regarding the R component.

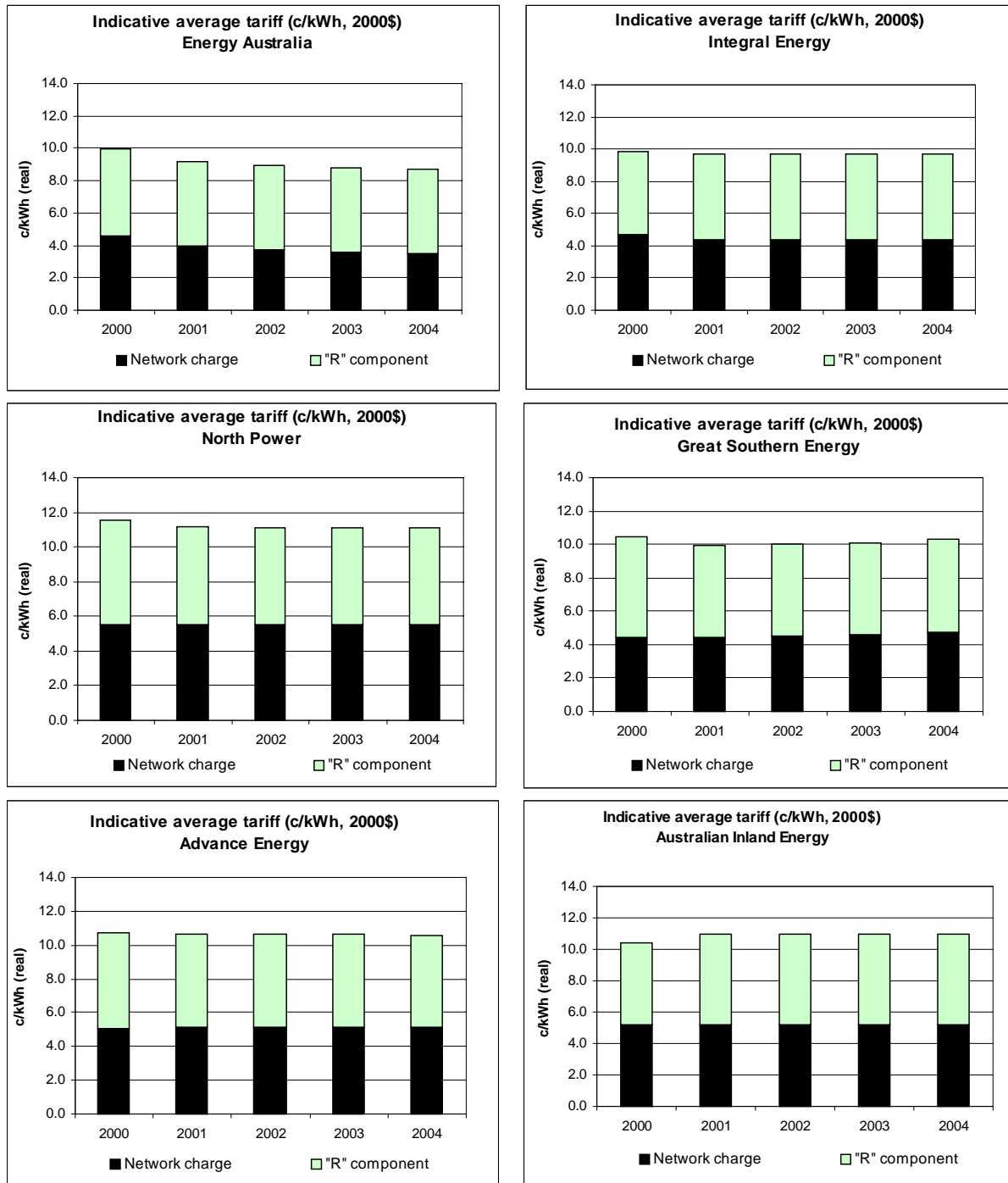
²⁶ If circumstances prohibit a 1 July price change, standard retail suppliers can change prices no earlier than 1 July and no later than 14 July.

²⁷ The arrangements beyond June 2004 are beyond the scope of this report.

²⁸ It is a condition of a standard retail supplier's licence that they notify the Tribunal of intended price changes 30 days in advance of the intended change.

²⁹ The regulated retail tariffs will include a charge for the N component and the R component. The R component comprises fixed and variable elements. The actual charge billed to, and paid by, customers will depend on their consumption. The figures depict average price movements based on the standard retail suppliers' forecasts of movements in the prices for the network component.

Figure 2.3 Indicative average target levels by standard retail supplier, 2000-2004



The substantial real reduction in the average price for Energy Australia is mainly due to reduction in network tariffs and growth forecast by that retail supplier. The moderate reduction in target prices of other major retail suppliers is largely due to expected growth in energy sales.

3 ESTABLISHING REGULATED RETAIL CHARGES (MISCELLANEOUS CHARGES) FOR SMALL RETAIL CUSTOMERS

The Tribunal’s terms of reference asked that it consider and report on the basis for regulating miscellaneous charges and security deposits — called regulated retail charges in the ESA — for small retail customers supplied electricity under a standard form customer supply contract. Regulated retail charges are separate charges additional to regulated retail tariffs. Standard retail suppliers may impose the regulated retail charges to cover the costs of supplying an additional administrative service, for example, or to discourage practices such as the late payment of bills. The Tribunal’s 1999 Determination regulating retail miscellaneous charges expires on 31 December 2000.

Regulated retail charges are:

- fees for dishonoured bank cheques
- late payment fees
- security deposits.

While the Tribunal understands that or further miscellaneous charges may be needed in the future, it has set the maximum allowable charges for the list of regulated retail charges specified in the Amending Act. The maximum amount a standard retail supplier can charge a small retail customer for each regulated retail charge is set out in Table 3.1. Standard retail suppliers may choose not to charge regulated retail charges, or to charge below the maximum.

Table 3.1 Regulated retail charges

Charge for miscellaneous service	Maximum allowable charge
Fee for dishonoured bank cheque	Twice bank fee
Late payment fee	\$5.00
Security deposit	1.5 times the average quarterly account or 1.75 times the average 2-monthly account, or 2.5 times the average monthly account

Where standard retail suppliers do choose to impose regulated retail charges under a standard form customer supply contract the standard retail supplier must inform small retail customers of these charges in accordance with the Tribunal’s requirements set out below.

The rationale behind the Tribunal’s decision to set regulated retail charges can be found in Appendix 4.

3.1 Fee for dishonoured bank cheque

Where a small retail customer pays a bill by cheque, direct debit or credit card and the payment is dishonoured or reversed by the small retail customer's financial institution, the standard retail supplier could incur a bank fee. If a cheque is dishonoured³⁰, the standard retail supplier is entitled to recover this bank fee from the small retail customer, plus an equivalent amount to cover associated administrative costs.

3.2 Late payment fee

Some standard retail suppliers charge small retail customers a fee if they pay their electricity account after the due date. The purpose of such fees is to encourage small retail customers to pay their bills when they are due, or make alternative payment arrangements with the standard retail supplier and to cover administrative costs involved in the late payment of bills.

The Tribunal recognises that some small retail customers genuinely have difficulty in meeting payments by the due date. The imposition of late payment fees should not adversely affect the small retail customers.

The late payment fee must not be applied:

- during the period of an extension, where the small retail customer and the standard retail supplier have agreed to the small retail customer having an extension of time to pay the account, or
- where a small retail customer has made a complaint in relation to the bill to the electricity industry ombudsman or another external dispute resolution body and the complaint remains unresolved, or
- during the period of an instalment arrangement, where the small retail customer has entered into an instalment arrangement with the standard retail supplier to pay the account.

The late payment fee is to be waived:

- where the small retail customer has contacted a welfare agency/support service for assistance, or
- where payment or part payment is by EAPA voucher³¹, or
- on a case by case basis as considered appropriate by either the standard retail supplier or the electricity industry ombudsman.

³⁰ The Tribunal considered that these provisions apply to direct debit or credit card dishonoured bank transactions as well as a dishonoured cheque, but the Amending Act provides for dishonoured cheques only to attract a dishonoured bank transaction regulated retail charge.

³¹ A voucher issued under the Energy Accounts Payments Assistance Scheme. This Scheme is administered by the NSW Department of Community Services.

The late payment fee may only be levied:

- on or after the date which is at least 5 business days after the due date shown on the account, and
- provided the small retail customer has been notified in advance that the late payment fee will be charged if the account is not paid, or alternative payment arrangements entered into, by the due date.

3.3 Security deposits

The Tribunal has set the maximum security deposit a standard retail supplier can require of small retail customers as either:

- 1.5 times that small retail customer's average quarterly electricity retail account³², or
- 1.75 times that small retail customer's average two-monthly electricity retail account, or
- 2.5 times that small retail customer's average monthly electricity retail account.

These amounts are to be based on the average consumption for that type of customer over the past 12 months.

Types of Security Deposit

The acceptable types of security deposits are:

- cash, cheque, credit card for residential and business small retail customers
- annual security levy for business small retail customers only
- guarantees, including Department of Housing guarantees for residential small retail customers and bankers' guarantees for business small retail customers.

Residential Small Retail Customers

Security deposits must not be required from residential small retail customers prior to connection unless one or more of the following applies:

- the small retail customer has left a previous supply address without settling an outstanding electricity usage debt, the debt remains outstanding and the small retail customer refuses to make an arrangement to pay it
- within the previous two years, the small retail customer has been responsible for the illegal use of electricity
- the small retail customer does not have a satisfactory credit history with the standard retail supplier or cannot demonstrate satisfactory credit history with another energy supplier³³, and the standard retail supplier has offered the small retail customer an instalment plan or other payment option (for example pay as you go by instalments, direct debit) and the small retail customer has refused, or failed to agree to the offer.

³² The amount of the average account will vary between standard retail suppliers, depending on average tariff levels and average consumption by the relevant small retail customer. The amount of the average retail account should be calculated as part of the process by which a regulated retail tariff is set. The amount of the required security deposits must be posted on the standard retail suppliers' tariff schedules.

³³ Includes gas as well as electricity.

Business Small Retail Customers

Security deposits must not be required from business small retail customers prior to the connection of supply unless one or more of the following applies:

- the business small retail customer does not have a satisfactory credit history with the standard retail supplier or cannot demonstrate satisfactory credit history with another retail supplier
- the small retail customer is a new business
- within the previous two years, the small retail customer has been responsible for the illegal use of electricity.

Interest on security deposits

Standard retail suppliers are not required to pay interest on security deposits.

Return of cash, cheque or credit card security deposits

Small retail customers who are required to pay a security deposit, and who pay in the form of cash, cheque or credit card, will become eligible for that deposit to be refunded when they have completed:

- for residential small retail customers, one year's payment of the billing cycle by the due dates listed on the initial bills (where the year starts from the due date of the first bill)
- for business small retail customers, two years' payment of the billing cycle by the due dates listed on the initial bills (where the two years start from the due date of the first bill) and the retention of a satisfactory credit rating.

When this occurs, the standard retail supplier must inform the small retail customer, in writing, of the amount that is refundable, and credit that amount to the small retail customer's account within 10 business days.

Maximum duration of requirement for annual security levy or guarantee

Small retail customers who are required to pay a security deposit and choose to do so in the form of an annual security levy or guarantee, will become eligible for this arrangement to cease when they have:

- for residential small retail customers, one year's payment of the billing cycle by the due dates listed on the initial bills (where the year starts from the due date of the first bill)
- for business small retail customers, two years' payment of the billing cycle by the due dates listed on the initial bills (where the two years start from the due date of the first bill) and the retention of a satisfactory credit rating.

The standard retail supplier must inform small retail customers who meet the above requirements that an annual security levy or guarantee is no longer required. Small retail customers must be informed in writing, and within 10 business days, of the above requirements being met.

Cessation of supply

When a standard retail supplier requires a small retail customer to pay a security deposit, and the small retail customer requests that the standard retail supplier cease supplying electricity to the small retail customer's supply address, the standard retail supplier must:

- inform the small retail customer in writing of the amount of the security deposit held, and
- pay the amount either to the small retail customer or into the small retail customer's account.

This must occur within 10 business days of the small retail customer ceasing to take supply.

3.4 Informing small retail customers

The Tribunal believes that it is appropriate for standard retail suppliers to inform small retail customers about the regulated retail charges that may be charged by the standard retail supplier, and the miscellaneous charges that the standard retail supplier may pass through to them from the network business. While the *Electricity Supply General Regulation 1996* specifies obligations on the standard retail suppliers to inform customers of variations in charges, the Tribunal believes that it is appropriate for that standard retail suppliers inform small retail customers:

- in advance of any fees being charged
- in plain language
- in a physical form — on bills, notices and websites, and so that the information is easily accessible by the customer
- in a way which makes clear the circumstances in which the fees will be applied.

The Tribunal also believes that it is appropriate for standard retail suppliers to inform small retail customers of:

- the internal and external dispute resolution mechanisms available to them if they query or dispute any of the regulated retail charges or miscellaneous charges imposed
- the times during which normal hours fees apply and those when after hours fees may apply
- the normal business hours for the standard retail supplier and related network business.

Further, the Tribunal believes that it is appropriate for standard retail suppliers to provide this information to:

- new small retail customers at the time of connection
- existing small retail customers in advance of fees being charged for the first time
- all small retail customers from time to time as part of general customer information.

4 COMPLIANCE AND NOTIFICATION

In the past, the electricity businesses have been responsible for developing tariff strategies. This has resulted in a situation where there are over 500 regulated tariffs across New South Wales, many of which are set at levels that are well below, or well above cost reflective levels.

While the Tribunal has established a framework that facilitates (but limits) price changes, the ESA does not provide the Tribunal with the powers to approve price changes. The Tribunal strongly encourages the standard retail suppliers to move regulated retail tariffs toward target levels in the manner set out in the recommendation, in order to ensure a smooth transition to full retail competition.

The standard retail suppliers will be required to provide such information to the Tribunal as determined by the Minister for Energy for the purpose of demonstrating that the tariffs are in accordance with the relevant determination of the Tribunal. As standard retail suppliers are required to change their regulated retail tariffs on 1 July each year, the Tribunal must receive notice of any price changes by 1 June each year.

The Tribunal considers that the type of information that may be required could be whether prices are at their target level and the rate of price increases.

APPENDIX 1 TERMS OF REFERENCE

Terms of reference for the provision of assistance by the Independent Pricing and Regulatory Tribunal to the Premier under section 9 of the *Independent Pricing and Regulatory Tribunal Act, 1992* ('the IPART Act') on Full Retail Competition in Electricity.

Description of services to be provided

Assistance is requested under section 9 of the IPART Act for the Tribunal to conduct an investigation and report on:

The appropriate setting of a system of regulated retail tariffs for all franchise customers and eligible default customers (as defined below) in each distribution area in New South Wales for the period from 1 January 2001 to 30 June 2004.

The regulated retail tariffs are to be set so as to facilitate a smooth transition to a competitive retail market in NSW. In investigating an appropriate regulated retail tariff for eligible customers, the Tribunal should aim to keep the arrangements as simple as possible, and have regard to the costs of supplying regulated customers, including the cost impacts of policies that comprise the final set of regulatory arrangements for franchise and regulated customers.

As part of their investigation the Tribunal may report on the nature and operation of any restrictions on price movements within the system of regulated retail regulated retail tariffs.

Background

An electricity retail franchise will remain for some customers at least until 31 December 2001. From 1 January 2001 until 30 June 2004 the Minister for Energy will appoint a 'default retailer' in each distribution area. As a condition of a retail licence under Clause 6 (1)(b) of Schedule 2 of the *Electricity Supply Act, 1995*, each default retailer will be required to offer a regulated retail 'regulated retail tariff' to eligible customers.

The purpose of this regulated retail tariff is to offer regulatory protection to customers who are no longer franchise customers and, for whatever reason, have not arranged electricity supply from the competitive retail market. The primary purpose of this arrangement is to ensure customers have an appropriate amount of time to consider their supply options and for the competitive retail market to mature.

The default retailer will also act as a 'retailer of last resort', responsible for supplying a customer in the retailer's relevant distribution area when the customer's own retailer is no longer able to supply that customer.

The default retailer will also be responsible for supplying franchise customers at least until 31 December 2001.

Definitions

'Franchise customer' means a person who is not a non-franchise customer by virtue of an order in force under s.92 of the *Electricity Supply Act, 1995*, and

'Eligible default customers' means:

- a) customers who are capable of becoming non-franchise customers by virtue of an order in force under s.92 of the *Electricity Supply Act, 1995* (who consume 160 MWh of electricity or less per annum) including:
 - i) customers who have been franchise customers at 31 December 2000 but who do not choose to enter into a negotiated contract (ie do not elect to choose their retailer) after they have the right to choose their retailer from 1 January 2001;
 - ii) any other customers that may be deemed to be eligible by the Minister for Energy (eg customers who, after electing to choose their retailer, subsequently decide to return as a customer receiving a regulated tariff from a default retailer); and
- b) customers supplied by a retailer of last resort (as defined in the National Electricity Code), being customers who consume 160 MWh of electricity or less per annum, and that are supplied by another retailer in the event that their retailer of choice defaults supplying that customer.

Matters for consideration

The matters the Tribunal is to consider in making its investigation and report include:

1. an allowance for electricity purchase costs based on an assessment of the long-run marginal cost of electricity generation
2. an allowance for purchases of 'green energy', consistent with retailer license obligations
3. energy losses as published by NEMMCO
4. network charges as determined by the Independent Pricing and Regulatory Tribunal and the Australian Competition and Consumer Commission
5. fees (including charges for ancillary services) as imposed by NEMMCO under the National Electricity Code
6. an appropriate Retail Gross Margin
7. recovery of some or all of *retail* under-recovery balances remaining at 31 December 2000 over the full franchise period to 31 December 2001
8. an allowance for annual indexation based on the Consumer Price Index and expected movements in regulated components and NEMMCO fees.

The investigation and report must consider the Government's objective of promoting competition in the retail market for electricity. In particular, the Tribunal is to take account of international experience with retail competition including any consideration of the extent to which the operation of the competitive retail market is affected by the relationship between the level of the regulated and competitive retail electricity prices.

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

The investigation and report should consider compliance and monitoring procedures (including submission of regulatory accounts), and notification provisions.

The Tribunal may consult with stakeholders as appropriate, within the time available for the review. The Tribunal's report is to be made publicly available.

Timing

The Tribunal is to investigate and provide a final report on their investigations by 30 October 2000.³⁴

Resourcing and Cost

The Tribunal may engage consultants to assist it with its investigation and report. The NSW Government will provide reasonable funding to the Tribunal to assist it in this review.

³⁴ The Premier granted an extension until 24 November 2000.

APPENDIX 2 OVERVIEW OF CHANGES IN THE NSW ELECTRICITY MARKET

Over the last decade, the NSW electricity industry has undergone major reform. The supply sector has been vertically separated into generation, transmission, distribution and retail sectors. The six government-owned electricity businesses have been corporatised. The generation sector now operates in a competitive environment (the national electricity market). The transmission and distribution sectors remain monopoly services and are subject to on-going regulation under the National Electricity Code. The current determination covers the period 1 February 2000 to 30 June 2004.

The retail electricity market is also being opened up to competition. Consumers are being given the right to choose their retail supplier in stages, starting with those with the highest level of annual electricity consumption. The NSW Government has announced the following transitional timetable for full retail competition:³⁵

- customers consuming 100 MWh to 160 MWh a year will be contestable from 1 January, 2001
- if the required national retailing systems are operating effectively, customers consuming 40 MWh to 100 MWh will be contestable from 1 July, 2001
- if the required national retailing systems are operating effectively, customers consuming between 0 MWh and 40 MWh a year will be contestable from 1 January, 2002.

To address the challenges of introducing full retail competition in the National Electricity Market from 1 January 2001, the Treasurer announced the establishment of the Market Implementation Group (MIG) within the NSW Treasury. MIG was established on 1 November 1999 and is responsible for developing retail competition policy for electricity in NSW³⁶.

As a result of MIG's work, the Amending Act was introduced into Parliament on 16 November 2000. The object of the Amending Act is to amend the ESA Act and other Acts so as to provide the necessary framework in the electricity industry for the introduction of full retail competition and to make other consequential amendments. The key elements of the Amending Act insofar as it relates to customer protection is that it:

- (a) extends the right to enter into negotiated contracts with retail suppliers to all customers (by removing the current distinctions between franchise customers and non-franchise customers) but makes savings and transitional provisions enabling the phasing in of full retail competition
- (b) recognises small retail customers and confers on them rights and protections, including rights to connection services, rights to apply to be supplied with electricity, rights to protections under contracts of connection and supply, rights to have electricity supplied at a regulated retail tariff, rights relating to transfers to different retail suppliers and rights relating to resolution of disputes

³⁵ Ministry of Energy and Utilities Press Release *New Energy Choice for Consumers* 6 May 2000.

³⁶ For further information visit the Market Implementation Groups homepage www.treasury.nsw.gov.au/mig.htm

- (c) provides a mechanism for the setting of regulated retail tariffs for electricity and regulated retail charges by the Tribunal and
- (d) extends the operation and application of the electricity industry ombudsman scheme.

APPENDIX 3 THE COST OF SUPPLYING ELECTRICITY

One of the Tribunal's key considerations in determining appropriate target levels for regulated retail tariffs was the cost to standard retail suppliers of supplying electricity. In particular, its terms of reference required it to consider and make an allowance for a range of cost components. These include:

- the cost of purchasing electricity based on the long run marginal cost of electricity generation, and the cost of purchasing green energy (as required by the retail suppliers licence agreements)
- the network charges retail suppliers pay to distribution businesses (as determined by the Tribunal and the ACCC)
- the cost of electricity lost during transportation (as published by NEMMCO)
- the fees (including charges for ancillary services) imposed on retail suppliers by the National Electricity Market Management Company (NEMMCO) under the National Electricity Code
- an appropriate retail margin
- the recovery of some or all of retail under-recovery balances remaining at 31 December 2000 over the full franchise period to 31 December 2001.

This appendix discusses how the Tribunal analysed each of these cost components and the allowance it made for each in setting the target levels in its Recommendation.

Cost of purchasing electricity and green energy

The Tribunal's estimate of the long run marginal cost (LRMC) of electricity generation is between \$36 to \$56 per MWh. The Tribunal based this assessment on a number of studies of the LRMC of electricity generation, including the Cap Gemini Ernst & Young (CGEY) study it commissioned. This range includes an allowance for the cost of purchasing green energy, and takes into account the costs to generators of the fees and charges imposed by NEMMCO under the National Electricity Code. The range is consistent with the schedule of target levels for regulated retail tariffs established under this report.

What was the basis of the Tribunal's decision?

The Tribunal took a number of factors into consideration in deciding on the range for the LRMC of electricity generation, including:

- the government's proposed electricity tariff equalisation fund
- the Cap Gemini Ernst and Young study that the Tribunal commissioned
- other studies of LRMC of electricity generation
- licence requirements for greenhouse energy purchases
- NEMMCO fees and ancillary charges incurred by generators.

Cap Gemini Ernst and Young study into LRMC of electricity generation

As part of its investigation, the Tribunal commissioned Cap Gemini Ernst and Young (CGEY) to undertake a study of the LRMC of electricity generation. CGEY presented its preliminary findings at a public round table meeting and its report was subsequently posted on the IPART website and distributed for comment. CGEY then considered issues raised in the public consultation and produced a final report.³⁷

The report presents three alternative assessments of the LRMC, based on three different approaches to estimating this cost:

1. the revenue sufficiency approach, which assumes that the generation sector earns a reasonable rate of return on its assets
2. the LRMC standard approach, through which the LRMC is determined by the marginal generator, which means that the LRMC of the peak generation is applied to all generation during peak times³⁸
3. the LRMC Snowy/Gas approach, which is similar to the LRMC standard approach but assumes that the Snowy Hydro infrastructure is replaced with gas-fired co-generation due to the fact that Snowy Hydro would not be built today because of its high asset replacement cost.

CGEY assessed the costs of peak, shoulder and base load generation plant in NSW using these three approaches, then applied these costs to the franchise load shapes for each of the six existing franchise retail suppliers³⁹. Table A3.1 below shows the resulting LRMC estimates for each retailer.

Table A3.1 LRMC of generation, based on franchise loads¹

(\$/MWh)	Revenue Sufficiency	LRMC Standard	LRMC Snowy/Gas
EnergyAustralia	35.9	37.1	49.8
Integral Energy	36.0	37.1	50.5
North Power	35.9	37.4	54.8
Great Southern Energy	36.1	37.3	53.6
Advance Energy	36.4	37.4	54.7
Australian Inland Energy	35.8	37.2	51.9

Notes:

1. excluding GST.

Source: CGEY *Assessing the Long Run Marginal Cost of Generation in New South Wales – Report for IPART*, September 2000.

It is important to note that the CGEY estimates do not provide any guidance about the likely profile of prices over time. Assuming the plant mix is appropriate and that the market functions efficiently, they do indicate the prices required over the long term if sufficient investment is to be encouraged. However, the market is likely to be characterised by extended periods of prices well-above or well-below the average LRMC level.

³⁷ Cap Gemini Ernst & Young, [Assessing the Long Run Marginal Costs of Generation in New South Wales](#), Report for IPART, September 2000.

³⁸ Similarly, during shoulder times, the LRMC of shoulder generation applies to all generation.

³⁹ For a discussion of the methodology and assumptions used, please refer to the CGEY report.

The Tribunal received a number of submissions in response to CGEY's preliminary report in early September. The main issues raised in these submissions were that:

- the use of a theoretical LRMC methodology means 'sanity checks' are required, including consideration of other elements which impact on energy cost, and actual and forecast market conditions. A 'reset to market' trigger may be needed for unforeseen events, as discussed in Chapter 1
- the draft report underestimated the quantity of green energy purchases required and the costs thereof
- the unit asset price of black coal relating to the capital cost of generation plant (\$950/KW) was too low
- standard retail suppliers supported a WACC in the range of 10 to 12 per cent, while PIAC considered 10 per cent was too high and inconsistent with treatment of NSW network operators
- standard retail suppliers generally supported the use of a LRMC estimate at the higher end of the CGEY range. Some stakeholders indicated that the cost of new (non-green) energy lies in the range of \$35 to \$40/MWh. However, PIAC was concerned that the proposed pricing approach is intended to create windfall revenue and that this will lead generators to inflate their costs
- concern that CGEY admitted that its analysis does not reflect the 'peakiness' of EnergyAustralia's load and therefore understates the LRMC, due to issues relating to the quality of EnergyAustralia's data
- for consistency, the Snowy Hydro assets should be valued at their replacement cost, rather than the written down accounting value, in the revenue sufficiency and LRMC-Standard approaches
- general questions about CGEY's categorisation of baseload, shoulder and peak, the accuracy of load data and load shapes, and the high level of its analysis and general lack of detail
- PIAC was concerned that the general community does not have capacity to deal with the complexity of this issue and that residential consumers may never see tangible benefits from full retail competition.

In response to these comments, in its final report, CGEY increased the proportion of green power cogeneration in its modelling, while reducing the proportion of black coal generation. This resulted in an increase in the base retailer costs of up to \$1/MWh. However, the potential costs of the Commonwealth's proposed '2 per cent renewables' legislation have not been taken into account, as this was outside the terms of reference and the legislation was not finalised at the time of the study.⁴⁰ CGEY's final report also includes a sensitivity which considers a higher black coal unit cost of \$1,150/KW and a sensitivity which increases the gas price.

If necessary, the Tribunal may assess the impact of the Commonwealth renewables legislation (if it proceeds) on retail supplier costs at the time of its mid-term review.

⁴⁰ The ESAA Electricity Supply Newsletter of 13 November 2000 stated that the Commonwealth's *Renewable Energy (Electricity) Bill, 2000* was 'still in limbo', as the bill has not yet been debated in the Senate.

Other LRMC studies the Tribunal took into account

In 1994, the Tribunal commissioned ACIL to assess the LRMC of electricity generation. ACIL estimated the LRMC to be around \$47/MWh.⁴¹ The approach that ACIL used to calculate the LRMC compared the net present value of cost streams with and without changes in demand.

The ACCC in its 1999 determination on NSW vesting contracts, noted that:

A consistent trend of average spot and contract prices reaching or exceeding the \$30-35/MWh range would trigger significant additions to generating capacity out of existing resources. Should pool prices increase to the high \$30s to low \$40s 'stand-alone' greenfield would become viable ...

The Commission still believes, in the absence of other considerations that \$37/MWh lies within the range of new entry pricing.

The Commission accepts that new entry costs will depend on a range of factors including the cost of capital, operating costs and capacity factors. After examining the various arguments the Commission believes new entry costs are better represented by a range of prices (\$35-45/MWh) assuming different cost parameters and market conditions.⁴²

The NSW Treasury, in a submission to the ACCC review, noted that:

Pool and contract prices are well below new entrant levels. ... new entrant average costs (or long run marginal costs) are in the region of \$35/MWh to \$40/MWh for coal plant and higher for peak load plant.

These studies tend to suggest a range for LRMC between \$35 and \$47/MWh. However, none of these assessments have explicitly taken into account the (higher) cost of green energy purchases, which is a licence requirement for each standard retail supplier. Also, these studies were conducted using a different approach to that used by CGEY in the estimation of LRMC. The analysis undertaken by CGEY took green energy purchase costs into account, resulting in an upper limit of around \$55/MWh.

The relationship between LRMC and pool prices

The Tribunal recognises that for significant periods of time, the LRMC of electricity generation can depart from pool prices.⁴³ The LRMC could be higher than pool prices in times of excess capacity, but in the lead up to capacity constraints, it could be below the pool price for extended periods.

⁴¹ In \$1999/2000 dollar terms.

⁴² ACCC, *NSW Vesting Contracts: Final Determination*, September 1999, p 49.

⁴³ This is because LRMC is an average measure of marginal costs over a 'long' period of time, while the pool price reflects short run marginal cost.

In New South Wales there is currently significant spare capacity, which gives rise to expectations that energy prices will be low in the short to medium term when compared with the LRMC. However, the Tribunal is aware of expectations that there may be higher pool prices in early 2001, flowing from the tighter supply-demand position in Victoria and South Australia.⁴⁴ As demand increases over the medium term, prices are expected to increase. The impact on pool prices of interconnections under way or planned from New South Wales to Queensland and South Australia and new generation capacity in Queensland is uncertain.

In the lead up to new investment in generation capacity, pool prices could exceed LRMC for an extended period. How quickly pool prices and short to medium term contract prices will increase in advance of new investment is not known. Nor is the effect of the relatively small number of suppliers.

One guide to future electricity prices is the price information published by the Australian Financial Markets Association (AFMA). AFMA gathers prices from market participants and publishes a forward curve of electricity prices for its subscribers. The AFMA forward electricity market curve to 2004⁴⁵ indicates average ('flat'⁴⁶) electricity prices of \$35/MWh, and peak⁴⁷ electricity prices just under \$48/MWh. This compares with an average NSW pool price of \$37.81 (volume weighted) in the 52 weeks to 4 November 2000.⁴⁸ That said, the forward electricity market lacks depth, and, at this stage, may not provide a reliable guide to expectations of future prices.

Green energy costs

CGEY's estimation of LRMC relates to an optimised generation mix. An important element in the optimisation exercise was the inclusion of a sufficient allowance for green electricity purchases to meet licence obligations.

The *Electricity Supply Act, 1995* requires that electricity retail suppliers, as part of their licence conditions, develop greenhouse gas reduction strategies. Each retail supplier is required to set out in its strategy the steps it proposes to take to meet its 'emissions' benchmark requirement. The benchmark of greenhouse gas emissions from electricity supplied to New South Wales customers is five per cent below 1989/90 per capita levels by 2000-01. There are no immediate penalties for failing to meet the emission benchmarks.

The required per capita level in 2000/01 is 7.27t CO₂ equivalent, remaining constant thereafter. CGEY noted that the green energy options available to retail suppliers to meet their forecast licence obligations may vary, leading to possible cost differences for each retail supplier. However, the CGEY analysis assumed that a least-cost approach would be adopted and therefore used gas cogeneration to supply all green purchase requirements in its modelling.

⁴⁴ However it should be noted that constraints on the interconnector may limit the impact of interstate pool prices.

⁴⁵ As at 13 September 2000.

⁴⁶ Covering the whole 24 hour period.

⁴⁷ Covering the period 7am to 10 pm.

⁴⁸ ESAA Electricity Supply Newsletter, No 141, 13 November 2000, p 9. The average NSW pool price in the week ending 4 November 2000 was \$42/MWh.

What does the ‘Long Run Marginal Cost of Electricity’ mean?

The marginal cost of supplying a product represents the ‘opportunity cost’, or sacrifice made by society to produce an extra unit of that product. It is the change in total cost that results from increasing production or output by one unit. According to economic theory, if a product’s price is higher than its marginal cost, its opportunity cost is overstated, and the consumer may buy less than the optimum quantity. Conversely, if its price is less than its marginal cost, the opportunity cost is understated, the consumer may buy too much and too much of that product may be produced. This may result in a less than efficient use of resources.

It has long been recognised that the application of marginal cost pricing has some complications in industries where high infrastructure costs are a feature of expanding supply. In the electricity supply industry, infrastructure is usually constructed in large blocks—for example, in the form of generation plants with lives of up to 50 years. Thus the costs of supply will be very ‘lumpy’.

Further, infrastructure is often built to provide for future demand, which can mean that there will be significant excess capacity in the system after new plant is built. While this excess capacity exists, the additional energy can be supplied at very little cost so the (short run) marginal cost is very low in the short run. If the system is close to capacity, however, the marginal cost of producing additional energy is likely to be quite high as it will include the cost of building new infrastructure.

To take these factors into account, economic theory distinguishes between short run and long run marginal costs. Short run marginal costs (SRMC) can be defined as the cost of supplying an additional unit of energy when system capacity is fixed. SRMC effectively relates to increments in operating costs. Long run marginal costs (LRMC) relate to the cost of supplying an additional unit when variations in system capacity are also taken into account.

Network charges

Retail tariffs, particularly regulated retail tariffs, need to accurately reflect the underlying network tariff—that is, the charges retail suppliers pay DNSPs for using the network to deliver electricity from the generation source to end users⁴⁹. The Tribunal established regulated retail tariffs that allow the network tariff to be passed through to the small retail customer, in each year.

What was the basis of the Tribunal’s decision?

The Tribunal believes that a pass-through arrangement for network tariff is appropriate for several reasons. First, network tariffs are a legitimate cost of retailing. The network tariffs payable by retail suppliers are established through regulation and cannot be controlled by them. Standard retail suppliers should be able to recover these costs, and the regulated retail tariff payable by the small retail customer should reflect the underlying network tariff payable by that customer.

⁴⁹ Network tariffs comprise distribution use-of-system charges and transmission end-of-use charges. The former are regulated by the Tribunal, while the latter are regulated by the ACCC.

Second, the difficulty in accurately estimating these charges mean network tariffs are best treated as a pass-through component. There are a number of reasons why network tariffs can not be known with certainty at this time. The regulatory arrangements that apply to the DNSPs provide certainty of future network *revenues* (and of average network tariffs, given demand forecasts),⁵⁰ but do not indicate the level and structure of future network *tariffs* for particular customer classes. Under current regulatory arrangements, actual network tariffs in any one year are not known until one month before they are put in place by the DNSP and payable by retail suppliers and customers.⁵¹ In addition, the outcome of the NECA review⁵² is still uncertain, providing further uncertainty about future transmission and distribution price determination methodologies and structures.⁵³

If the Tribunal were to use inaccurate forecasts of network tariffs in setting regulated retail tariffs it could result in distorted market incentives. For example, it could lead to some profitable and some unprofitable regulated retail tariffs, which would create incentives for 'cherry-picking' customers on the profitable regulated retail tariffs and potential financial difficulties for the standard retail suppliers (as they would be left with small retail customers on unprofitable regulated retail tariffs). Therefore, to ensure that the objectives of this review are met, the Tribunal's Recommendation requires that network tariffs be treated as a pass-through component of the regulated retail tariff.

The Tribunal's Recommendation is consistent with views expressed by retail suppliers throughout the public consultation process.

Loss factors

When electricity is transported along wires from the generator to the end-use customer some of it is 'lost'. Typically, 5 to 6 per cent of electricity transported in urban areas is lost, while in rural areas losses may be as much as 20 per cent. The Tribunal incorporated the cost of these losses into regulated retail tariffs. The target levels of regulated retail tariffs include a retailer-specific, separate dollar per MWh component for urban small retail customers and rural small retail customers to account for energy losses.

The Tribunal used the assumptions shown in Table A3.2 below for the purposes of calculating the cost of losses, and has incorporated that cost in the target level for regulated retail tariff.

⁵⁰ Although, the Tribunal's distribution determination incorporates a number of additional items to the 'glide-pathed base revenue' as established by the 'building blocks' – such as the costs of contestability, payments to embedded generators for demand management and avoided TUOS, and unders and overs account balances. These are uncertain quantities and, as such, the actual annual revenue requirement that each DNSP can earn any one year will remain unclear until the end of each financial year.

⁵¹ Although regulation requires DNSPs to submit and publish 'pricing strategies'—which set out the DNSPs' general pricing strategy and provide an indication of where future tariffs may be headed with respect to level and structure—there remains uncertainty as to the actual tariffs that will be put in place by the DNSP in any one year.

⁵² The NECA Transmission and Distribution Pricing Review considered the appropriateness of current pricing requirements for transmission networks and assessed the current methodologies and regulatory principles for the determination of prices for the distribution networks.

⁵³ Although, clause 9.16.2 of the Code does provide some certainty as to transmission price determination and structure until 30 June 2002. The clause implies that there is to be no re-allocation of the revenue requirement to bulk supply points using the CRNP/postage stamp allocation process, and as such the transmission price structure will not be changed (at least) until 30 June 2002.

Table A3.2 Tribunal’s loss factor assumptions for 2001-2004

Loss Factors (transmission loss factors plus distribution loss factors)	Urban %	Rural %
EnergyAustralia	5.6	5.6
Integral	8.1	8.1
NorthPower	11.6	19.4
Great Southern Energy	9.1	19.4
Advance Energy	11.8	16.3
Australian Inland Energy	19.5	19.5

Source: Calculated on loss factors published by NEMMCO.

What are loss factors?

The electricity industry measures three types of electricity loss, all of which reflect some part of the increased cost to the retail supplier of transporting electricity to the final end-use customer:

- **Distribution loss factors.** Under the National Electricity Code, DNSPs prepare distribution loss factors (DLFs) to describe the volume weighted average electricity loss they incur in distributing electricity between a transmission network connection point and all loads connected to it throughout the distribution network. These DLFs are submitted to the relevant jurisdictional regulator for approval (IPART in NSW), and then published on NEMMCO’s website. Each DNSP has between one and three DLFs applying to their various franchise customer tariffs.
- **Intra-regional transmission loss factors.** Intra-regional full marginal loss factors (MLFs) are a static measure, and apply to each connection point for a financial year⁵⁴. The MLFs are reassessed and adjusted as required on an annual basis. In NSW there are ninety six transmission connection points with almost all servicing the full range of customer types. As Table A3.3 below shows, the loss factor varies considerably from connection point to connection point, even within a retail supplier’s area.

By definition, the MLF is equal to 1 at the regional reference node (RRN)⁵⁵. The MLF may take on values greater than or less than unity where it is not located at the RRN. Connection points in areas with an overall net injection into the network tend to have MLFs less than one. Connection points at which there is an overall net load tend to have MLFs above unity.

- **Inter-regional transmission loss factors.** These describe the losses over a ‘notional’ interconnector between two regional reference nodes. The inter-regional loss factor equation relevant to NSW describes the losses between the Snowy RRN and the NSW RRN. These inter-regional MLFs are dynamic and measured on a five minute basis. Through the operation of the market, these losses are entirely captured in the relevant RRN spot price. Thus, the cost of these losses are not to be included explicitly in the retail price, as it is already included implicitly in the energy component of the tariff.

⁵⁴ 2000/01 is the first year in which intra-regional MLFs for transmission are applicable in NSW. Until now, intra-regional losses have been treated on an averaged basis.

⁵⁵ Transmission Network MLFs are referred to the RRN.

Table A3.3 Retail suppliers MLFs in 2001

Retailer	MLF Max Value	MLF Min Value
Energy Australia	1.01	0.97
Integral Energy	1.01	0.97
NorthPower	1.00	0.99
Advance Energy	1.04	0.97
Great Southern Energy	1.07	0.98
Australian Inland Energy	1.09	1.03

What is the basis of the Tribunal's decision?

Incorporating losses in regulated retail tariffs

Given the way in which losses are reflected in the market, the best way to incorporate the cost of energy losses into regulated retail tariffs is on a dollar per MWh basis, differentiated by the class of small retail customer and location (defined by the nearest connection point). Such an approach would ensure that regulated retail tariffs reflect the cost of supply, and do not result in distorted market incentives that create 'cherry picking' opportunities. However it would also be very complex to implement.

The Tribunal believes the next best option is to simplify this approach by averaging the cost of energy losses on a standard retail supplier-specific, dollar per MWh for rural small retail customers and for urban small retail customers to recover the cost of energy losses. This approach is broadly in line with current franchise retail tariff setting. The Tribunal also believes that, given the uncertainty about the level of customer churn at this time, the best way to manage the possibility that the cost of energy losses be over- or under-stated using this approach is to consider it in the mid-term review, if required. This is one of the reasons that the Tribunal proposed it conduct a mid-term review.

Calculating loss factors

To calculate the appropriate ‘cost of losses’ component to incorporate in prices, an assumption needs to be made about each of the standard retail suppliers’ urban and rural loss factors. The standard retail suppliers have provided the Tribunal with forecasts of the cost of energy losses over the period to 2004. Broadly, the loss factor remains static over the period from 2001 to 2004 in each of the standard retail suppliers’ projections.

However, the standard retail suppliers’ projections are on an averaged basis, and do not provide an indication of the expected urban/rural split. In addition, no standard retail supplier apart from Great Southern Energy provided separate cost estimates (or expected loss factors) for transmission and distribution losses. In most cases, they incorporated the cost of transmission losses into energy cost projections.

For this reason, the Tribunal has based its cost estimates on the disaggregated loss factors applicable in 2001, as published by NEMMCO. These are broadly consistent with the aggregate cost projections of the standard retail suppliers.

National electricity market fees

The Tribunal’s projections of total National Electricity Market (NEM) fees and ancillary charges applying to both retail suppliers (including standard retail suppliers) and generators over the next three years are set out in Table A3.4, below.

Table A3.4 Estimate of total NEM fees and ancillary charges (\$2000/01)

(\$/MWH)	2000 (Actual)	2001 (\$2001)	2002 & 2003 (\$2001)
Retail suppliers			
NEM Fees	0.47	0.39	0.32
Ancillary Charges	1.70	0.98	0.98
Total Retailer NEM Fees and Ancillary Charges	2.17	1.37	1.30
Generators			
NEM Fees	0.08	0.07	0.14
Ancillary Charges	0.00	0.98	0.98
Total Generator NEM Fees and Ancillary Charges	0.08	1.05	1.12
Total NEM Fees and Ancillary Charges	2.25	2.42	2.42

The Tribunal notes that, for retail suppliers, these projections are lower than the fees and charges they paid in 1999/2000 (which averaged around \$2.17/MWh). However, it also notes that from 1 July 2000, the share of ancillary charges paid by retail suppliers was reduced by 50 per cent. This will result in a significant reduction in the direct costs of these charges to retail suppliers. The Tribunal has taken the impact of these NEM fees and charges on generator costs into account in its assessment of the long run marginal cost of energy (discussed above).

What are NEM fees and ancillary charges?

The National Electricity Market Management Company (NEMMCO) sets fees that apply to participants in the NEM. Standard retail suppliers, as 'market customers'⁵⁶ are required to pay these fees, which are determined each year in advance, based on NEMMCO's budgeted revenue requirements.

Retail suppliers (including standard retail suppliers) are generally charged three types of NEM fees: NECA and NEMMCO establishment cost fees, market customer general fixed fees and market customer general variable fees. They are also charged for ancillary services, which are defined in section 3.11 of the National Electricity Code as services essential to the management of power system security⁵⁷. These arise on an ad hoc basis and retail suppliers are charged as the costs are incurred.

What was the basis of the Tribunal's decision?

NEM fees

On the basis of projections provided on NEMMCO's website, in 2000/01 around 85 per cent of NEM fee revenue will be raised from market customers, primarily through the general variable fees. NEMMCO advises that, due to a moderate restructuring of fees, market customers will pay around 70 per cent of total fees in 2001/02 and 2002/03. At the same time, NEM fees are expected to stay at around the 2000/01 level in real terms for the next two years.

However, the impact of the introduction of full retail competition (FRC) on the level of NEM fees is not yet known. NEMMCO's budgeted revenue requirement for 2000/01 set these fees at zero, but with FRC scheduled to commence on 1 January 2001, fees may well apply from 2001/02. NEMMCO had not published any projections relating to the timing or magnitude of these fees at the time of writing. The Tribunal will consider the impact of these fees on standard retail suppliers' costs at its mid-term review⁵⁸. In the meantime, the Tribunal has used NEMMCO's revenue forecasts for projecting NEM fees up to 2002/03.

⁵⁶ A market customer under the National Electricity Code is one who has classified any of its loads as a market load and who is also registered with NEMMCO as a Market Customer under Chapter 2. A market load is a load at a connection point, the electricity relating to which is purchased other than from the Local Retailer and which has been classified by the person connected at that connection point or, with the consent of that person, by some other person, as a market load pursuant to Chapter 2 of the Code.

⁵⁷ Ancillary services may include the provision of:

- sufficient regulating capability to meet fluctuations in load during a trading interval
- sufficient contingency capacity reserve to maintain power system frequency in event of network or generation outages
- reactive support to guard against power system failure through voltage collapse
- black start capability to allow restoration of power system operation.

⁵⁸ In the interim, the Tribunal has made allowance for FRC fees in its estimate of contestability costs – refer Appendix 4.5.

An estimation of NEM fees applying to all NEMMCO retail suppliers (including standard retail suppliers) on a \$/MWh basis is set out in Table A3.5 below:

Table A3.5 Estimate of NEM fees in dollars per MWh (\$2000/01)

	1999/00 (Actual)	1999/00 (\$2000/01)	2000/01	2001/02 & 2002/03
NEMMCO & NECA Total Revenue Requirement (NNTRR) (\$ million)	\$81.3	\$83.7	\$69.7	\$69.0 ⁵⁹
85 per cent ⁶⁰ NNTRR (\$ million)	\$69.1	\$71.2	\$59.2	\$48.30
NEMMCO total retail load forecast 2000/01 (MWh)	146,803,273 MWh	146,803,273 MWh	151,733,028 MWh	assume same as 2000/01
NEM Fees (\$/MWh)	\$0.47/MWh	\$0.48MWh	\$0.39/MWh	\$0.32/MWh

Ancillary charges

The incidence of ancillary service fees on standard retail suppliers is ad hoc and difficult to predict accurately. Unlike NEM fees, ancillary charges are driven by costs arising from the daily operation of the electricity market. NECA's Reliability Panel sets standards relating to the quality of electricity supply. NEMMCO then establishes agreements with external contractors to ensure that these supply standards are maintained. NEMMCO calls on these contractors as required, and this can be frequent. The costs incurred by contractors are immediately passed on in weekly bills to retail suppliers. Until 30 June 2000 market customers (retail suppliers) were responsible for 100 per cent of ancillary service costs. However, as of 1 July 2000, under schedule 9G of the Code, these costs will be shared on a 50/50 basis between market customers and generators.

An extrapolation of NEMMCO's estimates of total ancillary service costs for the 6 months to December 2000, indicates that these costs will increase by around 20 per cent⁶¹ in 2000/01. However, at the same time, NEM fees are projected to fall around 14 per cent in 2000/01, coinciding with a fall of this magnitude in the NEM revenue requirement.

Most standard retail suppliers have reported a significant jump in ancillary fees in recent times. This is important as information provided by standard retail suppliers indicates that ancillary charges represented an average of 74 per cent of total fees and charges paid to NEMMCO in 1999/2000. Retail supplier data indicates that in 1999/2000 retail suppliers paid NEM fees (including ancillary charges) which were an average of 72 per cent higher than the previous year.

⁵⁹ Extrapolated from data indicating a 1 per cent real reduction in NEMMCO fees in 2001/02. No real change in fees is predicted for 2002/03. Provided per telephone conversation with B Spalding, NEMMCO, 5 October 2000.

⁶⁰ 70 per cent in 2001/02 & 2003/03.

⁶¹ 13.75 per cent in the southern region.

The Tribunal is concerned that these NEM charges, imposed by NEMMCO in its monopoly role as market manager, are not subject to any form of regulation. NEM fees and ancillary charges have been treated in past determinations as a pass-through retail cost, but subject to price limits. It may be appropriate that some form of regulatory control or limit be placed on the extent to which these charges can increase in any given period, particularly given the significant rises reported in recent times.

NEMMCO, in conjunction with the ACCC, is currently conducting a review of the ancillary charges framework as the current regime for these charges ends on 31 December 2000.⁶² Retail suppliers are lobbying for a more commercial environment for the imposition of ancillary charges. It is likely that as a result of this review a more 'market-based approach' to charging for ancillary services will be established. This may address some of the existing concerns of retail suppliers.

However, the impact of a change to a market-based system on actual ancillary service charges is uncertain. Charges may increase or decrease under a market-based system. In view of the uncertainty, it seems reasonable to assume that total ancillary services costs continue at around the same level in real terms over the next few years. The Tribunal will assess the impact of any move to a market-based system for ancillary charges at its mid-term review.

Estimates of ancillary services costs for the southern region (NSW, ACT, SA and Victoria) and Queensland are provided on NEMMCO's website along with retail load forecast for 2000/01 for the whole region. (Separate load forecasts and cost data for NSW are not available.) Table A3.6 below sets out an estimate of ancillary charges per MWh applying to all retail suppliers in the NEMMCO region.

Table A3.6 Estimate of ancillary charges/MWh

	1999/2000 (actual)	1999/2000 (\$2000/01)	2000/2001
NEMMCO Ancillary Service Cost Estimates (\$m)			
Southern region	\$160	\$165	\$182
Queensland	\$89	\$92	\$116
Total	\$249	\$256	\$298
NEMMCO total retail load estimates (million MWh)	146.8	146.8	151.7
Ancillary Charge/MWh	\$1.70	\$1.75	\$1.96
Ancillary Charge/MWh borne by Retail suppliers	\$1.70	\$1.75	\$0.98

⁶² A requirement of Clause 3.11.1c of the National Electricity Code. Advice on NEMMCO's website (October 2000) indicates that owing to Review process running over time, the new regime is unlikely to be implemented prior to mid 2001.

Extrapolating from this data, Table A3.7 shows the estimated total cost of NEM fees and ancillary charges for retail suppliers.

Table A3.7 Estimate of total NEM fees and charges (\$2000/01)

	1999/00 (actual)	1999/00 (\$2000/01)	2000/01
NEM Fees	0.47	0.48	\$0.39
Ancillary Charges	1.70	1.75	\$0.98
Total fees and Charges \$/MWh	2.17	2.23	\$1.37

To estimate these fees and charges for 2001/02 and 2002/03, it seems reasonable to assume that ancillary charges will continue at the same level in real terms. Further, NEMMCO has advised that NEM fees are likely to remain around the same level in real terms in these years. However, given some restructuring of the allocation of NEM fees between retail suppliers and generators, as indicated above, total fees and charges are likely to fall by around 7c/MWh in these years. Thus, the Tribunal has estimated total NEM fees and charges at \$1.30/MWh (\$2000/01) for 2001/02 and 2002/03.

These estimates are significantly lower than the retail suppliers' own forecasts of total NEM fees for 2000/01, which averaged \$2.56/MWh⁶³. However the Tribunal's analysis suggests that these forecasts did not take into account the 50 per cent reduction in the proportion of ancillary charges that retail suppliers will be required to pay from July 2000.

Due to the uncertainty about the impact of full retail competition fees on total NEM fees paid by retail suppliers (discussed above) the Tribunal has included a separate allowance for these costs in its estimate of 'contestability costs' as set out in the following section on retail margins. This issue will also be reconsidered at the Tribunal's mid-term review.

Retail margin

The purpose of a retail gross margin is to allow standard retail suppliers to recover efficiently incurred retail costs (not captured elsewhere), and an appropriate profit margin. In making its Recommendation on regulated retail tariffs, the Tribunal estimated retail operating costs as ranging between \$40 to \$60 per customer per annum (in \$2001), allocated on a fixed (\$ per customer) and variable (c/kWh) basis, and allowed a net profit margin of 1.5 to 2.5 per cent. The \$40 to \$60 cost estimate includes \$5 for costs associated with full retail competition (FRC).

The Tribunal analysed and estimated the retail cost of electricity and an appropriate profit margin separately.

⁶³ Calculated using data in information returns provided by each standard retail supplier.

What was the basis of the Tribunal's decision on retail costs?

In making its estimate of retail costs, the Tribunal analysed and considered a range of factors, including:

- the reported operating costs of the standard retail suppliers
- information on the costs of electricity retailing in other states and countries
- the differing costs of standard retail suppliers due to economies of scale, and
- the appropriateness of reflecting retail operating costs in regulated retail tariffs.

Reported operating costs of the standard retail suppliers

Figures A3.1 and A3.2 below present the actual and projected retail operating costs reported by the standard retail suppliers, applicable to regulated or small retail customers, over the period 1996/97 to 2003/04. The combined costs are shown in aggregate and on a per customer basis.

The costs shown are those the standard retail suppliers reported in their regulatory accounts (and the submitted information requests), and there is some inconsistency between them and those set out in the standard retail suppliers' submissions to the Tribunal.

Figure A3.1 Total New South Wales industry retail costs (real, 2000 dollars)

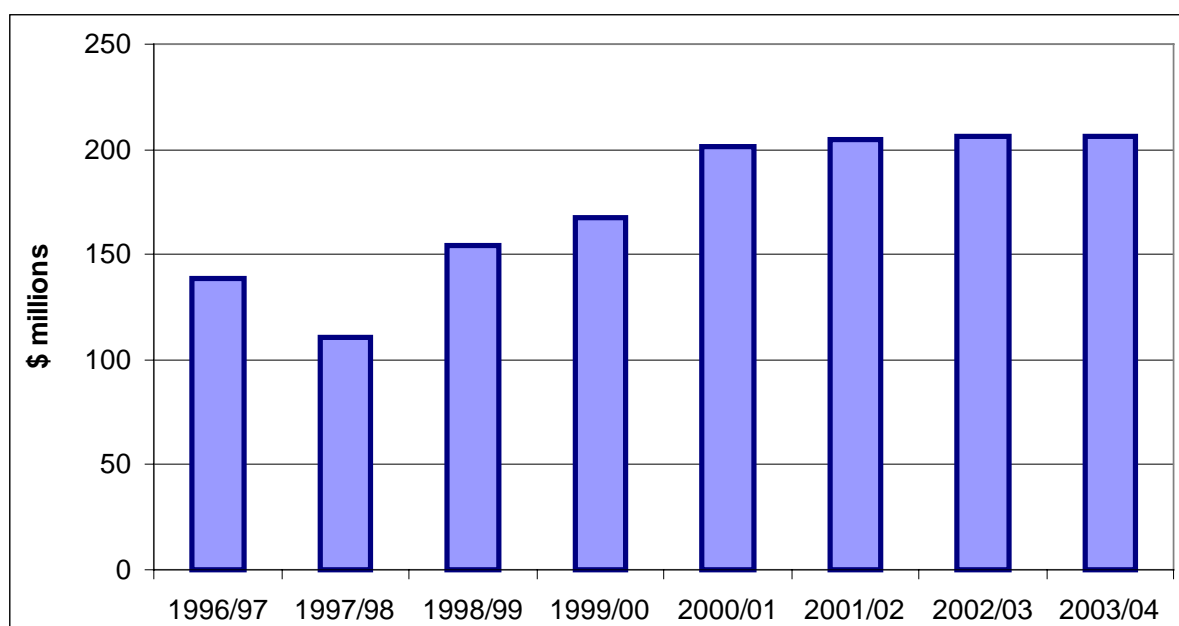
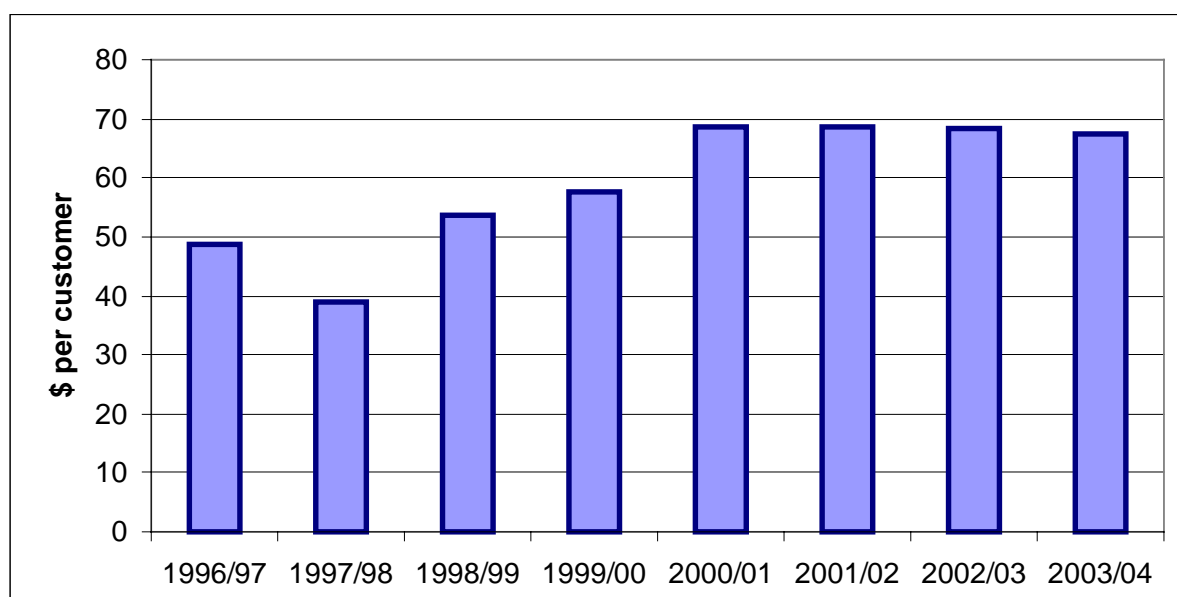


Figure 3.2 Total New South Wales industry retail costs per customer (real, 2000 dollars)



The fluctuation in the reported costs between 1996/97 and 1999/2000 is difficult to explain. In large part, it may stem from different cost allocation policies over the years and between standard retail suppliers. If so, this reflects the arbitrary nature of any cost allocation (between contestable and franchise customers, as well as between network and retail businesses), which suggests the projections in retail costs provided by the standard retail suppliers are somewhat arbitrary.

The increase in projected costs from 1999/2000 to 2000/01 is mainly due to the introduction of full retail competition (FRC). After this, costs tend to follow the projected increases in small retail customer numbers and load, with a slight decrease in (real) costs per customer.

The standard retail suppliers will need to incur additional capital and operating expenses to implement the Government's full retail contestability policies. The principal costs associated with FRC are:

- retail interfaces
- retail systems costs
- FRC project management costs and
- additional operating expenditure, such as those costs associated with transfers.

Further detail on the nature of these costs is provided below.

Some of these expenses will arise whether or not the standard retail supplier chooses to take on an active role in the contestable market. Insofar as FRC costs are incurred to provide services to small retail customers on standard form customer supply contracts, it is appropriate for standard retail suppliers to be able to recover them through regulated retail tariffs.

With respect to the capital costs of implementing FRC, clearly, the costs will depend upon the manner in which FRC is implemented. As several key features of the government's FRC model have not yet been finalised, it is not possible to forecast these costs accurately. The Tribunal proposes to incorporate FRC costs into regulated retail tariffs at a mid-term review, by which time the framework for contestability will be known and the Tribunal will be able to estimate costs with reasonable certainty. (See the section below entitled "What is the Tribunal's likely approach to FRC costs?")

As standard retail suppliers may need to incur some costs prior to the date of any mid-term review, the Tribunal believes that the best approach is to acknowledge FRC capital costs by incorporating an 'FRC allowance' into the regulated tariffs. At this time, the Tribunal has included an FRC allowance of \$5 per customer per annum⁶⁴ in the retail operating cost component of the regulated retail tariff. As a part of the proposed mid-term review, the Tribunal will make another assessment of an appropriate FRC allowance.

With respect to the additional operating costs arising from FRC, many of the standard retail suppliers have forecast increases in business/account management costs, customer 'handling' costs, and costs of handling bad debt. The standard retail suppliers' projections suggest that these additional operating cost items can amount to about \$10 per customer on average. However, there is a question of whether these costs are efficiently incurred, and so are appropriate for inclusion in a regulated retail tariff under a standard form customer supply contract.

First, one could argue that there is no need for a standard form customer supply contract to be marketed — it is a standard service at a standard 'no-frills' price — and therefore no additional business/account management costs should be incurred in providing this service (relative to a franchise service). As such the regulated retail tariff should not incorporate these costs. For example, in the US most utilities are prohibited from marketing or promoting the default 'standard offer service' (ie the regulated retail tariff).

Second, there is a question of whether the additional costs of customer handling due to customer churn should be included in regulated retail tariffs. The standard retail suppliers argue that these additional costs stem from additional meter readings, data entry, customer queries, etc. A portion of these costs — such as additional meter readings — relate more to the DNSP and therefore these will be recovered via network tariffs. Incorporating these costs in regulated tariffs would effectively allow them to be recovered twice, which is inappropriate.

Third, while the Tribunal recognises that the issue of bad debts is likely to rise over time due to the nature of the regulated market, questions arise as to:

- when increased bad debts is likely to become a significant issue, and
- whether this should be handled through an adjustment to the net profit margin or retail costs.

The Tribunal is mindful that full retail competition is due to begin from 1 January 2002, which is more than a year away. As such, it is unlikely that a *significant* increase in bad debts will occur over the next year, during the first year of full retail competition, or indeed even much before 2004.

⁶⁴ This figure includes any additional NEM fees that may be levied as a result of FRC.

Furthermore, in addition to projecting increased costs relating to bad debts, many of the standard retail suppliers have argued that the net profit margin should include an additional premium to account for the risk of handling increased bad debts.⁶⁵ However, it would be inappropriate for the Tribunal to allow the standard retail supplier to recover both a higher profit margin and higher retail costs to account for increased bad debts. This would be 'double dipping'. The Tribunal is of the view that the issue of bad debts is better handled through the profit margin, and is therefore further discussed below.

Information on costs of retailing elsewhere

Table A3.8 (next page) sets out the publicly reported retail costs applicable to energy retailing businesses in a range of jurisdictions.⁶⁶

⁶⁵ For example EnergyAustralia's submission argues for a premium of over 1 per cent. (EnergyAustralia submission to IPART on Full Retail Competition in Electricity, 1 September 2000, p 23.)

⁶⁶ Retail operating costs are very similar in nature and drivers between the electricity and gas retail industries.

Table A3.8 Comparison of the retail costs of energy retailing businesses

Utility	Retail cost per customer for 1999/00 (\$ pa)	Retail cost as a percentage of sales	Context
Electricity			
<i>NSW standard retail suppliers</i>	\$42-47	4.9	<i>Tribunal's decision, Dec 1999</i>
	\$40-70 ⁶⁷		Retail suppliers projections
ACTEW Corporation ⁶⁸	\$45	4	Utility's proposal, March 1999
Tasmanian Electricity ⁶⁹	\$81 ⁷⁰	6.2	Regulator's decision, 1999 <i>includes</i> metering costs
UK Public Electricity Suppliers (PESs) ⁷¹	\$34 - 67	2.9 - 6.5	Regulator's proposals, Oct 1999 <i>includes</i> metering costs
US electricity industry			
- Flaim (2000) ⁷²	\$34 ⁷³	-	industry 'benchmark'
- Joskow (2000) ⁷⁴	\$131 - \$186	3.3-4.7	industry 'benchmark', includes metering costs and customer acquisition costs
- Jacobs (1999) ⁷⁵	\$264 ⁷⁶		industry 'benchmark', includes metering costs and customer acquisition costs
Gas			
AGL Sales and Marketing ⁷⁷	\$39 ⁷⁸	-	Utility's reported actual margin, Nov 1999
AGL Sales and Marketing ⁷⁹	\$29-38 ⁸⁰	3.1-3.6 ⁸¹	Market Analyst's forecast, May 1999
British Gas Trading ⁸²	\$93 ⁸³	-	Regulators' decision, Feb 2000

⁶⁷ With the exception of AIE, whose costs are over \$100 per customer.

⁶⁸ As reported by the Tribunal in its determination, *Pricing for the retail supply of electricity to franchise customers*, December 1999, p 21.

⁶⁹ OTTER Decision.

⁷⁰ With the exception of Hydro-Electric, whose retail costs are equivalent to \$116 per customer.

⁷¹ As reported by the Tribunal in its determination *Pricing for the retail supply of electricity to franchise customers*, December 1999, p 21.

⁷² Flaim, Theresa "The Big Retail "Bust": What Will it Take to Get Competition", in *The Electricity Journal*, March 2000. We have assumed a 0.53 US\$/A\$ conversion rate.

⁷³ Flaim separates total retail costs in a competitive market into two types of costs: "customer care costs" and "customer acquisition costs". "Customer care costs" are costs associated with billing, payment processing, and call centres, which are in the order of US\$18 (ie, A\$34). "Customer acquisition costs" are costs for direct marketing, incentives, and general administration, which are in the order of US\$70 (ie, A\$132) assuming customers switch every 2 years. This estimate is based on data from the telecommunications industry.

⁷⁴ Joskow, Paul, L., *Why do we need electricity retailers? or Can you get it cheaper wholesale?*, Revised Draft Discussion Paper, MIT, 13 February 2000, p 29. Costs include meter reading, meter maintenance, capital costs associated with meters, customer accounts expenses (including bad debts), customer service expenses, and sales costs (incl advertising). Estimates have been estimated on the basis of FERC Form 1 data. We have assumed a 0.53 US\$/A\$ conversion rate.

⁷⁵ Jacobs, J.M., "Setting a Retail Generation Credit", *The Electricity Journal*, May 1999. Jacobs' "commercial costs" include collection costs, reserves for bad debts, customer acquisition costs, call centre costs, office overheads. We have assumed a 0.53 US\$/A\$ conversion rate.

⁷⁶ Jacobs suggests that US \$4 per MWh is required to recover "commercial costs" of retailing. If we apply this rate to a 0.53 US\$/A\$ conversion rate and an 'average' domestic customer load of 3,500 kWh per annum - this equates to \$26 per customer.

⁷⁷ IPART, *Review of the Delivered Price of Natural Gas to Tariff Customers Served from the AGL Gas Network in NSW*, Draft Report, p 24.

⁷⁸ This refers to the "gross margin" per tariff customer.

⁷⁹ Credit Suisse First Boston, *The Australian Gas Light Company*, May 1999.

⁸⁰ Assumes AGL Sales and Marketing maintains a customer base of around 800,000 customers.

⁸¹ CSFB's forecasts of costs and profit differ by year.

⁸² OFGEM, *Review of British Gas Trading's Price Regulation*, Final Proposals, February 2000, p 44.

⁸³ For a 'standard' customer. Excludes metering costs of A\$26 per customer (as determined by OFGEM). Applies a conversion rate of 2.7 Australian dollars to the pound sterling.

This information suggests that the retail costs proposed by the standard retail suppliers (less the additional cost items discussed above) are within a 'reasonable' level.

Differing costs per retail supplier due to economies of scale

In the 1999 retail review⁸⁴, several participants argued that it was not appropriate to allow retail costs to be recovered on the basis of an industry 'benchmark' or average due to economies of scale in retailing. As noted above, many of the retail suppliers continue to argue this case.

In response to consultation in December, the Tribunal stated its belief that in principle it is appropriate to set an industry benchmark rather than a retail supplier-specific cost because in an efficient retail market, through retailer entry and exit, standard retail supplier costs would converge to a similar 'efficient' level. The Tribunal highlighted that even if market entry and exit could not occur, then standard retail suppliers could 'contract out' these retail activities to an efficient operator. In addition, the Tribunal noted that it was mindful of imposing costs on small retail customers as a consequence of inappropriate industry structure.

The Tribunal has considered the arguments raised in submissions to this investigation and recognises that, in principle, a large proportion of retailing activities exhibit economies of scale. However, the Tribunal believes that:

- the standard retail suppliers' projections are similar on a per customer basis, irrespective of the standard retail supplier's size (with the exception of Australian Inland Energy), once the projected increases in the costs of marketing, advertising and handling bad debts have been extracted
- the 'default' service supplied under a standard form customer supply contract should be a standard or 'vanilla' service, and therefore the regulated retail tariff should reflect industry 'standard' retail operating costs.

On this basis, and given the arguments raised in the Tribunal's 1999 determination, the Tribunal remains of the view that an industry rate, to apply to all standard retail suppliers, is most appropriate. Given that the majority of retail costs relate to the number of small retail customers served by the standard retail supplier, the Tribunal believes that the industry rate should be set on a per small retail customer basis.

Reflecting retail operating costs in tariffs

As noted above, retail operating costs (such as billing, marketing etc) are largely fixed in nature, however, the exact split between the variable and fixed component is not clear. When asked to estimate the relative proportion of fixed costs in retail costs, the standard retail suppliers reported a range of proportions, from all variable to substantially fixed.

Retail operating costs are very similar in nature between the electricity and gas retail industries. In the current gas retail review AGLRE argues that that the majority of retail operating costs are fixed. The standard retail suppliers have also argued that retail costs should be recovered on a per customer basis.

⁸⁴ IPART, *Pricing for the retail supply of electricity to franchise customers*, December 1999.

The Tribunal is of the view, that on this basis, it seems appropriate to structure regulated retail tariffs so that the majority of retail costs are recovered via a fixed dollar per customer charge, and the remainder through a small uplift on the variable (c/kWh) charge.

Conclusion

On the issue of retail costs, the Tribunal concludes that:

- it is *not* appropriate for regulated retail tariffs to include the standard retail suppliers' projected increases in marketing costs (over and above those appropriately incurred for a regulated service), as these additional activities are not relevant for a regulated service
- it is *not* appropriate for regulated retail tariffs to include the standard retail suppliers' projected increases in customer handling costs, to the extent that these costs are already recovered by the network businesses
- it is *not* appropriate for regulated retail tariffs to include both a higher profit margin and the costs associated with handling additional bad debt. Rather, the additional risk/cost of bad debts is best managed by establishing the net profit margin (see section below)
- the level of retail costs recovered in regulated retail tariffs should be based on a standard industry rate, on a per small retail customer basis
- regulated retail tariffs should be structured so that the majority of retail costs are recovered via a fixed dollar per small retail customer charge, and the remainder through a small uplift on the variable (c/kWh) charge.

After allowances for these factors have been made, the standard retail suppliers' projections of retail costs are in the order of \$40 to \$60 per customer per year, including a \$5 FRC allowance.

What was the basis of the Tribunal's decision on the net profit margin?

The net profit margin ultimately represents the reward to investors for committing capital to the business. Retail margins are generally expressed as a percentage of revenue, and gas and electricity regulators in Australia, the UK and the US have consistently used this approach. The Tribunal recognises, however, that this approach may be somewhat simplistic, as some risks vary with the size of revenue, while others vary with the level of costs being managed or controlled by the business.

In making its decision on what profit margin is appropriate the Tribunal considered the information compiled during the 1999 determination⁸⁵, the level of risk faced by franchise retailers compared to standard retail suppliers (who have a 'default' function), and several other matters.

⁸⁵ IPART, *Pricing for the retail supply of electricity to franchise customers*, December 1999.

Information compiled during the Tribunal's 1999 determination

There is little information available on the profit margins (ie, after retail costs) earned by comparable businesses to the NSW standard retail suppliers, as there are no competitive markets with similar features.⁸⁶ At the last retail review, the Tribunal compiled information which showed that:

- energy retail businesses in other jurisdictions earn margins of between 0 and 1.5 per cent of sales turnover as net profit⁸⁷, even though many of these businesses face 'full retail competition'
- regulators have established net margins of between 0.5 and 1.5 per cent of sales turnover for regulated energy retail suppliers in other jurisdictions.

On the basis of this analysis, the Tribunal signalled in its 1999 determination that an allowance of around 1.6 per cent to 1.8 per cent of sales turnover—as a net profit margin—was appropriate for the franchise business. However, there is a distinction between this review and the Tribunal's last review, which focused on franchise retailers. In particular, there is (arguably) a difference between the risks faced by the current 'franchise retailers' and standard retail suppliers.

Level of risk faced by franchise retailers

In its 1996 report to the Tribunal, London Economics noted that:

Retail supply is a high turnover activity involving the purchase and resale of power, bulk contract trading and logistic services to the final customer. These logistic services (essentially meter reading, billing, customer service activity) are essentially low risk.

The main justification for a high rate of return for retail supply services would then have to derive from the riskiness of the power trading activity.⁸⁸

Nevertheless, the risks faced by franchise retailers may include:

- energy purchasing risks (though the Government's proposed electricity tariff equalisation fund eliminates this risk)
- risk of customer default and bad debts
- risk of competition from electricity substitutes, such as gas.

Level of risk faced by standard retail suppliers

The level of risk faced by a franchise retailer is slightly different to the level of risk faced by standard retail suppliers. As noted in many submissions, standard retail suppliers are likely to face slightly higher risks as a consequence of serving a fluctuating customer base, which is also likely to evolve to a 'riskier' profile compared to the franchise customer profile (particularly as the competitive retail market matures). As such, the risk of bad debts is likely to rise (as discussed in the retail costs section).

⁸⁶ With the exception of several jurisdictions in the US, eg, Connecticut, where the right to provide the 'standard offer service' has been established by competitive bid or auction. Bidders will incorporate the amount of profit and risk premium that they are comfortable with in any bid. Bidders with lower profit margin or lower risk premiums through better diversity of sources of risk management will win.

⁸⁷ AGL Sales and Marketing was an outlier, with an expected profit margin of 3.5 per cent to 4.5 per cent.

⁸⁸ London Economics, *Retail Margins for the NSW Distribution Businesses*, Final Report, February 1996.

Hence one of the key differences between the assessment of an appropriate profit margin in this review and the 1999 determination is the question of whether there should be differential margins, for example, between regulated retail tariffs and the existing franchise tariffs

Arguably, small retail customers will be riskier to serve in the context of a contestable market, and as such standard retail suppliers should receive a higher margin for serving those customers.

This is consistent with the margins established by the UK regulators. For example, in 1997 OFFER increased the net profit margin incorporated in to the public electricity supplier's (PES) supply price controls from 0.5 per cent of turnover to 1.5 per cent to reflect the additional risk of FRC.⁸⁹

In the context of the US electricity industry, a US commentator, J.M. Jacobs, suggests that:

Unfortunately, utility accounting and the convention of associating returns with assets rather than business functions make it difficult to unbundle profits. Therefore we must again appeal to an estimate of the profits an efficient competitor would demand. With energy costing \$30-50 per MWh, it is not unreasonable to assume profits of about \$1 per MWh.⁹⁰

Relative to the average bundled electricity retail rates in the US, a \$1 per MWh margin would equate to about a 0.7 to 1.0 per cent net margin.

The profit margin adopted by the Tribunal in its draft decision on AGLRE's regulated retail tariffs

Several submissions note that the Tribunal signalled in its draft decision on AGLRE's regulated retail tariffs that a profit margin of 2.6 per cent was 'not unreasonable'. However, while retail margins are generally expressed as a percentage of revenue this approach may over-simplify the assessment of appropriate margins.⁹¹ Risk-adjusted returns are likely to vary partly by total revenue, and partly by the level of *controllable* costs.

For example, the dollar level of bad debts will, other things being equal, increase as the level of revenue increases. It therefore makes sense that for this element of risk, return is related to a percentage of revenue. However, retail costs are more closely related to the number of customers served by the retail supplier, rather than the level of revenue. These are costs that are under the management of the business, and thus on which it bears risk. It could be expected that the return to the business for managing these risks relates more closely to the number of customers than to the level of revenue. Other factors will also contribute to risk (such as the level of uncertainty in energy prices).

⁸⁹ OFFER, *The Competitive Electricity Market from 1998: Price Control Proposals*, October 1997. Note that OFFER also incorporated the cost of hedging in the energy costs, which amounted to an additional 3 per cent on turnover to cover the risk of energy purchasing.

⁹⁰ Jacobs, J.M., 'Setting a Retail Generation Credit', *The Electricity Journal*, May 1999. Jacobs also notes that a \$5 per MWh should be incorporated in tariffs to account for the risk of wholesale energy purchase risk, although that risk is not relevant for this review (due to the vesting replacement proposal).

⁹¹ Gas and electricity regulators in Australia, the UK and the US have consistently expressed retail margins as a percentage of revenue. Despite its widespread use, this approach may be somewhat simplistic as some risks vary with the size of revenue, while some risks vary with the level of costs being managed or controlled by the business.

In conclusion, it is likely that returns should be based to some extent on factors related to the level of revenue, and to some extent on the level of costs under management (and thus the customer base). As a result, it may not be appropriate to assume that the profit margin (as a percentage of revenue) should be the same for electricity retail suppliers as for gas retail suppliers. Given that neither AGLRE nor the electricity retail suppliers bear significant energy price risk, and that electricity retail suppliers collect more revenue per customer, but incur similar retail costs per customer, one can argue that AGLRE should be allowed a slightly higher net profit margin (as a percentage of revenue).

Scope for introducing differential margins between customer groups

On the question of differential margins between customer groups, the Tribunal acknowledges that the relative risk of serving residential small retail customers and business small retail customers may differ, and if this is the case then, in principle, the net profit margin and regulated retail tariffs should reflect this.

Given that the risk differential is likely to be very small for small retail customers, the Tribunal is of the view that incorporating differential margins in regulated retail tariffs is of little merit.

Promoting competition

A number of submissions to the Tribunal argue in favour of a larger retail margin so as to encourage retail supplier entry and customer switching. The argument is that this will 'promote' competition. These arguments are frequently raised in markets elsewhere, such as the US where the matter has proved to be a contentious issue. For a brief discussion of the experience in the US see Appendix 5.

When a small retail customer chooses to participate in the contestable market, there are transaction costs incurred by both standard retail suppliers and small retail customers. As regulated retail tariffs are effectively the 'price to beat', if there is not a sufficient margin in regulated retail tariffs to accommodate these transaction costs there is a risk that small retail customers will not switch (or market entry may not occur).

The Tribunal believes that creating additional margin in regulated retail tariffs is not desirable from an economic efficiency or equity perspective and none has been built into the net profit margin. If the target level of the regulated retail tariff is set at the efficient level, then economically-efficient retail suppliers can compete – either by providing a value-added service to the customer at an appropriate price, or by being more efficient than the standard retail supplier. As observers of evolving competitive retail markets elsewhere have argued,⁹² creating artificially high regulated tariffs is a version of the infant-industry argument. High regulated tariffs results in non-switching customers subsidising switching customers. If regulated retail tariffs were set an appropriate level, then all small retail customers should have lower electricity bills, not just switched small retail customers.

⁹² See, eg, Kahn, Alfred, "Bribing Customers to Leave and Calling it 'Competition'", Guest Editorial, *The Electricity Journal*, May 1999.

Nevertheless, it should be noted that the energy cost component of the retail margin has been set on the basis of the LRMC rather than the average market price. To the extent that the market price is below the estimated LRMC, costing energy on this basis is likely to offer retail suppliers the opportunity to undercut the regulated retail tariff.

Conclusion

The net profit margin ultimately represents the reward to investors for committing capital to the business. It should reflect the opportunity cost of the capital invested, ie, the (risk-adjusted) return that could be achieved using the capital for another purpose. For the reasons detailed above, the Tribunal concludes that a net profit margin of 1.5 to 2.5 per cent of sales turnover is a sufficient risk-adjusted return for the standard retail suppliers.⁹³

The Tribunal is mindful that full retail competition is not due to begin until 1 January 2002, which is more than a year away. It is therefore unlikely that a significant change will occur in the retail suppliers' customer base over the next year, or even during the first year of full retail competition.

What is the Tribunal's likely approach to FRC costs?

Given the uncertainty about how much the introduction of full retail competition will eventually cost standard retail suppliers, the Tribunal cannot incorporate an accurate allowance for these costs into regulated retail tariffs at this stage. As a general principle, however, it intends to allow standard retail suppliers to recover appropriate costs associated with supplying small retail customers on standard form customer supply contracts.

As an interim measure, it has included a \$5 allowance for FRC costs in these recommendations and will undertake a more detailed assessment and adjust this amount accordingly when more reliable information is available.⁹⁴ This section outlines the key costs associated with FRC, and the Tribunal's likely methodology for making this assessment and determining an accurate FRC allowance at a later date.

Retail interface costs

Under FRC, standard retail suppliers will need to establish and operate a centralised interface with NEMMCO. The interface is known as the Market Settlement and Transfers Solution (MSATS).⁹⁵ MSATS will:

- inform the standard retail supplier that a small retail customer on standard retail supply contract has requested to switch to an alternative retail supplier, so it can prepare the final bill
- initiate transfers when a customer seeks to be transferred back to a standard retail supply contract
- inform the standard retail supplier when it is required to operate as retailer of last resort, or as the automatic retailer in the interim between a customer setting up an account for a new connection and selecting their retailer of choice.

⁹³ The net profit margin would start at the bottom end of the range, and increase as standard retail suppliers' risks increase.

⁹⁴ The Tribunal intends to make any necessary adjustments during its mid-term review.

⁹⁵ The National Electricity Market Management Company (NEMMCO) will operate this system.

At the time of writing, the capital and operating costs for standard retail suppliers involved in installing and operating MSATS is uncertain. However, they will essentially be fixed costs and will be borne by all standard retail suppliers, whether they enter the contestable market or not. Moreover, as the same interface will be used for small retail customers on standard form customer supply contracts and small retail customers on negotiated customer supply contracts, the costs will be the same for both customer groups.

The Tribunal will need to obtain reliable estimates of the costs associated with MSATS in order to incorporate them into regulated retail tariffs. It will also need to identify which incremental costs have been imposed by serving small retail customers on standard form customer supply contracts in the new environment, and separate these from the incremental costs of serving other customers. The Tribunal will judge the likely size of each standard retail supplier's regulated and unregulated customer base by considering factors such as the tranches that are contestable, and the likely churn rate of each tranche of customers.

Retail systems costs

There are a number of additional retail systems costs that standard retail suppliers may incur as a result of their participation in the contestable market. They include costs associated with developing:

- mass-market systems to win and retain customers
- billing systems and customer registers to support non-standard billing
- alliances with other utilities and service providers.

Retail systems costs associated with contestable customers should not be recovered from small retail customers on standard form customer supply contracts. The standard retail suppliers already have retail systems capable of servicing their current customer base. Therefore, the Tribunal is likely to exclude the cost of any additional retail systems costs generated by FRC from the FRC allowance.

Project management costs

The standard retail suppliers have incurred project management costs while participating in processes to develop the systems and policies required to introduce FRC, such as national forums and working groups. These costs can be separated into discretionary and non-discretionary elements. Non-discretionary costs arise from, for example, standard retail suppliers' obligations to cooperate with government and contribute to the policy development process. Discretionary costs would include, for example, those arising from standard retail suppliers choosing to participate in other industry forums. The Tribunal is likely to only take into account non-discretionary project management costs in setting regulated retail tariffs.

Operating expenditure associated with transfers

In addition to expenditures associated with building and operating the MSATS interface, standard retail suppliers will incur operating costs associated with managing customer transfers. These costs will vary according to:

- the number of small retail customers transferring
- the efficiency with which standard retail suppliers manage the process.

As noted above, to the extent that this expenditure relates to small retail customers on standard form customer supply contracts, it is likely to be included in regulated retail tariffs as a part of normal operating expenditure.

Likely methodology for estimating an accurate FRC allowance

The Tribunal is likely to use the following methodology to assess the accuracy of the \$5 allowance included in these recommendations:

- ask standard retail suppliers to provide more detailed information on FRC costs, to be presented in accordance with the categories of costs set out above
- require standard retail suppliers to engage an independent auditor to review this information, and verify that the information it presents a true and accurate description of actual FRC costs, in accordance with auditing standards
- require standard retail suppliers to have their choice of auditor approved in writing by the Tribunal⁹⁶
- assess expenditure for prudence
- determine the respective size of the regulated and unregulated customer bases, on the basis of the size of the tranches and likely churn rates
- calculate whether the FRC allowance of \$5 made in these recommendations was too high or too low, and make an appropriate adjustment
- allocate fixed and common costs (such as certain retail interface and project management costs) across the entire customer base of the standard retail suppliers
- calculate incremental FRC costs in accordance with the principles set out in this section
- consider the approach towards FRC costs adopted in other States and other markets where new entrants operate, with the goal of securing competitive neutrality.

The Tribunal would then determine an appropriate, prudent amount to be included in the regulated retail tariff (subject to the limit on price increases set out in section 2.2.3) and adjust the current \$5 per customer per annum allowance accordingly.

Recoupment of retail under-recovery balances

The Tribunal's Recommendation requires that no further recoupment of remaining retail under recovery after 31 December 2000 be allowed.

For several years, standard retail suppliers have been accumulating 'unders and overs' accounts to account for differences between forecast demand/small retail customer numbers and actual demand/small retail customer numbers. In its last determination, the Tribunal required standard retail suppliers to reduce or eliminate the balances in these accounts by 31 December 2000 while remaining within the constraints on price movements it had imposed. By March 2000, standard retail suppliers were required to submit to the Tribunal the cumulative balance of their unders and overs account as at 31 January 2000. A record of transactions which reconciles the movement between 30 June 1999 and 31 January 2000 was required to be provided by 10 March 2000. Any under-collected balance recorded

⁹⁶ Further, the Tribunal could reject the results of an audit if it has reason to believe that the audit is materially flawed.

at 31 December 2000 will be foregone. Any over-collected balance as at 31 December 2000 would be repaid to franchise customers.

The Tribunal has decided not to allow standard retail suppliers any further time to recoup past under recovery for several reasons:

- it could have a significant impact on the final price for some standard retail suppliers, which would place additional pressure on the limits on price movements
- it is contrary to the Tribunal's stated intention in the 1999 determination
- it would lead to inequitable recovery from small retail customers, including households. The franchise base from which future recoveries would be made is shrinking with the progressive introduction of competition—from customers consuming less than 10 GWh per annum in 1996, to customers consuming less than 160 MWh per annum in 2000. While around only 1 per cent of customers consume more than 160 MWh per annum, they represent around 50 per cent of electricity sales. Therefore, if recoupment of past under recovery were allowed to continue it would mean that under recoveries accumulated from a substantially larger market would be recovered from a diminished base that comprises many smaller consumers, resulting in smaller consumers cross-subsidising larger consumers.

The estimated balances that will be foregone by the six standard retail suppliers in NSW are shown in Table A3.9 below.

Table A3.9 Over and under recovery, estimated by retail businesses

	<i>Over (under) recovery as at 31 January 2000 (\$000)</i>	<i>Estimated Over (under) recovery as at 31 December 2000 (\$000)</i>
EnergyAustralia	(22,977)	Nil
Integral Energy	(131,713)	(131,713)
NorthPower	(30,472)	(22,940)
Great Southern Energy	2,301	Nil ⁹⁷
Advance Energy	(9,204)	(5,504)
Australian Inland Energy	(1,092)	(1,092)
Industry Total	(193,153)	(161,249)

⁹⁷ Great Southern Energy will need to rebate any over recovery to its customers before 31 December 2000.

APPENDIX 4 REASONS FOR REGULATING REGULATED RETAIL CHARGES (MISCELLANEOUS CHARGES)

The Tribunal first considered the regulation of regulated retail charges (then known as miscellaneous charges) in its October 1994 interim report on electricity prices.⁹⁸ At that time, the Tribunal expressed its concerns that a light-handed approach to regulation could result in an abundance of new charges, and in charges for each service becoming excessive. After considering various options, the Tribunal decided to prescribe allowable regulated retail charges and their maximum rates, on the basis that this approach provides the simplest way to review the cost-reflectiveness and effectiveness of fees. In its 1999 pricing review, the Tribunal decided to regulate security deposits as well. This decision was made after considering the wide variation in standard retail suppliers' practices regarding security deposits, and complaint reports from the electricity industry ombudsman.⁹⁹

During the investigation for this report, stakeholders expressed a range of views on whether regulated retail charges should be regulated. In its submission, EnergyAustralia contended that regulated retail charges should not be regulated for small retail customers that are, in effect, 'default' customers because these customers can choose their retail supplier, and because regulation could restrict the development of products and packages for the contestable market.¹⁰⁰ Integral Energy submitted that:

... miscellaneous charges should be regulated in the transition to full competition. However, once full competition is implemented there should be little need if any for regulation of these types of charges as the market will determine if they are appropriate and at what level.¹⁰¹

PIAC suggested that, as a minimum, regulated retail charges should be regulated for small retail customers on standard form customer supply contracts.¹⁰² The Smith Family pointed out that these charges pose problems for low income groups, and that the late payment fee, for example, has a disproportionate impact on those small retail customers who cannot afford to pay on time.¹⁰³

In addition, there has been a lot of discussion about the multi-service or 'dual fuel' packages likely to become increasingly prevalent in a contestable market, and how this creates the need for electricity and gas regulation to be as closely aligned as possible. The Tribunal is conscious that currently, gas retail miscellaneous charges are unregulated. The question of whether or not AGL Retail Energy's (AGLRE's) retail miscellaneous charges should be regulated is being examined as part of a separate review.

After considering all these views, the Tribunal proposes that regulated retail charges be regulated beyond 31 December 2000 for small retail customers. This decision is aimed at protecting low income small retail customers from the potential impacts of additional fees.

⁹⁸ *Paying for electricity An interim report*, IPART, October 1994, p 187.

⁹⁹ *Pricing for electricity networks and retail supply report, Volume II*, IPART, June 1999, p 120.

¹⁰⁰ EnergyAustralia submission to the retail review, 1 September 2000, p 14.

¹⁰¹ Integral Energy submission to the retail review, 11 September 2000, p 6.

¹⁰² PIAC submission to the retail review, 2 September 2000, p 12.

¹⁰³ The Smith Family submission to the retail review, 8 September 2000, p 2.

How did the Tribunal set the level of regulated retail charges?

Fee for dishonoured bank cheque

The Retail Miscellaneous Fees Working Group¹⁰⁴ did not raise any significant concerns about the level of this charge. The Tribunal therefore proposes maintaining it at its current level, twice the bank fee, for all small retail customers on standard form customer supply contracts.

However, the Amending Act provides for a dishonoured bank transaction to be levied for cheques only. Therefore, direct debit and other dishonoured bank transaction charges cannot be levied.

Late payment fee

The late payment fee is designed to recover the costs of sending reminder notices and other customer notifications, and to encourage customers to either pay their bills by the due date or make alternative payment arrangements with their retailer. As it is not the Tribunal's intention that this charge be levied on small retail customers who are experiencing financial hardship, it has recommended a number of circumstances where the late charge must be waived (see section 4.2).

Integral Energy submitted that it supports the concept of a late payment fee, as it encourages customers to pay on time, and makes a contribution to the costs of recovering overdue accounts. It also suggested that the late payment fee be increased to \$10, in line with that charged by AGLRE.¹⁰⁵ NCOSS, on the other hand, proposed that the late payment fee (and other regulated retail charges) be abolished, due to the impacts on low income small retail customers.¹⁰⁶

In view of the concerns regarding low income customers, and in the absence of information from standard retail suppliers regarding the costs incurred in issuing reminder notices or other customer notification, the Tribunal recommends that the maximum amount for the late payment fee remain at \$5.

Security deposit

As the purpose of the security deposit is to ensure standard retail suppliers do not lose too much money when small retail customers default on a bill, the deposit needs to be sufficient to cover the amount likely to be owing. For this reason, the Tribunal has set security deposits as a multiple of an average account (see section 4.3). The Tribunal considered several submissions about security deposits before making its recommendations. These submissions are discussed below.

¹⁰⁴ The members of the Miscellaneous Fees Working Group are representatives from EWON, Integral Energy, PIAC, Australian Inland Energy, NorthPower, NCOSS, Advance Energy, DoCS, The Smith Family, EnergyAustralia and IPART.

¹⁰⁵ Integral Energy submission to the retail review, 11 September 2000, p 6.

¹⁰⁶ NCOSS submission to the retail review, 8 September 2000, p 2.

According to the Retail Miscellaneous Fees Working Group, the average deposit for electricity supply is around \$200, while for gas it is around \$100. Welfare agencies are unable to cover an amount as high as \$200 for small retail customers. However, the availability of instalment plans or direct debit as an alternative to paying a deposit does provide assistance for low or fixed income customers.¹⁰⁷ The Working Group advised that a maximum deposit of \$100 would not be sufficient to cover an electricity bill. Therefore, the Tribunal will retain the current maximums for deposits.

One stakeholder asked that the Tribunal include a provision for the review of security deposits, and if necessary, the imposition of a further deposit. This would be in cases where customers have agreed to pay by alternative arrangements such as direct debit, or have received a refund of their deposit, and have subsequently defaulted on payments.¹⁰⁸ The Tribunal does not support the imposition of additional or higher deposits. Instead, standard retail suppliers should identify small retail customers on standard form customer supply contracts who consistently fail to pay accounts, and arrange a payment option which best suits both parties. Standard retail suppliers should contact small retail customers to advise them that a deposit is about to be credited to their account, and of the amount of the credit.

The Retail Miscellaneous Fees Working Group discussed the levels and the appropriateness of annual security levies (ASLs) for use as deposits. The Group also questioned whether ASLs should be removed from the list of acceptable deposits. The Tribunal has looked at the Working Group's comments, and proposes that for flexibility, ASLs be retained as an option for security. The Tribunal is not convinced, however, of the need for the introduction of still more options such as interest bearing deposits.

PIAC comments that as AGLRE is required to pay interest on security deposits, interest should be payable on electricity deposits as well.¹⁰⁹ The 1999 Miscellaneous Charges Working Group considered the matter of interest on deposits. Their report¹¹⁰ concluded that the amount of interest payable per customer over one or two years would be low, and would likely be a lesser amount than the administrative costs involved. Accordingly the Tribunal proposes that standard retail suppliers not be required to pay interest on security deposits.

Other issues raised in public consultation

As part of this review the Tribunal held a public forum on 7 September 2000. The Tribunal also consulted with a group of industry stakeholders on the current regulated retail charges, and the implications for fees of the introduction of full retail competition. In addition to the issues of regulation and the appropriate level for fees outlined above, participants in the forum and the Retail Miscellaneous Fees Working Group were concerned about:

- improving communication with customers about regulated retail charges
- reducing the need to charge regulated retail charges
- the introduction of multi-service packages/bundled services and the implications for regulated retail charges.

¹⁰⁷ The Smith Family submission to the retail review, 8 September 2000, p 3.

¹⁰⁸ EnergyAustralia submission to the retail review, 1 September 2000, p 14.

¹⁰⁹ PIAC submission to the retail review, 2 September 2000, p 13.

¹¹⁰ *Miscellaneous Charges Report to the Electricity Industry Consultation Group*, 30 September 1999, p 6. (This report is available on IPART's website.)

Improving consumer communication

The Working Group considers that better communication with small retail customers would solve many problems related to late payments. Small retail customers need to be informed about the payment options available to them, and about when they may be charged regulated retail charges. The Group suggests that all standard retail suppliers provide, on all bills, a free call number for small retail customers who are having difficulties paying their bills. Consumer representatives on the Working Group request that standard retail suppliers ensure their call centre staff have access to all current information on rights of standard retail supplier and small retail customers.

Reducing the need to charge regulated retail charges

The need to differentiate between those customers who can't pay their bills, and those who won't, was emphasised in public consultation.

Discounts for on-time payment may be helpful. However, the Tribunal rejects the concept of including the \$5 late fee on all bills, and then waiving it if customers pay on time, as proposed by one standard retail supplier.

The best ways to reduce the level of overdue accounts appears to be:

- a proactive approach by standard retail suppliers to assist small retail customers who are frequently unable to pay bills by the due date,
- the availability of a variety of payment options, and
- communication between standard retail suppliers to assist small retail customers.

As noted in the Tribunal's June 1999 report to the Premier and PIAC's submission¹¹¹ work done in Victoria suggests that while the use of security deposits has a limited impact on non-payment, the introduction of early intervention alternative payment plans can dramatically reduce disconnections.

The electricity industry ombudsman's 1998/99 Annual Report praises those standard retail suppliers who have taken active and innovative steps to assist customers in managing their accounts:

Some providers ... are offering customers a range of flexible payment options, eg periodic payment cards, direct debit, and accounts based on estimated usage with an annual adjustment. Some are also trying to identify and contact low income customers who are regularly overdue to try to help them find a payment system which best fits their budget and avoids fees for late payment and the threat of disconnection.¹¹²

The availability of for example, a 'pay as you go in advance' instalment system, is much more likely than the imposition of additional charges to help low income customers pay their bills on time.

¹¹¹ *Pricing for electricity networks and retail supply report Volume II*, IPART, June 1999, pp 121-2, PIAC submission to the retail review, 2 September 2000, p 12.

¹¹² *98/99 Annual Report*, Energy Industry Ombudsman NSW, p 16.

Multi-service packages and the implications for regulated retail charges

There has been a lot of discussion about the application of charges to multi-service packages or 'bundled' services where, for example, a customer receives gas and electricity services as a package from one supplier. Can more than one late payment fee or security deposit be charged where there is one bundled bill? If a customer part pays a bill, can they nominate which service the part payment should be allocated to? If a bill is paid only in part by the due date, can some services be disconnected? If so, which services?

The Miscellaneous Fees Working Group proposes that for a single bill, only one late payment fee or security deposit may be imposed. The Tribunal also suggests that:

- if a small retail customer provides part payment of a bill, the small retail customer should be able to choose which service that payment is directed to
- where part payment has been directed for example to electricity services, and payment for other services is in arrears, electricity disconnection must not proceed if the electricity portion of the bill has been paid in full or if satisfactory arrangements to pay for electricity supply have been made.

APPENDIX 5 INTERNATIONAL EXPERIENCE OF PRICE REGULATION UNDER RETAIL COMPETITION

This section looks at the approaches to pricing taken by regulators in the United States, England and Wales in response to the introduction of retail competition in the electricity sector. It focuses in more depth on the arrangements put in place in England and Wales, given the similarities to Australia in terms of the approach to industry restructuring and the introduction of competition.

Overall, international experience suggests that:

- no single approach to regulating prices in the lead-up to or during the initial phases of competition is definitively superior
- regulated prices can reduce/increase incentives for customers to enter the competitive market (if set out of line with the cost of supply), while market arrangements put in place to support competition, such as customer transfer arrangements, will also significantly influence switching rates and ultimately the success of full retail competition
- customer switching rates, while easy to measure, are not necessarily a definitive measure of the success of competition.

United States

Retail competition is being introduced in the US on a state-by-state basis. The approach being taken is somewhat different to that in Australia and the UK, largely as a result of the different approach the US has taken to restructuring. In the US, many utilities remain vertically integrated, and provide a bundled service to their customers (ie, generation, network and retail services). In some states, they have been required to divest generation and/or to set up generation subsidiaries, and many have established unregulated retailing affiliates. In addition, many have been required to turn over transmission operations to Independent System Operators (ISOs). Nevertheless, many utilities remain vertically integrated.

As a result of this industry structure, retail competition has proceeded on the basis that customers who choose to leave their incumbent receive a 'credit' (referred to as a generation credit or a shopping credit) which reflects the value of generation and retail services. This shopping credit, defined in terms of c/kWh deducted from the bundled incumbent's bill, then becomes the price that competitive retail suppliers have to beat in order to attract customers.

Default service offerings generally involve one of the following:

1. a standard offer for customers who continue to purchase their generation service from the utility
2. a default service offer, which applies as long as the utility has a provider of last resort obligation (ie, needs to meet customer demands if the customer stays with the utility, or comes back to default service after choosing generation or other competitive services from other providers).

A key attribute of most default service offerings is that they are part of restructuring deals that include regulated price caps for a specified transition period. Only a limited number of utilities have moved into an environment where there is no cap on the price of the default service.

Most often, the default service is provided by the incumbent utility, but in several states the price and provider of default services were determined by a competitive bid. (In Connecticut, for example, the regulator explicitly chose to add an amount to the residential and small commercial bid to incorporate retail costs.)

Debate in the US has focused on the value of the 'shopping credit' received by customers when they switch from the incumbent. Clearly, the smaller the discount received by the customer, the more challenging the 'price to beat' becomes. Incumbent utilities (particularly those that still own generation) have argued that the credit should reflect their *avoidable* costs of serving the customer's demand. In contrast, competitive retail suppliers and some regulators have tended to focus on setting prices that include a retail margin that covers their costs and allows them to make profit an incentive for customers to switch.

Setting the shopping credit above avoidable cost has implications for economic efficiency. Efficient competition and market entry requires that the potential new competitor is able to supply the good or service at long-run incremental costs lower than the incumbent supplier. If the shopping credit is set higher than this level, then customers may have an incentive to switch supplier even though the underlying costs of supplying the customer are higher for the competitor than those incurred by the incumbent.

The various approaches adopted by the different states fall into three broad categories – variable, fixed, and embedded cost-based shopping credits – as outlined below.¹¹³

Variable shopping credits

In some states, the shopping credit varies with prices in the wholesale market. In California, for example, customers who continue to receive bundled service from their utility pay the average price of power in the Power Exchange (PX). This average price is calculated as a rolling monthly average, updated weekly for actual prices. In California, no additional increment has been added to the shopping credit to reflect the retail margin, which has attracted criticism. California has also recorded one of the lowest rates of customer switching in the country, with rates of around 1 to 2 per cent in the first year of competition.¹¹⁴

The disadvantage of setting the shopping credit in this way is that it (and the price paid by customers staying with the utility) can vary significantly from month to month, as the wholesale market price varies. In California, high wholesale market prices during summer 2000 were passed through into the price paid by customers for the bundled service.

¹¹³ This section has relied extensively on Kathan, D and A Selting, NERA, *Economically-Efficient Shopping Credits*, Draft, May 2000.

¹¹⁴ The Tribunal does recognise that there a number of reasons separate to the level of the shopping credit which are likely to have also had an impact on customer switch rates in California.

Fixed price shopping credits

Many states have adopted a fixed shopping credit, where the price does not vary over a period of time (usually a year). The value of the fixed shopping credit may be based on forecast wholesale prices, or through competitive bidding.

The disadvantage of fixed shopping credits is that they may not reflect actual market conditions. In Massachusetts, for example, where fixed price shopping credits were initially adopted, forecast wholesale prices in the first few years of competition were below actual outcomes, and therefore the prices for default customer service were not cost-reflective. In other instances the fixed price determined may be higher than actual outcomes.

The state of Connecticut uses fixed price shopping credits. The default service (standard offer) in Connecticut was set by competitive bid, however, the regulator came to the view that additional 'headroom' should be built into default tariffs to encourage customer switching. For this reason, the regulator explicitly chose to add to the residential and small commercial bid to incorporate retail costs and margin (see Table A5.1).

Table A5.1 Connecticut generation service charge for Standard Offer Service¹¹⁵

	Proposed price	Approved price	Additional Headroom	Margin on bundled price¹¹⁶
	c/kWh	c/kWh	c/kWh	%
Residential Electric Service (non-heating)	4.7	5.5	0.8	6-9
Residential Electric Heating Service	4.7	4.9	0.2	1-2
Residential time of day	4.7	4.9	0.2	1-2
Controlled Water Heater	4.6	4.6	0	0
Small Time-of-Day General Service	4.6	4.6	0	0
Small General Electric Service	4.6	4.6	0	0

Shopping credits based on embedded costs

The third approach establishes the shopping credit based on the component of the bundled tariff that represents embedded generation costs, and splitting this amount between stranded cost recovery and the shopping credit. Using this approach the shopping credit is higher than the likely wholesale power price, and the stranded cost charge (CTC) is minimised. This encourages customers to switch.

This approach was adopted in Pennsylvania. Regulators in this state explicitly set default service prices at a level above projected incremental costs to stimulate customer switching. The size of the allowed headroom can be seen in the following table. Note that although the size of the retail margin is not explicitly recorded by the regulator, it is implied as a residual.

¹¹⁵ State of Connecticut DPUC, *DPUC Determination of the Connecticut Light and Power Company's Standard Offer*, Supplemental Decision, December 15 1999, p 4.

¹¹⁶ Assumes an average bundled retail price of 9 to 14 c/kWh.

Table A5.2 Pennsylvania ‘Shopping Credits’ in 1999

	‘Shopping credit’	CTC ¹¹⁷	T&D ¹¹⁸	Bundled rate	Example Energy cost	Headroom with 3c/kwh energy cost	Implied gross margin
	c/kWh	c/kWh	c/kWh	c/kWh	c/kWh	c/kWh	%
PECO Energy	4.46	1.72	2.98	9.16	3	1.46	15.9
Pennsylvania P&L	3.81	1.57	1.74	7.12	3	0.81	11.4
Duquesne Light Co.	4.03	2.58	2.34	8.95	3	1.03	11.5
Metropolitan Edison Co.	4.35	1.68	2.27	8.3	3	1.35	16.3
Pennsylvania Electric Company	4.4	1.55	2.01	7.96	3	1.4	17.6
Penn Power	3.63	1.45	2.12	7.2	3	0.63	8.8

Interestingly, the rate of customer switching has been high in Pennsylvania relative to states with lower implied headroom (such as California and Massachusetts). For example, in Pennsylvania over the period 1 January 1999 to 1 July 2000:

- 17.5 per cent of residential load previously serviced by PECO Energy switched to an alternative retail supplier
- 39.15 per cent of commercial load previously serviced by PECO Energy switched to an alternative retail supplier.¹¹⁹

This compares to a 1.7 per cent residential customer switching rate in California, and 0.17 per cent in Massachusetts.¹²⁰

England and Wales – Electricity Market

Liberalisation of the electricity industry in England and Wales was initiated in 1990, and all customers have been part of the contestable electricity market since May 1999. Over time, the number of regulated tariffs and the customers eligible for regulated tariffs have diminished and currently there are only two major domestic regulated tariffs.

Current regulated tariffs

In December 1999 the regulator proposed that price restraints for non-domestic and direct-debit customers be withdrawn from March 2000. However, prices for the two major tariffs of domestic customers, Standard Domestic and Domestic Economy 7 continue to be regulated.

Customers being served by a retail supplier from another area are supplied on competitive contracts.¹²¹ The current regulatory period commenced in April 2000 and will run until March 2002.

¹¹⁷ CTC refers to Competition Transition Charge, which is the component for stranded cost recovery.

¹¹⁸ T&D refers to Transmission and Distribution.

¹¹⁹ Joskow, Paul, L., *Why do we need electricity retailers? or Can you get it cheaper wholesale?*, Revised Draft Discussion Paper, MIT, 13 February 2000.

¹²⁰ Massachusetts and California implemented restructuring in a different way. In Massachusetts, for example, the standard offer (or the default service price) was based on a 1996 forecast of market prices (wholesale energy), and did not include any administrative or other retail costs.

¹²¹ A customer can always return to the incumbent retailer, for supply at the regulated tariff.

The form of regulation

During the period of transition to contestability for small customers, (that is, over the 1998 to 2000 regulatory period) tariffs for small and domestic customers were regulated via an RPI-X adjusted cap on increases to a volume-weighted bundle of individually priced tariffs. The control allowed some re-balancing between the fixed and variable components of each tariff. There were also additional side-constraints applying to individual tariffs. In addition, the principle of cost pass-through, a feature of the price control up until 1998, was abandoned with the exception of the fossil fuel levy.^{122,123}

Currently, a cap on final prices restrains the current regulated tariffs in the first year of the two-year regulatory period. In the second year, prices will be required to remain at their nominal level. Current regulated prices are set to reflect actual network use of system costs, the fossil fuel levy and a pre-specified allowance for generation costs.

The price restraints, in the first year, led to an average reduction in regulated tariffs of £15 (A\$41 or about 6 per cent) on an average annual bill for Standard Domestic customers, and £7 (A\$18 or about 2 per cent) for Economy 7 customers.¹²⁴ In the second year, as noted above, prices will remain at their nominal levels.

Process

During the current regulatory period, domestic customers have three options for electricity supply. They may:

- i. apply to the local Public Electricity Supplier (PES) for a 'tariff supply', the terms and conditions for which are specified in the Electricity Act 1989, rather than in a contract
- ii. negotiate a competitive contract with the local PES
- iii. negotiate a competitive contract with a new supplier.

A customer who has not changed supplier since the market was opened to full competition remains on their existing tariff, with their existing retail supplier, under tariff supply terms.

¹²² The initial price control in 1990 contained a cost pass-through term to allow Public Electricity Suppliers (PESs) to recover a range of costs deemed beyond their control. PESs then set prices against estimates of costs, sales volumes, etc, adjusting them during the year as better estimates became available. However, at the end of each year PESs generally found they had collected either more than or less than the price control allowed. Such over- and under-recoveries were subtracted from or added to the next year's price control. The regulator abolished this regime in 1998, introducing maximum price limits. Maximum price limits were seen by the regulator as having several advantages, in that:

- they could be published in advance to reassure customers and inform competitors;
- they would provide greater transparency;
- they would put stronger financial incentives on PESs to purchase economically;
- there would be no need for calculation and implementation of correction factors; and
- regulatory monitoring of the control would be more straightforward.

¹²³ All retailers pay the Fossil Fuel Levy. The money collected by the Fossil Fuel Levy is used to pay for the on-going additional costs of the Government's commitment to increase the amount of new renewable generating capacity. OFGEM sets the levy on the basis of forecasts of the additional costs of purchasing energy under the Non-Fossil Fuels Obligation. Electricity businesses that have these obligations receive compensation from the levy.

¹²⁴ Assuming an exchange rate of 2.7 A\$/£.

Competitive Contracts

Most retail suppliers use rolling contracts under which customers continue to be supplied until they decide to cancel. Retail suppliers must provide customers with ten days notice prior to any change in tariffs. If, at any time, a customer decides to change to an alternative supplier they may do so without penalty.

Retail suppliers may offer contracts that last for a fixed time, eg, one or two years. Typically these contracts attract discounts, but if the customer changes to another supplier before the fixed period is over they may have to pay a termination fee. Generally these contracts roll over. The customer is sent a notice prior to expiry asking if they want to retain the current terms and conditions, and if they don't respond, the contract rolls. Such fixed contracts appear to be offered to non-residential customers only. If a contract does not roll and a customer fails to negotiate a new contract prior to expiry of the existing contract then they will pay 'default tariffs', these are unregulated and set by the local PES. This arrangement only applies to commercial customers.

Regulator's objectives for price controls

From 1990, the regulator was bound by the duties set out in the Electricity Act, 1989 when setting price controls. The primary duties were to:

- ensure that all reasonable demands for electricity are met
- ensure that licence holders are able to finance their activities
- promote competition in the generation and retail sectors.

Secondary duties included to:

- protect customer interests regarding electricity prices, continuity of supply, and quality of service
- promote efficiency and economy in electricity supply and consumption
- promote research and development by licence holders in generation and transmission
- ensure public safety and promote the health and safety of workers in the industry
- take into account environmental impacts.

These primary and secondary duties will be replaced following passage of the Utilities Act.¹²⁵ The Act gives the regulator a principal objective, in carrying out its functions, to protect the interests of consumers wherever appropriate by promoting effective competition. The regulator will have a primary duty to carry out its functions in the way best calculated to further the principal objective.

This duty to further the principal objective incorporates the matters that form the regulator's existing primary duties. The regulator must have regard to the need to secure that all reasonable demands for electricity are met. Likewise, the regulator must recognise that, to the extent that the utilities legislation places obligations on utility companies (whether directly, through licence conditions or otherwise), such companies must be able to finance those obligations.

¹²⁵ The Act was passed on 28 July 2000, and will be brought into force on a day or days appointed by the commencement order. Various provisions will be brought into force as soon as possible, once the necessary preparatory measures have been taken.

In determining the 'interests of consumers' for the purpose of the principal objective, the regulator is entitled to take into account the interests of any group or class of consumer. However, the regulator must always have regard to the interests of consumers who:

- are disabled or chronically sick
- are of pensionable age
- on low incomes
- live in rural areas.

Identifying groups of consumers in this way, however, does not oblige the regulator to give these consumers preferential treatment.

As well as protecting the interests of existing consumers, the regulator is required to protect the interests of those who will be consumers in the future.

To the extent that it is consistent with furthering its principal objective, the regulator should carry out its functions in the manner best calculated to achieve the following aims, while having regard to the effect on the environment:

- promote efficiency and economy on the part of electricity companies (other than electricity generators)
- promote the efficient use of electricity
- secure a diverse and viable long-term energy supply
- protect the public from dangers arising from the generation, transmission, distribution and supply of electricity.

The regulator must also have regard to social and environmental guidance issued, from time to time, by the Secretary of State, when discharging its functions.

Retailer of last resort

Retail suppliers' licences require them to offer terms on request to 'designated customers' (small and domestic customers) and to supply the premises in question on those terms. The new Utilities Act requires licences to contain a section incorporating the protection of small customers.

Under the Utilities Act, where a retail supplier fails, the retail supplier's customers will be deemed to have a contract with an interim supplier nominated by the regulator. Current retail licences require the retail supplier to inform, and to offer terms to, the customers of another retail supplier whose licence is about to be revoked. While this arrangement relies on the customer taking action to agree a new contract, the recent failure of Independent Energy showed that the regulator is prepared to intervene on behalf of small customers where it feels this is necessary.¹²⁶

¹²⁶ Receivers sold the major gas and electricity supply business assets of Independent Energy to Innogy, the UK business of National Power, in September 2000. Independent Energy had asked its banks to appoint a receiver after continued billing and cash collection problems. A continuing supply was offered to all electricity and gas customers under the arrangement, overseen by OFGEM. While commercial and large industrial customers have been offered new contracts, domestic customers can continue to be supplied under the same terms and conditions they held with Independent Energy.

Future plans

Under the Utilities Act the concept of the PES (ie, the incumbent) will be abolished and therefore also the differential conditions for 'incumbent' and 'other' suppliers. It is intended that there will be a set of standard licence conditions that will apply to all suppliers, and another set applying only to those engaged in supply to designated customers (broadly domestic or small customers). There will be a greater emphasis on customer protection via regulatory supervision for designated customers. There will also be a further set of conditions that will apply to companies which are dominant in a region, ensuring that the retail services currently provided by the incumbent to other licensed suppliers will continue to be available. These services include the provision of pre-payment meter infrastructure.

The Act also repeals the legislation providing for 'tariff supply' by PESs. This means that all supply will be on the basis of a contract between a supplier and a customer.

England and Wales - Gas Market

The gas market in England and Wales was liberalised more quickly than the electricity market, with the phased introduction of contestability for domestic customers between April 1996 and May 1998. OFGEM is currently consulting on whether the remaining retail price controls should be removed at expiration of the current restraints in March 2001.¹²⁷

Regulated Tariffs

British Gas Trading Ltd's (BGT's) PromptPay, Standard and Prepayment tariffs for domestic customers are still subject to price control.¹²⁸ As with electricity customers, direct-debit customers are not subject to retail price control.

The form of regulation

Customers have been able to choose a gas supplier other than BGT since the market was opened between April 1996 and May 1998. During this period, tariffs for non-contestable customers were regulated through two price controls. The first control, expiring in March 1997, involved controlling the overall revenue that could be charged to tariff customers by BGT by an RPI-X price control. The allowed rise in the standing charge was limited by a separate cap, which specified that the standing charge element could not increase from the level at privatisation by more than the cumulative change in the Retail Price Index since December 1985.

The subsequent price control, in place for three years from April 1997, comprised RPI-X tariff caps with a pass-through of gas costs, storage costs and transportation costs, and application of a correction factor. There were two formulae for each tariff, one for the standing charge per customer and one for volumetric charge per therm.

¹²⁷ See *Review of British Gas Trading's Price Regulation, Initial Proposals*, OFGEM, November 1999, and *Review of British Gas Trading's Domestic Gas Supply Regulation, A Consultation Document*, OFGEM, June 1999.

¹²⁸ These tariffs are distinguished only by payment type.

Process

When a customer became contestable they could negotiate a contract with their existing retail supplier or a new retail supplier. If a customer failed to enter into any contract then the existing retail supplier would supply them under a 'deemed contract'. This was likely to be at a higher price than if the customer had negotiated a contract, being the regulated price as set out above. To switch retail supplier a customer is required to negotiate a contract with the new retail supplier. Once a customer has left their original retail supplier they have no 'right to return' to their previous tariff, instead they are considered a new customer and must enter into a competitive contract. Domestic customers tend to be served by rolling contracts.

As with electricity, most retail suppliers operate on the basis of rolling contracts and must provide 10 days notice prior to any price change. Large customers without rolling contracts have no regulated tariff to fall back on if they do not negotiate a contract, and instead they must pay an unregulated 'default tariff' to BGT.

Regulator's objectives for price controls

Prior to the implementation of the Utilities Act, the Gas Act, 1986 set out the duties the regulator was bound to when setting price controls. The primary duties are to:

- ensure that all reasonable demands for gas are met
- ensure that licence holders are able to finance their activities
- secure effective competition in shipping and supply.

Secondary duties include to:

- protect consumer interests regarding gas prices, continuity of supply, and quality of service
- promote efficiency and economy in the licensed functions, and efficiency in the use of gas
- take into account environmental impacts
- take into particular account the interests of those who are chronically sick, disabled or of pensionable age
- protect the public from dangers arising from the transmission and distribution of gas.

As with electricity these duties were replaced by a 'principle objective and general duty' to protect the interests of consumers following passage of the new Utilities Act.

Retailer of last resort

Under the Gas Act a 'domestic customer' is defined by the volume of gas consumed. This implies that some large domestic users—that is, those who use in excess of 2,500 therms per year—are in fact not protected as 'domestic customers'. As with the electricity licences, gas retail licences require retail suppliers to offer terms on request to 'domestic customers' and the retail supplier is required to supply the premises in question on those terms.

In common with electricity, in the event of retail supplier failure, customers are deemed to have a contract with an interim retail supplier nominated by the regulator. At present, there is scope for deemed contracts for domestic gas customers (ie, up to 2,500 therms/73,200 kWh), and where the retail supplier so elects, up to 75,000 therms.¹²⁹

Under the Utilities Act, deemed contracts for retail supplier of last resort will apply to all gas customers, irrespective of size.

Lessons from the UK experience

OFGEM is required under the Gas and Electricity Acts to review the development of competition in the gas and electricity retail markets annually, and is currently conducting such a review. In the electricity market, the following issues have been raised:

- the lack of a competitive wholesale electricity market
- the lack of separation of PES (incumbent) electricity retail and distribution functions
- the lack of competition in electricity meter reading services
- PESs' market position and behaviour.

It is hoped that the new Utilities Act addresses the first two items. Metering is currently the subject of further consultation. OFGEM continues to monitor the incumbent electricity businesses' and British Gas Trading's market position and behaviour. The Utilities Act, and the various OFGEM consultations attempting to remedy the deficiencies in the current institutional arrangements for full retail competition in electricity and gas, are outlined below.

The Utilities Act

Among the main objectives of the new Utilities Act are:

- the separation of electricity distribution and retail into separate companies
- the implementation of the New Electricity Trading Arrangements
- the fusion of the gas and electricity regulators into a new Gas and Electricity Markets Authority
- the alignment (as far as practicable) of the regulation of the gas and electricity industries.

There are new duties and powers for the new regulatory body, and a new system of electricity licensing, based on the present gas model of standard licence conditions.

In performing these duties, the Authority will be required to have regard to the interests of individuals who:

- are disabled or chronically sick
- are of pensionable age
- are on low incomes
- reside in rural areas.

¹²⁹ Under paragraph 8 in Schedule B to the Gas Act 1986, and in Standard Conditions 4 and 5 of the Gas Supplier's Licence.

Current issues and consultations

OFGEM is consulting on 'categories of gas and electric customers who should continue to benefit from certain regulatory safeguards'. Aimed at small customers, the types of regulatory protection being considered are:

- price controls
- determination of disputes
- services levels (including codes of practice and standards of performance)
- the duty to supply (including things such as contract terms and marketing)
- retailer of last resort arrangements.

Consultation on the possible removal of the non-discrimination conditions from gas and electricity licences, because of the development of competition, has also been announced.¹³⁰ While the principal objective under the new Utilities Act indicates that certain domestic customers should continue to enjoy additional protection, the reduction of regulatory intervention is seen as a guiding principle.

A further OFGEM consultation regarding reform of the arrangements for customer transfers in the electricity and gas markets, where the customers are in debt, has also been initiated. The regulator has sought comments on changes in the current regime, seen as prohibiting the overall reform objective (removal of barriers to competition) and thus the enabling of customers to exercise choice of supplier more easily. OFGEM has suggested removing the right of the existing supplier to raise objection to transfer on the grounds of debt, and cessation of the current rights for assignment of debt for domestic customers (on the grounds that these do not significantly reduce the number of unrecovered debts and that the costs are disproportionate).

The Department of Trade and Industry is carrying out a review of the barriers to customers switching suppliers in the gas and electricity market. This review was announced to address concerns that only one in four gas and electricity customers had chosen to switch supplier despite the price savings available. It is expected that the conclusions of this review will be announced later in 2000.

In addition, the National Audit Office is currently reviewing OFGEM's role in the introduction of competition into the domestic and small-business electricity retail market. This review will assess the introduction and development of competition in this market and identify any actions that OFGEM can take to improve the development of competition. It is expected that the conclusions of this review will also be published later this year.

¹³⁰ The gas and electricity non-discrimination conditions set out certain types of behaviour that dominant suppliers in both the industrial and commercial, and domestic sectors of the gas and electricity supply markets are prohibited from engaging in. The prohibited behaviour is:

- showing undue preference
- exercising undue discrimination
- setting unduly onerous prices; and
- predatory prices.

The prohibition on dominant companies showing undue preference and exercising undue discrimination becomes less restrictive as competition develops. For example, Standard Condition 13(2) of the gas suppliers' licence allows a dominant supplier to set terms that are reasonable to meet established competition, but not terms that are predatory or unduly onerous.

APPENDIX 6 THE TRANSITION TO RETAIL COMPETITION IN AUSTRALIAN JURISDICTIONS

This section outlines the plans currently in place for small customers following the introduction of competition in electricity in Victoria, South Australia and Queensland. It also considers arrangements that were put in place for larger customers who have already been made contestable in these states and in NSW.

As highlighted in many submissions, the workability of arrangements for full retail competition in NSW is likely to be affected by the arrangements put in place elsewhere. Putting in place consistent arrangements is highly desirable. For this reason, the information in this section provides important context to the Tribunal's investigation.

Victoria

In Victoria, the Department for Natural Resources and the Environment (NRE) has assumed a reserve power for regulating retail tariffs for small customers during the transition to competition.¹³¹ Under this reserve power, NRE may "regulate, in such manner and in relation to such period as the Governor in Council thinks fit, tariffs for the sale of electricity to prescribed customers or a class of prescribed customers".¹³² In this respect, NRE has been given a relatively broad scope as to the exact form of regulation they might choose to develop.

The Victorian government has indicated that electricity retail suppliers will be able to compete for business from commercial consumers using 40 to 160 megawatts of electricity per hour from 1 January 2001. For households and businesses using less than 40 megawatts, competition will begin later in 2001 at a date to be announced.¹³³

There is a provision for community service agreements (CSOs) where concessionary rates will be applied. No further details are available as yet.

Regulated tariffs during the initial period of contestability

As with the other jurisdictions, final arrangements for full retail competition are yet to be announced. However, the Tribunal understands that the intention is for there to be two types of 'regulated' tariffs, in parallel with the market-based private contracts that retail suppliers will be offering. These regulated tariffs, known as 'deemed contracts' and 'standing offers', will apply to different customer groups depending on their particular circumstances, as outlined below.

¹³¹ However, the government has the option to transfer this role to the Regulator-General.

¹³² *Electricity Industry Acts (Amendment) Act, 2000*, Act No. 38/2000, 6 June 2000.

¹³³ Victorian Minister for Energy and Resources, Media Release, *Household Electricity Bills to Drop, Says Minister*, 21 September 2000.

Deemed contracts

Former franchise customers will be 'deemed' to have a contract between themselves and their retail supplier in place immediately prior to the introduction of contestability, assuming that:

- they were a franchise customer immediately before the introduction of contestability and
- they have not entered into a new contract with a licensee which takes effect on or after that date.¹³⁴

The tariffs offered under these 'deemed' contracts are to be developed by the businesses and submitted to the NRE for approval. NRE holds the 'right' to regulate in the case that they do not accept the tariffs proposed by the businesses. Tariffs must be gazetted two months prior to introduction. Tariffs are not required to be uniform across geographic regions, and it will be up to the businesses to set tariffs as they see fit (subject to NRE approval). The ORG will regulate the terms and conditions of 'deemed contracts'.

Deemed contracts are intended to apply for all customers with demand less than 160 MWh. NRE is able to adjust this customer base over time as competition develops and as it sees fit. The deemed contract tariffs will expire on 31 December 2003.

Standing offer

Customers who enter into a market-based contract will not have a right to return to the deemed contract. They will instead have the right to a 'standing offer' contract.¹³⁵

As with the deemed contract, the standing offer will be a regulated published tariff set by the businesses and approved by NRE. Under a condition of their licence, incumbent or host retailers are obliged to offer the standing offer to customers as they become contestable. All retailers will be obliged to offer the standing offer for smaller customers. Terms and conditions will be regulated by the ORG.

Ongoing regulation

It is too early to say whether it will be thought necessary to have on-going regulation and, if so, what form of regulation might be adopted. In consultation with retail suppliers, the ORG has expressed the view that it is likely there will always be a need for some form of published —although not necessarily regulated— tariff available to customers as a form of 'safety net'.¹³⁶

¹³⁴ See the *Electricity Industry Acts (Amendment) Act, 2000*, Act No. 38/2000, 6 June 2000.

¹³⁵ *Offer to domestic or small business customers*, is included in the *Electricity Industry Acts (Amendment) Act, 2000*, 6 June 2000.

¹³⁶ See ORG, *Electricity Retail Competition for Small Customers, Consultation Paper No. 7: Obligation to Offer Terms of Supply, Default Retailer and Price Information Disclosure*, July 2000.

Retailer of last resort

Retailer of last resort arrangements, designed to deal with retail suppliers who go out of business, have not yet been decided.

The ORG has suggested that, once a retail supplier has accepted a new customer, they should not be able to stop supplying the customer (even in cases of debt) unless the customer chooses to switch retail supplier. The intention is to limit the extent that the existing incumbent retail suppliers are left with a rising cost base of customers with poor payment records. Instead, this risk would be shared amongst retail suppliers as much as possible.¹³⁷

Experience for large customers who are already contestable

The experience for customers with demand greater than 160 MWh has been somewhat different than that planned for small customers. Most larger customers had no suite of regulated tariffs to 'protect' them during their transition to contestability.¹³⁸ Customers were expected to have arranged a contract by, or on, day one of contestability. Where this did not occur then the existing retail supplier supplying the address would send a letter to the customer setting out the terms on which they were prepared to offer supply, and it was up to the retail supplier and the customer to reach an agreement.

South Australia

South Australia's regulatory arrangements are set out in the South Australian Electricity Pricing Order (EPO), which was issued by the Treasurer on 19 October 1999. Customers with demand less than 160 MWh are scheduled to become contestable on 1 January 2003. The EPO does not include any provisions for retail tariffs post 1 January 2003, other than a restriction on the price divergence between tariffs for small country customers and their city counterparts. It is understood that while there is an intention to consider regulated tariffs more generally prior to the introduction of contestability, there are no plans in place for small customers as yet.

Regulated tariffs

The EPO defines maximum tariffs for both 'non-contestable' and 'grace period' customers, as outlined below.

Non-contestable tariffs

Regulated tariffs are set out in the EPO for non-contestable customers, ie, those with load less than 160 MWh per annum. The EPO regulates the maximum tariff and the maximum price for each component of the tariff, rolling them forward annually, adjusted by CPI (with an adjustment for GST). There are also provisions for introducing new tariffs. The tariffs apply until 31 December 2002 (when all customers are scheduled to become contestable), after which there are no arrangements in place as yet.

¹³⁷ This reflects informal discussion with the ORG regarding its current understanding, and details may still need to be developed.

¹³⁸ However, customers on tariff H prior to contestability were provided with a default tariff.

Grace period tariffs

The EPO defines maximum tariffs for grace period customers. Grace period customers are defined as customers who are contestable but have not yet made a choice of retailer. This applies to customers with demand greater than 160 MWh. Grace period arrangements expire on 30 June 2001 for all customers.

The EPO specifies both the maximum tariff and the maximum price for each component of the tariff. Grace period tariffs increased in July 2000 by approximately 2.2 per cent more than non-contestable tariffs. The intention is to encourage customers off grace-period tariffs and onto market-based competitive contracts.

Should a customer's contract lapse for any reason, it is likely that the customer would have a right to return to AGL SA's grace period tariff assuming it is still in place, ie, prior to 30 June 2001. It is unclear what arrangements will apply after June 2001.

Ongoing regulation

The Tribunal understands there is an intention to consider regulatory arrangements for small customers in the period following the introduction of contestability, and that this will be addressed closer to the time. There is no further information available at this stage.

Country equalisation scheme

The country equalisation scheme is included in the EPO and applies on an on-going basis, regulated by the South Australian Independent Industry Regulator. The scheme requires all retail suppliers to charge retail tariffs to small contestable customers in rural areas that are no more than 101.7 per cent of the amount charged to equivalent contestable city customers.

Retailer of last resort

The arrangement currently in place for larger customers is that, should any retail supplier go out of business, ETSA Utilities (the distributor) would be obliged to step in as the retailer of last resort. ETSA Utilities would be allowed to charge a price that leaves them 'economically neutral'.

Queensland

At present customers whose electricity consumption exceeds 200 MWh per annum are eligible to be contestable. The Queensland Department of Mines and Energy is currently assessing the costs and benefits of introducing full retail competition in Queensland. On completion of this assessment a report will be made to government following which a decision on whether to proceed with full retail competition will be made.

Retail prices for non-contestable customers

Arrangements for small customers during the initial period of full retail competition have not yet been developed.

Currently the Minister for Mines and Energy decides the prices that retail suppliers may charge non-contestable customers. These prices are called franchise tariffs. The prices are uniform for each customer class throughout the state (covering all non-contestable customers, including those eligible to be contestable but who have not yet chosen a market-based contract). The franchise tariffs were increased by 2.8 per cent on 1 July 2000, the first increase since March 1994 (over that time inflation has been around 15 per cent). Once customers become contestable and leave the franchise tariffs they have no 'right to return'. The government pays a CSO to the host retail suppliers to fund the uniform franchise tariffs.

Experience for large customers who are already eligible to be contestable

Customers become contestable at the time they first commence a market-based contract. Both new customers and existing customers who have not yet become contestable may access the franchise tariffs as non-contestable customers. There is no time limit to this arrangement as yet, although this could be changed in the future. Once a customer has left the franchise tariff, that customer has no right to return.

The franchise tariffs are relatively low, and it is likely that some customers are deterred from entering the competitive market. This particularly applies in some 'high cost' areas such as North Queensland.

New South Wales

Experience of large customers who are already contestable

From the date each customer class became contestable, customers had 12 months to choose a retail supplier. During this time the customer had a right to supply from their existing retail supplier under regulated pricing arrangements. After this period, the electricity price is unregulated.

If a customer fails to negotiate a contract by the end of the 12-month period, their existing retail supplier may continue to supply them under a negotiated customer supply contract. The ability to choose an alternative retail supplier is available to customers at any time.

On-going regulation

While electricity prices for larger customers are unregulated after the first 12 months of contestability, there are still some consumer protection arrangements in place. The *Electricity Supply (General) Amendment Regulation, 1998* incorporates:

- provisions for standard form customer supply contracts to contain a statement of guaranteed customer service standards, including minimum standards of service and minimum disconnection procedures
- compulsory participation for electricity distribution and retail supply licence holders with standard form contracts, in an electricity industry ombudsman scheme
- mandatory provision of social programs via a requirement for licence holders to comply with a direction given by the Minister with responsibility for the administration of the particular social program.

Retailer of last resort

New South Wales is considering retailer of last resort arrangements, in tandem with arrangements for standard retail suppliers. NSW Treasury has indicated that a retailer of last resort will be assigned responsibility for offering supply at a regulated retail tariff in each network area when the customer's own retail supplier is no longer able to supply that customer. Comment has been sought on the processes for nominating default service providers, as well as business rules that should apply in these instances.¹³⁹

¹³⁹ NSW Treasury, Full Retail Competition Group, *Customer Transfer Rules and Systems*, Discussion Paper, August 2000, p 31.

Table A6.1 Approaches to retail pricing during the lead up and introduction to full retail contestability

	<i>Contestability timetable</i>	<i>Retail pricing for franchise customers</i>	<i>Regulated retail tariffs</i>	<i>Expiry of provisions</i>	<i>Role of the Jurisdictional Regulator</i>
Victoria	<ul style="list-style-type: none"> • >160 MWh customers are currently contestable • full retail competition scheduled to commence for 40 MWh to 160 MWh customers from 1 January 2001 • full retail competition to commence for <40 MWh from late 2001 	<ul style="list-style-type: none"> • at present, prices are set by the ORG according to the methodology specified in the Tariff Order 	<ul style="list-style-type: none"> • at present, non-franchise customers who were on Tariff H prior to contestability are eligible for a regulated retail tariff • other non-franchise customers are not eligible for a regulated retail tariff • the government is negotiating with retail suppliers to establish regulated retail tariffs to apply during the period 1 January 2001 to 30 June 2001 • after 1 July 2001, Victorian retail suppliers may be required to submit “standing offers” (a set of standard safety net contracts) of supply to the ORG for approval • in addition, the government has retained the power to set prices if necessary 	<ul style="list-style-type: none"> • the current Tariff Order expires on 1 January 2001 • the consumer safeguards that are being developed for full retail competition are intended to be ongoing 	<ul style="list-style-type: none"> • at present, the ORG is responsible for administering the Tariff Order: <ul style="list-style-type: none"> ○ making annual adjustments in accordance with specified methodology ○ approving changes to tariff structures ○ monitoring compliance • after full retail competition, the ORG may be required to approve retail suppliers “standing offers” of supply • if this role is conferred on the ORG, it is likely to be undertaken as a licence condition

Table A6.1 Approaches to retail pricing during the lead up and introduction to full retail contestability (cont)

	<i>Contestability timetable</i>	<i>Retail pricing for franchise customers</i>	<i>Regulated retail tariffs</i>	<i>Expiry of provisions</i>	<i>Role of the Jurisdictional Regulator</i>
South Australia	<ul style="list-style-type: none"> • >160 MWh customers are currently contestable • FRC scheduled for 1 January 2003 	<ul style="list-style-type: none"> • prices are set by the SAIIR according to the methodology specified in the Electricity Pricing Order 	<ul style="list-style-type: none"> • during the grace period, non-franchise customers (>160MWh) will continue to be supplied at a regulated tariff if they do not enter a contract with a competitive retailer • at this stage there is no provision for a grace period to apply after FRC 	<ul style="list-style-type: none"> • the Electricity Pricing Order expires on 1 January 2003 • the grace period for currently contestable customers expires on 30 June 2001 	<ul style="list-style-type: none"> • until full retail competition, the SAIIR is responsible for administering the Electricity Pricing Order for both franchise and grace period customers • the SAIIR has an ongoing role in ensuring that small rural customers are not required to pay excessively high retail prices for electricity

Table A6.1 Approaches to retail pricing during the lead up and introduction to full retail contestability (cont)

	<i>Contestability timetable</i>	<i>Retail pricing for franchise customers</i>	<i>Regulated retail tariffs</i>	<i>Expiry of provisions</i>	<i>Role of the Jurisdictional Regulator</i>
Queensland	<ul style="list-style-type: none"> • >200 MWh customers are currently contestable • Introduction of FRC is subject to a full cost benefit analysis by government 	<ul style="list-style-type: none"> • the Minister for Mines and Energy sets retail prices under the Electricity Supply Act 1994 	<ul style="list-style-type: none"> • non-franchise customers may choose to enter the contestable retail market, or they may remain on a regulated tariff 	<ul style="list-style-type: none"> • these provisions remain in place until such time as the Electricity Supply Act 1994 is amended 	<ul style="list-style-type: none"> • the Department of Mines and Energy assists the Minister in making pricing decisions • at present, the Queensland Competition Authority is not responsible for electricity pricing. However, it assumes responsibility for distribution pricing on 1 July 2001.
	<i>Contestability timetable</i>	<i>Retail pricing for franchise customers</i>	<i>Regulated retail tariffs</i>	<i>Expiry of provisions</i>	<i>Role of the Jurisdictional Regulator</i>
NSW gas market	<ul style="list-style-type: none"> • FRC commenced (in principle) on 1 July 2000 • however, the technical capacity to implement FRC is not expected to be in place until 2001 	<ul style="list-style-type: none"> • prior to 1 July 2000, IPART set a maximum average tariff according to a price control formula 	<ul style="list-style-type: none"> • gas retail suppliers comply with a set of voluntary pricing principles rather than have IPART set maximum prices • IPART developed the voluntary pricing principles, which maintains the former franchise tariffs as regulated retail tariffs until the end of 2001 	<ul style="list-style-type: none"> • IPART will review the arrangements in the second half of 2001 	<ul style="list-style-type: none"> • IPART: <ul style="list-style-type: none"> ○ monitors prices and conducts retail reviews from time to time ○ confers with industry in order to develop voluntary pricing principles ○ under the <i>Gas Supply Act</i>, IPART has the power to issue a gas pricing order if necessary

APPENDIX 7 DEFINITION OF CPI

CPI^{-GST} means the CPI exclusive of the net cumulative impact since 1 July 2000 of:

- (a) the GST; and
- (b) changes to any other Commonwealth, State or Territory taxes or charges, consequent upon the introduction of the GST, as calculated and published by the Australian Bureau of Statistics from time to time. If the Australian Bureau of Statistics does not, or ceases to, calculate and publish it then **CPI^{-GST}** will mean:
 - (i) an index published by Commonwealth Treasury which is its best estimate of the **CPI^{-GST}**; or
 - (ii) if Commonwealth Treasury does not, or ceases to, publish an index then an index published by the Reserve Bank of Australia which is its best estimate of **CPI^{-GST}**; or
 - (iii) if the Reserve Bank of Australia does not, or ceases to, publish an index, then at the Tribunal's discretion, either:
 - (A) an index published by a person appointed by the Tribunal which is that person's best estimate of **CPI^{-GST}**; or
 - (B) an index published by the Tribunal that is its best estimate of **CPI^{-GST}**.

CPI means the consumer price index, All Groups index number for the weighted average of eight capital cities as published by the Australian Bureau of Statistics, or if the Australian Bureau of Statistics does not or ceases to publish the index, then **CPI** will mean an index determined by the Tribunal that is its best estimate of the index;

GST means the Goods and Services Tax as defined in *A New Tax System (Goods and Services Tax) Act, 1999*.

1.2 Application of the formula

CPI_1^{-GST} means the number derived from the application of the following formula:

$$CPI_1^{-GST} = \left(\frac{CPI_{Mar2000} + CPI_{June\ 2000} + CPI_{Sep2000}^{-GST} + CPI_{Dec2000}^{-GST}}{CPI_{Mar1999} + CPI_{Jun\ 1999} + CPI_{Sep\ 1999} + CPI_{Dec1999}} - 1 \right) \times 100\%$$

CPI_2^{-GST} means the number derived from the application of the following formula:

$$CPI_2^{-GST} = \left(\frac{CPI_{Mar2001}^{-GST} + CPI_{Jun2001}^{-GST} + CPI_{Sep2001}^{-GST} + CPI_{Dec2001}^{-GST}}{CPI_{Mar2000} + CPI_{Jun2000} + CPI_{Sep2000}^{-GST} + CPI_{Dec2000}^{-GST}} - 1 \right) \times 100\%$$

CPI_3^{-GST} means the number derived from the application of the following formula:

$$CPI_3^{-GST} = \left(\frac{CPI_{Mar2002}^{-GST} + CPI_{Jun2002}^{-GST} + CPI_{Sep2002}^{-GST} + CPI_{Dec2002}^{-GST}}{CPI_{Mar2001}^{-GST} + CPI_{Jun2001}^{-GST} + CPI_{Sep2001}^{-GST} + CPI_{Dec2001}^{-GST}} - 1 \right) \times 100\%$$

where:

- CPI is as defined and where the corresponding subtext (for example Jun2000) means the CPI for the quarter and of the year indicated (in the example the June quarter for the year 2000)
- CPI^{-GST} is as defined and where the corresponding subtext (for example Jun2001) means the CPI for the quarter and of the year indicated (in the example, the June quarter for the year 2001).

APPENDIX 8 SUBMISSION LIST

Organisation	Name
Advance Energy	C. Murray
AGL	J. Barton
Australian Inland Energy	E. Norris
Energex	P. Mimnaw
EnergyAustralia	P. Broad
Ergon Energy	S. Heymer
Great Southern Energy	P. Hoogland
Integral Energy	F. Nevill
Integral Energy	D. Neville
Macquarie Generation	L. Welfare
NCOSS	M. Perkins
NorthPower	J. Adams
NorthPower	P. Topfer
PIAC	T. Benson
PIAC	T. Benson
Pulse United Energy	R. Pugsley
SEDA	C. Dunstan
The Smith Family	R. Dean

GLOSSARY OF ACRONYMS AND TERMS

ACCC	Australian Competition and Consumer Commission
AFMA	Australian Financial Markets Association
AGL	The Australian Gas Light Company
AGLRE	The Australian Gas Light Company Retail Energy
AIE	Australia Inland Energy
Amending Act	The <i>Electricity Supply Amendment Act, 2000</i>
ASL	Annual security levies
BGT	British Gas Trading Ltd
Business	Includes rural business
Business small retail customer	A small retail customer who is not a residential small retail customer (includes rural business)
CEO	Chief Executive Officer
CGEY	Cap Gemini Ernst & Young
Code	National Electricity Code
Contestable market	A deregulated market where customers can choose their electricity supplier
CPI	Consumer Price Index (see Appendix 7)
Customer churn	Measured as the quantity of customers that change retailer
DLF	Distribution loss factors. The volume weighted average electricity loss incurred in the distribution of electricity between a transmission network connection point and all loads connected to it through a distribution network
EAPA	Energy Accounts Payments Assistance (Scheme). A voucher allocated by charity organisations to aid low-income households in paying their electricity bill
EFTPOS	Electronic Funds Transfer Point of Service
Eligible default customer	<p>(a) customers who are capable of becoming non-franchise customers by virtue of an order in force under s.92 of the Electricity Supply Act 1995 (who consume 160MWh of electricity or less per annum)</p> <p>(b) customers supplied by a retail supplier of last resort (as defined in the NEC), being customers who consume 160MWh of electricity or less per annum, and that are supplied by another retail supplier in the event that their retail supplier of choice defaults supplying that customer</p>
ESA	The <i>Electricity Supply Act, 1995</i> as amended by the Amending Act

Franchise tariff	A tariff for customers that are not eligible to enter the competitive market
FRC	Full Retail Contestability. A deregulated market where customers can choose their retailer, regardless of consumption
GSE	Great Southern Energy
GWh	Gigawatt hour (one GWh=1000 megawatt hours (MWh) or one million kilowatt hours (kWh))
IPART	The Independent Pricing and Regulatory Tribunal of NSW established under the <i>Independent Pricing and Regulatory Tribunal Act, 1992 (NSW)</i>
kWh	Kilowatt hour (the standard unit of energy which represents the consumption of electrical energy at the rate of one kilowatt over the period of one hour)
LRMC	Long Run Marginal Cost. Is equal to SRMC plus the capital costs associated with increasing system capacity
Miscellaneous charges (regulated retail charges)	Fees separate to the charges applying to the supply of electricity, but represent an indication of the costs to supply a service. Eg late payment fee
MLF	Marginal Loss Factors. The difference between the pool price at reference nodes to the local point of connection for each participant
MSATS	Market Settlement and Transfers Solution. A process whereby a market settlement function will handle the spot and forward trading markets, with allowance for inter-regional hedging
MWh	Megawatt hour (one MWh=1000 Kilowatt hours)
National Electricity Code	The National Electricity Code directs how the Tribunal regulates distribution and franchise retail electricity services in New South Wales
NEC	National Electricity Code
NCOSS	NSW Council of Social Services
NECA	National Electricity Code Administrator Limited A.C.N. 073 942 775, the company responsible for administrating the Code
NEM	National electricity market. The national electricity market is the market for the wholesale supply and purchase of electricity in five Australian states and territories - the ACT, NSW, QLD, SA and Victoria - together with a regime of open access to the transmission and distribution networks in those states and territories

NEMMCO	National Electricity Market Management Company Limited, the company, which operates and administers the market in accordance with the Code
Network component (N component)	Payment by retailers to distributors for distribution and transmission of electricity from the generating source to the final customer
Nominal Terms	Without inflation
Over Recovering Tariff	A tariff higher than the Tribunal's target tariff
PIAC	Public Interest Advocacy Centre
PES	Public Electricity Suppliers
Regulated customer (also known as a franchise customer)	A customer who: <ul style="list-style-type: none"> • is ineligible to participate in the competitive electricity market, by virtue of an order in force under s92 of the <i>Electricity Supply Act, 1995</i> • consumers of less than 160 MWh/annum and has not entered the competitive market for whatever reason
Residential	Includes rural residential
Residential small retail customer	A non-business small retail customer (includes rural residential)
Retailer of last resort	The retail supplier that will supply electricity to customers when their retailer is unable to supply electricity for any reason, including ceasing to trade or withdrawal or authorisation under the National Electricity Code
Retail supplier	An entity that buys electricity from the wholesaler and sells directly to customers
Retail tariff	The price paid for electricity and the retail level
SRMC	Short Run Marginal Cost. The short run cost that results from increasing production or output by one unit, where the systems capacity is considered fixed
Standard retail supplier	The current retailer of electricity for a consumer under a franchise condition
Target tariff	A tariff established by the Tribunal based on the cost of supplying electricity to customers
Therm	A unit of heat, as the former statutory unit of gas supplied in the UK equivalent to 100,000 British thermal units of 1.055×10^8 joules
Transitional Tariff	The name given to exiting tariffs that are in the process of moving toward the target tariff
Tribunal	The Independent Pricing and Regulatory Tribunal of New South Wales established under the <i>Independent Pricing and Regulatory Tribunal Amending Act, 1992</i>

TSLRIC	Total Service Long Run Incremental Costs. For a new service, TSLRIC measures the increase in costs causally associated with the supply of the new service at the full volume of its likely demand; for an existing service, TSLRIC measures the decrease in costs associated with discontinuing supply of the service in its entirety
Unders and overs account	A compulsory account for each retailer to record the variation between the target tariff revenue and actual revenue collected. It is cumulative from year to year
Under recovering tariff	A tariff is less than the target tariff established by the Tribunal
WACC	Weighted Average Cost of Capital. A 'forward looking' weighted average cost of debt and equity for a commercial business entity. The network owner's WACC will represent the shadow price or social opportunity cost of capital as measured by the rate of return required by investors in a privately-owned company with a risk profile similar to that of the network company